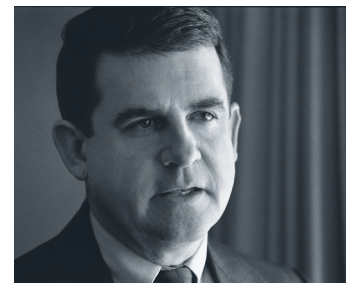


What's Ahead in 2011

An Investment Perspective: Year-End Summary and Market Outlook

- ▶ **A Review of 2010:** It was rocky, but 2010 goes into the history books marking a second consecutive year of double-digit returns for equities. *See page 3.*
- ▶ **Deflation and Inflation:** Over the coming years, we expect deflationary and inflationary forces to become more balanced, but we are not anticipating an increase in the fed funds rate in 2011. *See pages 3 & 4.*
- ▶ **The Outlook for 2011:** Our overall call for the coming year is that it should look somewhat similar to 2010 – but with the risks balanced more to the upside than was the case last year. *See page 5.*
- ▶ **The Scorecard for Our 2010 Predictions:** Most of the predictions we made one year ago came to pass, although we fell short on a couple. *See pages 6 & 7.*
- ▶ **10 Predictions for 2011:** We offer 10 new predictions about the economy and financial markets for the coming year. *See pages 8, 9 & 10.*
- ▶ **Investment Opportunities:** At this juncture, we recommend investors continue to overweight equities, and to focus on opportunities in US markets in particular. *See page 11.*



Bob Doll
Chief Equity Strategist,
Fundamental Equities

Executive Summary

“Muddle through” was one of the phrases we used repeatedly throughout 2010 to describe our expectations for the US economy, along with our forecast that stocks would “grind higher.” This turned out to be a pretty accurate description of events last year. We entered 2010 calling for a year-end S&P 500 Index target of 1,250, right around where the index actually wound up (1,257). For the coming year, we are forecasting a similar environment, but perhaps one that is slightly better – call it “muddle through; grind higher plus.”

Last year, we thought our 1,250 number represented a pretty good guess, but were concerned that we might have been too optimistic. In 2011, we are calling for a year-end S&P 500 landing point of around 1,350, or higher. This would represent roughly the same percentage gain as in 2010. The wrinkle we would add this time, however, is that we think we may be too pessimistic. In other words, in 2010 we thought the risks were primarily to the downside, while in 2011 we believe the risks are primarily to the upside.

We enter the New Year with confidence levels improving, with the outlook for growth accelerating and with deflationary risks shrinking. The corporate sector is in solid shape, and is positioned to deliver another year of strong earnings. Monetary policy will eventually normalize, but for the foreseeable future, it should remain quite easy. The economy will hardly be robust, but growth levels (and the quality of growth) should improve over the coming year. Inflationary threats are all but invisible in most parts of the developed world. In all, the backdrop suggests that risk assets (particularly stocks) should be in for another strong year.

A Look Back at 2010

A Year in Three Acts

A year ago at this time, we made the forecast that cyclical stimulus would beat out structural problems. This turned out to be a good representation of what actually happened, and over the course of the year, risk assets continued the choppy advance they began in 2009. In some sense, there were three parts to 2010. The early months saw risk assets move higher as they continued the 2009 asset recovery story, helped by preliminary signs of employment improvements and very strong fourth quarter 2009 and first quarter 2010 earnings. The middle months of 2010 saw a double-digit percentage correction on the back of the Greek sovereign debt crisis and a stalling in jobs growth, leading to fears of a double-dip recession. Investors were also unnerved by the May “flash crash” and the uncertainty surrounding the financial reform bill. Nevertheless, after touching a late summer low, the market experienced a very strong finish to the year (US stocks advanced more than 20% from their August lows through the end of the year) as double-dip fears receded, jobs growth resumed and the US midterm elections results were perceived to be capital markets friendly. Additionally, Federal Reserve President Ben Bernanke delivered his famous Jackson Hole speech, leading to a second round of quantitative easing measures (QE2) and, perhaps most importantly, the Bush-era tax cuts were extended and supplemented with some fiscal sweeteners.

Regarding the economic backdrop, debt and deflationary risks remained present throughout 2010, causing central banks (especially the US Fed) to respond with unprecedented actions. Real gross domestic product (GDP) growth continued in a positive direction but remained subpar compared to most recoveries on the historic record. In the United States, jobs growth was not strong enough to reduce the unemployment rate. Corporations, however, managed to notch fantastic earnings gains despite mediocre economic growth. Inflation remained a non-issue in the developed world, but began to rear its ugly head in some emerging economies. Government deficit spending and debt levels continued to haunt investors, but corporate financial health remained remarkably strong in both balance sheet and income statement terms.

US stocks ended the year up double-digit percentages, and the S&P 500 closed at close to our 1,250 target, outpacing most developed markets and many important emerging markets. Still, the year saw investor assets flow out of equity funds (especially US equities) and into bond funds as the insatiable thirst for income continued. Overall, equity market movements were choppy in 2010, but ultimately a double-digit percentage gain goes into the history books.

From Deflation to Inflation (Eventually)

One of the main themes that dominated the global economy in 2009 was the competing forces of deflation and inflation, and 2010 saw a continuation of that battle. Over the past few years, deflationary risks have obviously dominated, but there has been evidence of inflationary pressures in some markets (most obviously in China), and we have seen inflation in the form of rising commodities prices. With the high degree of excess capacity in labor and manufacturing, however, it is almost impossible to imagine widespread inflation taking hold any time soon. Recent data shows inflation remains muted, and the Federal Reserve’s launch of QE2 demonstrated that, if anything, the Fed is trying to promote higher levels of asset price inflation.

A year ago at this time, we made the forecast that cyclical stimulus would beat out structural problems.

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US stocks ended the year up double-digit percentages, and the S&P 500 closed at close to our 1,250 target, outpacing most developed markets and many important emerging markets.

With the high degree of excess capacity in labor and manufacturing, it is almost impossible to imagine widespread inflation taking hold any time soon.

A Look Back at 2010 (continued)

Assuming our growth outlook is correct, the Fed is likely to keep rates near zero through the year, although it is possible that by the end of 2011 the futures curve may begin to price a rate increase into the markets.

Outside of the United States, stocks generally performed well, but in a noticeable change from previous years, the United States was one of the best-performing markets around the world.

Over the longer term, the combination of easy monetary policy, further injections of quantitative easing and high deficits has led many to worry about the prospects for inflation. In our view, the worst of the deleveraging situation is now in the past and the impact of deleveraging on future growth will be less than it was over the past two years. Along with the easing of deflationary pressures, the falling dollar, higher commodity prices and the addition of more quantitative easing should prime the pump for inflationary pressures to begin increasing. As such, we believe the shift from a deflationary to an inflationary environment may be on the horizon over the next couple of years.

In this environment, we believe the Fed is unlikely to increase interest rates in 2011. Assuming our growth outlook is correct, the Fed is likely to keep rates near zero through the year, although it is possible that by the end of 2011 the futures curve may begin to price a rate increase into the markets.

2010 By the Numbers

Although the course of the year was uneven and high levels of market volatility remained a constant for stocks, 2010 ended strongly, marking the second consecutive year in which US stocks recorded double-digit percentage gains. For the year as a whole, the Dow Jones Industrial Average gained 14.1% to close at 11,577 and, in the process, moved past the levels last seen before the collapse of Lehman Brothers in late 2008. For its part, the S&P 500 Index advanced 15.1% to 1,257, while the Nasdaq Composite moved up 18.2% to 2,662. Small cap stocks experienced even stronger gains for the year as investors began to move into higher-risk assets. For all of 2010, the small cap Russell 2000 Index climbed 26.9%.

Outside of the United States, stocks generally performed well, but in a noticeable change from previous years, the United States was one of the best-performing markets around the world. Europe was plagued with sovereign debt problems throughout the year, and many emerging European markets posted negative results for 2010. Among developed European markets, however, German stocks rose 16.1% and UK markets advanced 13.0%. Japan, which has long been suffering from anemic economic growth and deflationary problems, lost ground in 2010, with Japanese stocks declining 1.5%. China, which is combating inflation and is in the process of tightening monetary policy, saw market declines of 11.3% for the year. Despite problems in areas of emerging Europe and in China, however, emerging markets as a whole posted respectable returns, with the MSCI Emerging Markets Index advancing 18.9% for the year.

In bond markets, the theme for almost all of 2010 was one of yields trending lower as investors continued to move into the relative safety of fixed income investments. That theme turned around abruptly in the fourth quarter of the year as investors began to seek out higher-risk assets, prompting bond yields to rise sharply as the year drew to a close. For the year as a whole, however, yields were down, with the 10-year Treasury yield dropping from 3.85% to 3.30%. In this environment, the Barclays Capital US Aggregate Bond Index gained a relatively modest (when compared to stocks) 6.5% for the year. In an environment of near-zero interest rates, cash investments, as represented by the 3-month Treasury bill, returned 0.1% for 2010.

Looking Ahead to 2011

A Solid Backdrop for Stocks

As we indicated earlier, our outlook for 2011 is generally optimistic. Over the course of the year, we expect to see continued improvement in US economic growth, especially the quality of that growth. This trend, coupled with improved business and consumer confidence as well as a less hostile capital markets attitude from Washington, DC, should lead to another reasonably good year for risk assets.

Our 1,350+ S&P 500 Index target implies that the stock market should appreciate at least in line with earnings in 2011, with the risks skewed more to the upside than was the case last year. The cyclical recovery should continue, but as in 2010, the pace will be less than that of a typical recovery due to the structural problems that continue to face most of the developed world. In this environment, the Fed will likely remain accommodative, which will probably result in some further steepening of the yield curve. Equities are likely to surpass fixed income as the preferred asset class, both in terms of price appreciation and investor flows. We expect the US stock market to outperform the MSCI World Index again in 2011. The gap between the higher growth rates in the developing world and the lower ones of the developed world will likely shrink somewhat in 2011, causing less differentiation in equity returns.

On the possible what-can-go-right front, we include an acceleration in jobs gains, improving business and consumer confidence, a possible upside surprise in real GDP, corporate earnings exceeding expectations (as seen in 2010) and Washington, DC, beginning to address the debt and budget problems. The what-can-go-wrong list includes the possibility of credit problems resurfacing (e.g., in the US housing market, sovereign nations and among state and local governments), commodity price increases causing profit margin pressure, inflation fears, a higher-than-expected rise in interest rates and excessive policy tightening in emerging markets to curb asset bubbles. Additionally, the magnitude of the market return since the August 2010 lows (US stocks rose more than 20% from mid-August through the end of the year) means equity markets may have come too far, too fast, and there is a chance that markets may have “borrowed” some of 2011’s returns in late 2010.




The upside possibilities could lead to a stock market that appreciates 10% to 20% more than we expect, while the downside prospects could result in low double-digit percentage losses. In summary, while our forecasted gains for equity markets are similar entering 2011 as they were at the start of 2010, it appears to us that the risks have moved from the downside to the upside, meaning we see a higher probability of the S&P 500 Index ending the year above 1,350 than below it.

Equities are likely to surpass fixed income as the preferred asset class, both in terms of price appreciation and investor flows.

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The 2010 Scorecard

Overall Scoring

	Correct	7
	Half Correct	1
	Wrong	2
<hr/>		
Total		7.5/10

Economic data fluctuated strongly throughout 2010 as the global economy continued to emerge from the “Great Recession.” Likewise, financial market volatility remained elevated, but equity markets finished the year with strong gains. Against this backdrop, most of the predictions we made one year ago came to pass, although we fell short on a couple.

1



The US economy grows above 3% in 2010 and outpaces the G-7.

Although final fourth-quarter growth numbers will not be available for a while yet, economists are currently revising their estimates upward, and it looks like GDP will have grown roughly 3% in the fourth quarter. Also, it is looking like US growth for all of 2010 should just clear the 3% hurdle. Among other G-7 countries, with the exception of Canada, no other country’s growth level will surpass that of the United States.

2



Job growth in the United States turns positive early in 2010, but the unemployment rate remains stubbornly high.

It would have been almost impossible to have phrased this prediction any better, since this exactly describes what happened on the labor market front in 2010. Employment growth did turn positive toward the end of the first quarter, but gains were not strong enough to lower the unemployment rate.

3



Earnings rise significantly despite mediocre economic growth.

When we made this prediction at the beginning of the year, our point was that earnings improvements would outpace the broader improvements in the overall economy, and that is exactly what came to pass. In many ways, the degree to which corporate America was able to weather slow economic growth, ongoing credit issues and a still-troubled financial system was quite a surprise.

4



Inflation remains a non-issue in the developed world.

Despite some inflationary concerns in areas of the developing world, deflationary pressures persisted among developed nations throughout 2010. We acknowledge that inflation may become a concern in the years ahead given high deficits and some of the structural problems facing the United States, but such an environment is not likely to develop in the near future.

5



Interest rates rise at all points on the Treasury curve, including Fed Funds.

This is a prediction that we will have to mark in the “incorrect” column for this year. Some might say that we were not exactly wrong on this call, but simply early since interest rates did climb strongly over the last several weeks of the year. Overall, however, credit concerns, quantitative easing and deflationary issues pushed the yield curve lower for the year. On the Fed Funds front, rates are likely to remain low for some time, and we have no expectation that the Fed will raise the target rate at any point in the coming months.

6



US stocks outperform cash and Treasuries, and most developed markets.

The broad asset class call we made at the beginning of the year has come to pass. With US equity market returns well into the double-digits, US stocks handily outperformed Treasuries (which came in at less than 10%) and cash (which returned just over 0%). With few exceptions, US stocks also outperformed other developed markets.

7



Emerging markets outperform as emerging economies grow significantly faster than developed regions.

Economic growth in emerging markets was much stronger than in the developed world in 2010. From an equity markets perspective, emerging markets on balance outperformed developed markets, but it was close and the degree of outperformance was narrower than we expected.

8



Healthcare, information technology and telecommunications outperform financials, utilities and materials.

This is a prediction that came down to the wire. Going into the last week of the year, we were slightly in the “correct” column on this one. Unfortunately (for our predictions scorecard), we were wrong on this call, if only barely, since a basket of healthcare, information technology and telecommunications stocks slightly underperformed a basket of financials, utilities and materials stocks.

9



Strong free cash flow and slow growth lead to an increase in M&A activity.

Strong free cash flow and strong balance sheets allowed companies to put their cash to work by ramping up merger-and-acquisition activity. Dividend increases and share buybacks also increased strongly this year.

10



Republicans make noticeable gains in the House and Senate, but Democrats remain firmly in control of Congress.

We got the first part of this prediction correct, but the second part wrong, since Republicans did, of course, take over the House of Representatives. In retrospect, there was a much larger non-incumbent wave that dominated the midterms than we expected.

Our Predictions for 2011

In an economic environment likely to be characterized by a modest cyclical recovery combined with ongoing structural problems, we expect equity markets to remain volatile, but to see continued gains. With this backdrop, we venture forward with our 10 predictions for 2011.

1

US growth accelerates as US real GDP reaches a new all-time high.

Not only is US growth likely to be stronger in 2011 than it was in 2010, but more importantly, the quality of growth will improve. Economic activity in 2010 was based heavily on government stimulus and inventory rebuilding. Both of these factors will be less significant in 2011 than they were in 2010, meaning final demand is going to pick up the slack. In particular, we believe real final sales will increase from around 2% to almost 4%. This sort of growth is healthier for the economy and more sustainable. Additionally, we believe economic growth in 2011 will be supported by an increase in money growth, a steeper yield curve and easing credit conditions. Nominal GDP in the United States already reached a new all-time high in 2010, and we expect real GDP to also reach a new high at some point during the first half of 2011. Despite this outlook, however, we would caution that growth levels are still likely to remain below trend.

2

The US economy creates 2 million to 3 million jobs in 2011 as unemployment falls to 9%.

We expect improved jobs growth as 2011 progresses, finally making some dent in the unemployment rate. Our prediction represents a clear acceleration over the 1 million+ new jobs created in 2010 and, in effect, would represent a doubling in the rate of jobs growth. It takes approximately 125,000 jobs per month to accommodate new entrants into the labor force, and our view is growth will be noticeably higher than that, averaging 175,000 to 250,000 per month. We believe the removal of the uncertainty around tax policy and the fears of a double-dip recession, together with improved confidence, will lead to more hiring. Leading indicators of hiring, including hours worked, productivity, initial jobless claims and profitability, all point to more jobs. We note with interest that new hiring plans on the part of corporations have improved as well. Historically, equity market returns have been more ebullient when unemployment rates have been high and falling than at any other time.

3

US stocks experience a third year of double-digit percentage returns for the first time in over a decade as corporate earnings reach a new all-time high.

The last time the stock market posted three consecutive years of double-digit percentage gains was in the late 1990s. We believe a double-digit percentage total return is certainly possible for 2011. We expect earnings growth to continue to be better than economic growth, stocks are reasonably inexpensive and confidence levels are improving. We are using a 1,350 target as a floor for our year-end 2011 S&P 500 forecast, which is consistent with expected earnings gains. Our view is that the risks in 2011 are more to the upside when compared with the downside risks of 2010, meaning that, if anything, our 1,350 target may be overly conservative. Should business and consumer confidence levels continue to improve, if credit problems remain manageable and if politicians remain reasonably capital markets friendly, then we could see some valuation improvements, which could push market prices even higher. Regarding the earnings component of this prediction, operating earnings per share achieved an all-time high of \$91.47 for the S&P 500 in June 2007, and we believe corporate earnings will exceed that number sometime around the middle of 2011. We note that, in recent months, earnings revisions have again turned positive after faltering in mid-2010.

4

*Stocks outperform
bonds and cash.*

While stocks did ultimately outperform bonds and cash in 2010, it wasn't until the fourth quarter that stocks pulled ahead of bonds for the year. We expect stocks' leading edge to continue in 2011. Assuming stocks have any sort of positive return in 2011, they will outperform cash investments, since short-term interest rates (and cash returns) are essentially stuck at just over 0%. The bigger question is bonds; however, we believe interest rates are likely headed higher given accelerating economic and jobs growth, the revival of business capital investment, the likelihood of a slowdown in bond fund inflows and the fading of deflation fears. At present, there is still a wide gap between the S&P 500 earnings yield and the BAA-rated corporate bond yield in favor of stocks, and we expect that gap to close somewhat in 2011 as stocks outperform bonds.

5

*The US stock market
outperforms the MSCI
World Index.*

Before 2010, there was a multi-year pattern in which the MSCI World Index outperformed US stocks. In a surprise to many, that streak ended last year with US stocks beating the MSCI World Index by nearly 400 basis points. We think 2011 will mark the second year of US outperformance. Compared with the rest of the world, the United States is benefiting from more fiscal and monetary stimulus and has a more innovative economy and better earnings growth prospects – all of which should help US stock market performance. We also expect that emerging market economies will perform well, but that the gap between emerging and developed economies is likely to narrow in 2011 (which should also help US stocks on a relative basis). In other markets, we expect Europe will continue to struggle with credit and sovereign funding issues and that Japan's secular growth problems will likely remain.

6

*The US, Germany and
Brazil outperform Japan,
Spain and China.*

2010 was a year in which geographic allocations played an important role in determining investors' overall portfolio returns, and we think 2011 will see a continuation of this trend. We favor markets that have evidence of accelerating economic momentum and low levels of inflationary threats. We also prefer to avoid markets that are facing significant credit risks. As a result, we are predicting that a basket of US, German and Brazilian stocks should outperform a basket of Japanese, Spanish and Chinese stocks. As we indicated in our fifth prediction, there are a host of reasons to favor US stocks, including improving quality and quantity of US economic growth. Germany is exhibiting strength in manufacturing and exports and Brazil is benefitting from a rapidly growing middle class and solid consumer spending levels. On the other side of our equation, Japan is suffering from persistently slow growth and Spain has a troubled banking system and ongoing credit woes. Regarding China, we expect economic growth will remain strong, but that market is in the midst of a tightening cycle designed to combat inflation – an environment that does not bode especially well for equity market performance.

Our Predictions for 2011 *(continued)*

7

Commodities and emerging market currencies outperform the dollar, euro and yen.

As long as global growth is at least reasonably strong (as it was in 2010), commodities prices should appreciate in 2011. We believe oil could top \$100 per barrel at some point during the year due to better macro demand and continued inventory declines. At the same time, since gold is “the only currency without debt,” gold prices are likely to move higher over the course of the year, albeit at a slower pace and more irregularly than they have over the past couple of years. Additionally, industrial commodities such as copper should benefit from continued global growth and urbanization in emerging markets. As indicated earlier, we expect the growth differential between emerging market countries and developed markets will narrow in 2011, but we remain preferential toward emerging market currencies over a basket of the dollar, euro and yen.

8

Strong balance sheets and free cash flow lead to significant increases in dividends, share buybacks, mergers and acquisitions (M&A) and business reinvestment.

Corporations in America are doing very well. Balance sheets are strong and income statements are showing high levels of free cash flow. This backdrop led to high levels of M&A activity and business reinvestment in 2010, and in the year ahead, we are calling for double-digit increases in dividends, buybacks, M&A and business reinvestment. We believe the key to getting this prediction right is for business confidence to improve, signs of which became evident toward the end of 2010. In addition, we would argue that unlocking the \$2 trillion+ of cash on corporate balance sheets is a significant key to better and more sustainable US GDP growth.

9

Investor flows move from bond funds to equity funds.

Should the economic and market backdrop play out as we expect, we should see fixed income flows slow and equity fund flows pick up materially in 2011. This would reverse a multi-year trend in which investors have been embracing bond funds and shunning equity funds. Indeed, this reversal appeared to kick off in the fourth quarter of 2010 when equities began to noticeably outperform fixed income. Flows tend to follow prices, and we would expect that during the course of this year, we will see a noticeable slowdown in bond fund flows and the switch into equity funds. The “era of fear” that we have seen in equities in the past couple of years is in contrast to the “era of greed” we saw in the late 1990s.

10

The 2012 presidential campaign sees a plethora of Republican candidates while President Obama continues to move to the center.

Election seasons seem to grow longer every cycle, and already there appears to be an ample list of potential GOP presidential candidates. While it is impossible to know exactly who will run, our view is that many will declare their intention to run for president during 2011. Meanwhile, after a very difficult election for President Obama in November of last year, his move toward the political center is likely to continue as he attempts to be more business and capital markets friendly. It is clear that elections are decided by independents, and the President will need to increase his support within the independent ranks significantly in order to improve his odds for reelection.

What's an Investor to Do?

The start of a new year is always a good time to review your investment goals and asset allocation with your financial professional, and to make portfolio changes where necessary. With that in mind, we suggest some ideas investors may wish to consider:

- ▶ **Retain equity overweights:** A combination of supportive fiscal and monetary policy, decent economic growth, low inflation, strong corporate earnings and decent valuations should be a recipe for stock price appreciation in 2011. As such, we would recommend retaining overweight positions in equities relative to cash and bonds.
- ▶ **Focus on free cash flow:** One of our primary investment themes for the coming year will be to focus on companies that have high levels of free cash flow, and we are seeing opportunities across capitalizations, investment styles and geographies. At the same time, we think investors need to hold a mix of both high-quality and cyclical stocks in their portfolios.
- ▶ **Think about geography:** As indicated by our overall market outlook and our specific predictions, we expect US stocks to continue to outperform most other global markets. Economic growth should be stronger in the United States than in almost any other developed market, as should corporate earnings growth. At the same time, it is important to maintain a diversified portfolio with some allocation to better-positioned international markets, including emerging markets.
- ▶ **Stay with commodities:** Gains will likely be uneven, and volatility in the commodities markets is likely to remain high, but long-term investments in commodities continue to make sense.
- ▶ **Remember that gains will be harder to come by:** In many ways, the “easy money” in this bull market has already been made. The year ahead will likely see ongoing volatility and heightened dispersion between the winners and the losers. In this sort of environment, selectivity will be critical.

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