

SEARCHING FOR BELIEVABLE LEADERSHIP

It is that time of the four-year political cycle when presidential campaigning kicks into high gear. With a Democratic president as the incumbent, Republican candidates are left to wrangle over who will be selected to compete to become commander in chief. The airwaves (and digital networks) are filled with spirited debates, interviews, pollsters and political commentators all seeking to provide their own unique perspectives. There are a range of important issues to deliberate including our country's economic health, debt levels and budget deficits, tax rates, immigration policy, health care reform, defense spending, foreign policy and entitlement programs (to name just some of the usual subjects for consideration). While each candidate highlights their differences in an attempt to gain support, all express their unanimous agreement they would assuredly do a better job than the current president. The rhetoric sounds familiar.

According to the Gallup Poll, President Barack Obama's average annual approval rating dropped to its lowest level ever in 2011, sinking to 44 percent. To date, President Obama has not shown traditional strong leadership abilities, specifically the ability to organize people to achieve a common goal. "Robin Hood" policies and an overtaxed citizenship have turned off hard-working Americans who generally view government as bloated and wasteful. As a result of highly opposed views, divisiveness in Washington remains elevated, a great frustration to the American public who want to see their elected officials tackle important issues, rather than trying to look good so as to get reelected and gain access to insider tips and favorable retirement benefits.

Despite disappointment by many, President Obama's approval ratings have actually been rising since their mid-fourth quarter trough, along with the moderate improvements recently reported in the domestic economy. With a little less than a year before the next national election, there certainly remains a possibility of his ratings improving materially before votes are cast, especially should the economy continue to gain traction. As is typical of the fourth year of a presidential cycle, the Federal Reserve is determined to stay out of the way, this time around by vowing to keep interest rates low until well past the election. As in previous elections, the public needs to see both improving economic conditions and employment trends for an incumbent president to have a reasonable chance of getting reelected. Current polls indicate voters view President Obama and Mitt Romney equally, but with President Obama having a higher probability of winning over the other leading Republican candidates.

Leadership change is taking place throughout the world, most recently in Europe. The flamboyant Silvio Berlusconi resigned his position as Prime Minister of Italy after growing economic problems related to the European debt crisis and Italy's souring debt. Berlusconi was replaced by Mario Monti to implement reforms and austerity measures. Italian Prime Minister Monti, a former European Union commissioner, has a distinguished background

in economics and finance, including post graduate work at Yale University under Nobel Prize winning economist James Tobin. Interestingly, according to Wikipedia, among other things, Tobin "advocated government intervention to stabilize output and avoid recessions." What a perfect mentor for the oversight duties Monti now finds himself responsible. Around the time of the Berlusconi's resignation, Italy's 10-year debt yield was upwards of 7.5 percent. Italy's debt yield is trending downward, now approaching 6 percent. Whether a result of Monti's stewardship and greater confidence in his abilities relative to Berlusconi or large scale European Central Bank intervention, it is a sign of at least a temporary lessening of stress in the European region.

Uncertainty regarding Europe's ability to solve its debt crises persists and remains an ongoing tail risk for investors. As a result, we still recommend some modest reserves on the sidelines in case of a European meltdown. However, in the fourth quarter, U.S. investors were heartened by signs of an improving domestic economy; belief in the ability to remain relatively protected from Europe's economic challenges and an uptick in general sentiment. A contraction in Europe is currently built into estimates while world economic growth has been marked down accordingly. It is the potential depth of a European recession which could have an impact on U.S. growth. The current view is it will be contained, similar to the 1998 period when emerging markets were facing their own challenges. The United States is showing improvement on a number of fronts. Low interest rates and favorable weather conditions have stimulated housing activity, a much needed component to economic growth and employment. The University Of Michigan Survey Of Consumer Confidence Sentiment reached a low in November 2011 of 55. While a rebound into the 90 range as seen during the middle of the last decade is unlikely in the near term, the current rebound into the mid-70s is a welcome improvement. The same can be said of the unemployment rate dropping from almost 10 percent at the end of 2009, to its latest reading of 8.5 percent. While the headline statistic is somewhat misleading due to potential workers leaving the labor force or working in positions below their capability, the trend is favorable nonetheless.

Market leadership in 2011 overall was dominated by investors seeking safety. Bonds and fixed income funds once again gained the greatest proportion of money flow as a result of the previous mentioned concerns. For the year as a whole, 10-year Treasuries generated outsized returns of 16 percent. High-quality corporate bonds and longer term Treasuries performed even better, up 18 percent and 35 percent respectively. High yield bonds, which have equity-like characteristics, were only up a more modest 2.6 percent as yield spreads widened in this more aggressive bond asset class. For the year, the best performing equity sectors were "defensive" in nature including utilities, consumer staples and health care. These companies tend to have consistent earnings and return capital

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to shareholders via dividend yield. Investors have migrated to high dividend paying stocks as substitutes to low yielding fixed income alternatives. While these asset classes and sectors were leaders in performance, they certainly do not represent the leadership generating the greatest confidence in the pace of future economic growth, but represent a comfortable place to hide in times of uncertainty.

We would expect these sectors to underperform when traditional fixed income yields return to more normalized levels and/or when economic confidence improves. In fact, fourth quarter equity performance reflected this change in leadership and represent an improvement in the economic outlook. Sectors generating the best returns in the latest period included cyclical areas, specifically energy, industrials and materials. The favorable equity market trend has continued into the new year and time will tell if this market-related activity is representative of a temporary rebound from oversold levels or perhaps a more sustainable shift. We suspect this trend is likely to continue, since most investors remain suspicious and risk averse. The market has a way of moving opposite to the broadly accepted consensus view.

In many respects, a political campaign takes on similar characteristics to investment decision making. As a candidate's ratings improve and primaries are won, it causes other voters to take notice and view the candidate as more favorable. This in turn creates greater future support. The same can be said as a candidate, or investment, loses momentum. Just as there are economic environments where certain investments perform well, there are some states where a candidate's platform resonates well with the local population. Trying to determine if an investment, or a candidate, has sustainable leadership can only be determined after facing adversity and over time. Recognizing leadership skills are developed over time, often after early mistakes are made, we can only hope for believable leadership in both Washington and on Wall Street.

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