

As we head into the new year, markets - driven by positive earnings surprises, continued growth of emerging markets as well as QE2 - are finally trading above their pre-Lehman levels. However, in our opinion, the question remains: Do you invest like most investors and pretend the financial crisis was a bad dream? Or do you pay attention to the unresolved problems, invest cautiously and be prepared to take advantage of opportunities as they present themselves?

We continue to believe the current economic downturn is likely to last longer than other retrenchments and that there are some questions that will need to be answered to determine how investors will fare in 2011.

- *Will long term interest rates rise or fall in 2011? If interest rates rise, will they rise high enough to trip up the economy and equities?*
- *Will foreign bondholders force austerity measures on the US?*
- *Will China revalue the Yuan?*
- *How far will the Federal Reserve go in terms of stimulus?*



GMAG Outlook: Interest Rates

When referring to higher interest rates we focus more on the bond market demanding higher yields on US Treasuries as opposed to the prospect for higher interest rates through the Federal Reserve changing its monetary policy. As we see it, long term rates are likely to go higher in 2011, the question is primarily whether the increase in rates will be due to favorable conditions or unfavorable conditions.

Favorable conditions will exist if rates go up because of stronger economic growth. An increase in interest rates for this reason would possibly even be bullish for equities and an improving economy means higher earnings.

Unfavorable conditions will exist if a rise in interest rates is attributed to investors demand for a higher return for holding treasuries. This could result from an increase in inflation expectations (which the Fed has said they want to have happen) or from foreign investors desiring a higher interest rate on a currency that is depreciating.

The tipping point between good and bad rise in rates is likely at the 5% level on the 30 year bond. Above that level, not only would bonds continue to sell off, but equities would as well due to the new higher rates on newer bonds being more attractive than holding equities.

GMAG Outlook: Implications to the U.S. through Actions of its Creditors

Will austerity measures be imposed on the US by its creditors? The pattern we have seen historically and most recently in Europe have been similar. Investors fears about a country's finances results in widespread selling of that country's debt. Politicians initially reject austerity measures, but as bond prices continue to fall they accept them. The country's citizens protest against the austerity measures, sometimes violently. The politicians try to appease both groups, but bondholders' don't care, they just want their money back. Eventually austerity measures are implemented. The results of the mid-term elections have most thinking that there is a lesser chance of major new fiscal stimulus. Should the markets come to think otherwise, it could lead to a sell-off in US Treasury bonds.

GMAG Outlook: The Revaluation of the Chinese Yuan

Here at GMAG, we believe that a revaluation of the Chinese Yuan will occur in 2011. China is in the early stages of a transition from an export-led economy to one driven by consumer demand. The country's growth rate has benefitted from its currency's linkage to the US dollar. As the US dollar has weakened over time, exports from China have resulted in China becoming the 'world's manufacturer'. This has created an increase in wealth in China.

With this new wealth, people in China are looking to become more American in terms of their consumption. They are looking to trade in their bikes for cars, get better housing, eat more and better food, etc. The problem is, pursuing these goals involves an increasing demand for commodities which, because they are priced in US dollars, are more expensive for the Chinese to purchase. This is the horn of the Chinese politician's dilemma: if they raise the value of the Yuan, it might hurt exports and decrease economic growth; if they don't, inflation will erode the purchasing power of the newly wealthy, potentially reducing standards of living.

GMAG Outlook for the Chinese Yuan

While we do not believe the Yuan will freely float in 2011, we do expect the Chinese government to significantly increase the trading range of the Yuan. We expect this to be seen as a negative by global markets and will very likely result in a quick synchronized sell off as investors worry about future economic growth as exports potentially decline.

Eventually, however, the market will realize that a stronger Yuan increases the purchasing power for people in China, allowing them to buy more goods. We expect that any movement in the Yuan exchange rate will be carefully calibrated so that any decline in exports will be largely offset by an increase in domestic consumption spending.

GMAG Outlook: Fed Stimulus

How far will the Fed go in trying to stimulate the economy and inflate asset prices?

From a statutory standpoint, there really is no restriction on what the Fed can do. True, they can't drop interest rates below zero percent, but here are several things they can do:

- During the financial crisis the Fed required banks to keep larger cash balances at the Fed by paying interest on those balances.
- They could eliminate that interest payment or even assess a penalty for keeping excess reserves at the Fed.
- They could lower reserve requirement, or the amount of cash banks are required to hold at the Fed.
- Buy securities outright, like they are currently doing with US Treasuries. The Bank of Japan has started a program that involves buying shares of ETF's to boost asset prices there. There is no reason that our own Fed could not do something like that or even just buy futures contracts.

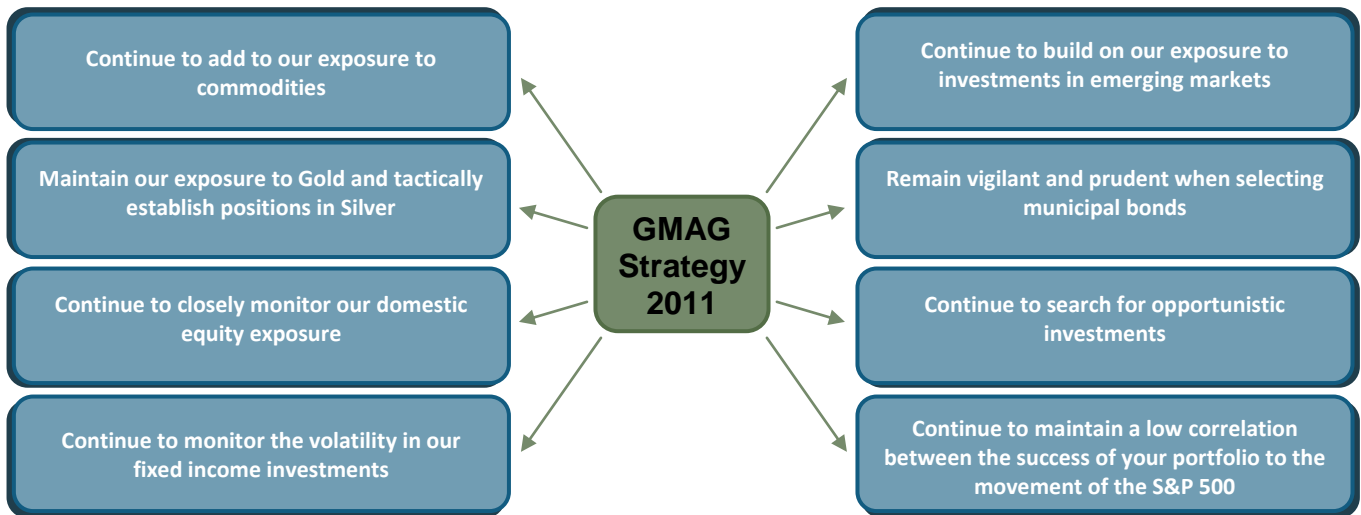
Each of these action items have their own far reaching implications on our economy and the financial markets.

GMAG Outlook: In Summary

It continues to be very difficult to determine the direction this market will head in the short term. Our focus is to continue to determine how this will affect your portfolio and what steps we can take to successfully navigate through the volatility. We evaluate all the necessary facts and research reports, assess all technical and fundamental indicators and factor all this information and more into our recommendations.

We believe the current economic recovery is likely to be different than the post-WWII experience. Our view is that periods of economic expansion will be of shorter magnitude and duration and recessions will be more frequent and severe.

As a result of our forecasts, heading into 2011, our strategy at GMAG is to:



Commodities

Over the last 150 years, there have been two great commodity super cycles. The first was associated with the industrial revolution, which created a powerful, sustained demand for commodities and ran for 33 years from 1885 to 1918. The second super cycle was in the post-WWII rebuilding of Europe and Japan. This cycle ran for 29 years, from 1946 to 1975.

At GMAG, we believe we are in another commodity super cycle, this one being driven by demand from emerging markets. This new super cycle started in 2002 and is being driven by the following classic supply/demand trends:

- Emerging markets are becoming an increasingly important factor in global economic growth, having passed the developed nations in 2009 in their share of world GDP
- Most emerging market countries have a young workforce and a rising per capita GDP
- History shows that as per capita GDP approaches \$5,000 – 10,000 level, demand for commodities begins to rise substantially
- China has already hit that level and several emerging market economies are quickly approaching it.

Where will supply come to meet this demand? That is the key question for commodities going forward. Most of the 'low hanging fruit' has already been picked, meaning that new sources of supply are going to come from places that are harder to reach, cost more to produce, are of lower quality, or some combination of all three.

In addition to the global demand/supply imbalance, commodities should also get a boost from the declining value of global currencies. Commodities are perceived to be a store of value. The three major global currencies currently are the US Dollar, the Euro and the Yen.

At present, both the US and Japan are trying to devalue their currencies in order to make their goods less expensive abroad so that exports increase and provide a boost to their respective economies. It may not be long before the Euro zone starts their own devaluation program in order to protect their export markets. In such a competitive race to the bottom, the US dollar may become "...the prettiest horse in the glue factory...", meaning it may strengthen relative to the euro and yen. In such an instance, commodities may sell off on a short term basis. On a longer term view, the ongoing debasement of world currencies will eventually become inflationary and investors will look to hard assets like commodities as an alternative to depreciating currencies.

The combination of growing global demand, supply constraints and a generally weaker US dollar from current levels should continue to support commodity investments in 2011.

Maintain our exposure to Gold and build a position in Silver



As a companion to the portfolio's allocation to gold, we continue to add an allocation to silver. Investment demand for silver has been on the rise. In Nov, 2010 sales of silver coins at the US Mint totaled 4.16 million ounces. This is the highest monthly amount since the coin was introduced in 1986. Thru November 2010, 32.8 million 1 ounce silver coins have been sold versus 29 million coins in 2009. Record sales have also been reported at Royal Canadian, Austrian and Perth Mints.

In addition, silver has a number of industrial applications as well. It is a very good conductor of electricity and thus may be used in alternative power applications; it has disinfectant properties that make it useful for medical surfaces; and it has strong purification properties that make it useful in water purification systems.

Within these industrial applications, the silver content as a proportion of final price is very small, so a dramatic increase in the price of silver is not likely to have a significant impact on the price of the product in which it is used.

GMAG sees silver as underpriced relative to gold. Whereas gold is over 60% higher than its \$850 nominal high in 1980, silver is still 40% below its 1980 high of 48.70. At their respective highs, the gold-to-silver ratio was 17x versus its current 47x level.

Domestic Equity

Our current allocation to equities is well below our strategic targets. Similar to last year, we head into 2011 looking to increase equity exposure, but to do so in a judicious manner as conditions dictate.

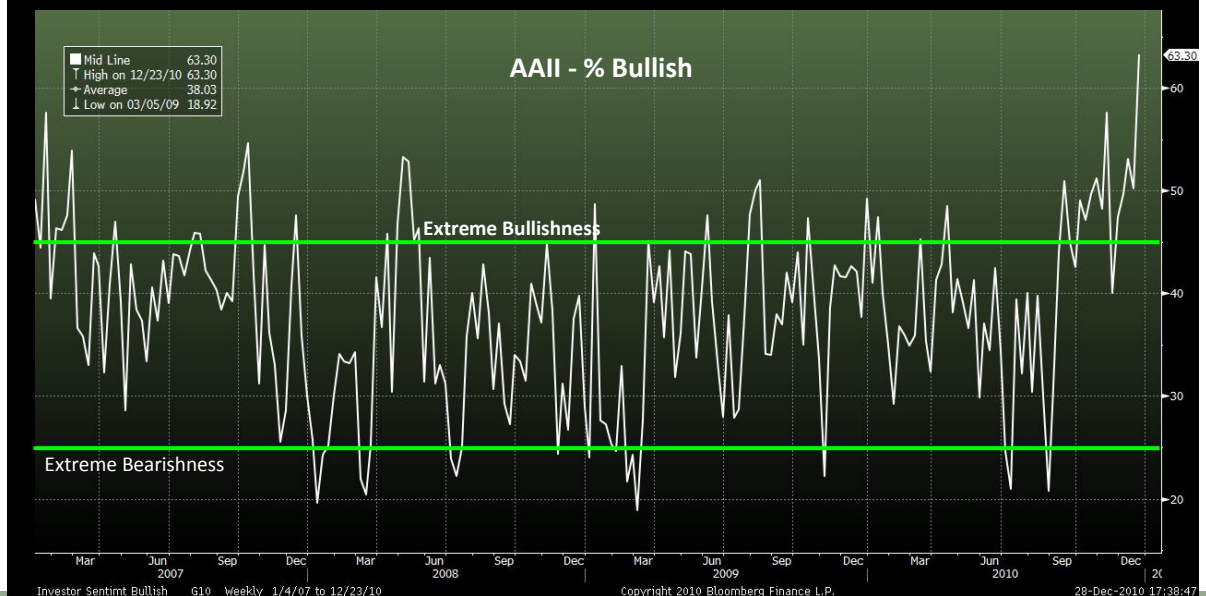
As we enter the new year, there are no shortage of indicators suggesting caution. Despite these indicators, the current trend for the equity markets as we head into 2011 is higher. Accordingly, as has been the case for the last two years, we expect the equity markets to continue to be volatile, with big swings up and down, but to essentially move sideways within a very wide trading range.

Besides the fundamental challenges our economy faces and in addition to the headwinds the long overextended US consumer faces, we have outlined below a few other interesting indicators that are **flashing warning signs**:

- Both the AAIL and Investors Intelligence sentiment surveys are very bullish



As can be seen by these charts, investors are very bullish on the market. Sentiment has not been this high since 2007. Such surveys are generally contrarian indicators, meaning when bullish sentiment is high it's time to sell and when investors are bearish it's time to buy. Right now they are bullish.



GMAG Market Outlook for 2011

➤ **Mutual fund cash positions are low**

The cash level at equity mutual funds is very low at around 3%. The implication of low cash levels at mutual funds and high bullish sentiment is 'Who is left to buy?'

➤ **Insider selling**

Over the last few months corporate insiders have been aggressive sellers of their company's stock. This raises the question, if things are getting better, as the government and most Wall Street analysts are saying, why are insiders selling?

On the positive side, we have

➤ **Increases in earnings estimates for the S&P 500**

For 2011, the as reported earnings estimate for the S&P 500 is \$86.84, up from \$84.90 at the end of the third quarter 2010.

➤ **Improved economic outlook**

Recent economic indicators have been improving to the point where chances of a recession in 2011 are low. Most Wall Street strategists are actually raising GDP forecasts for 2011, anticipating continued improvement in GDP growth.

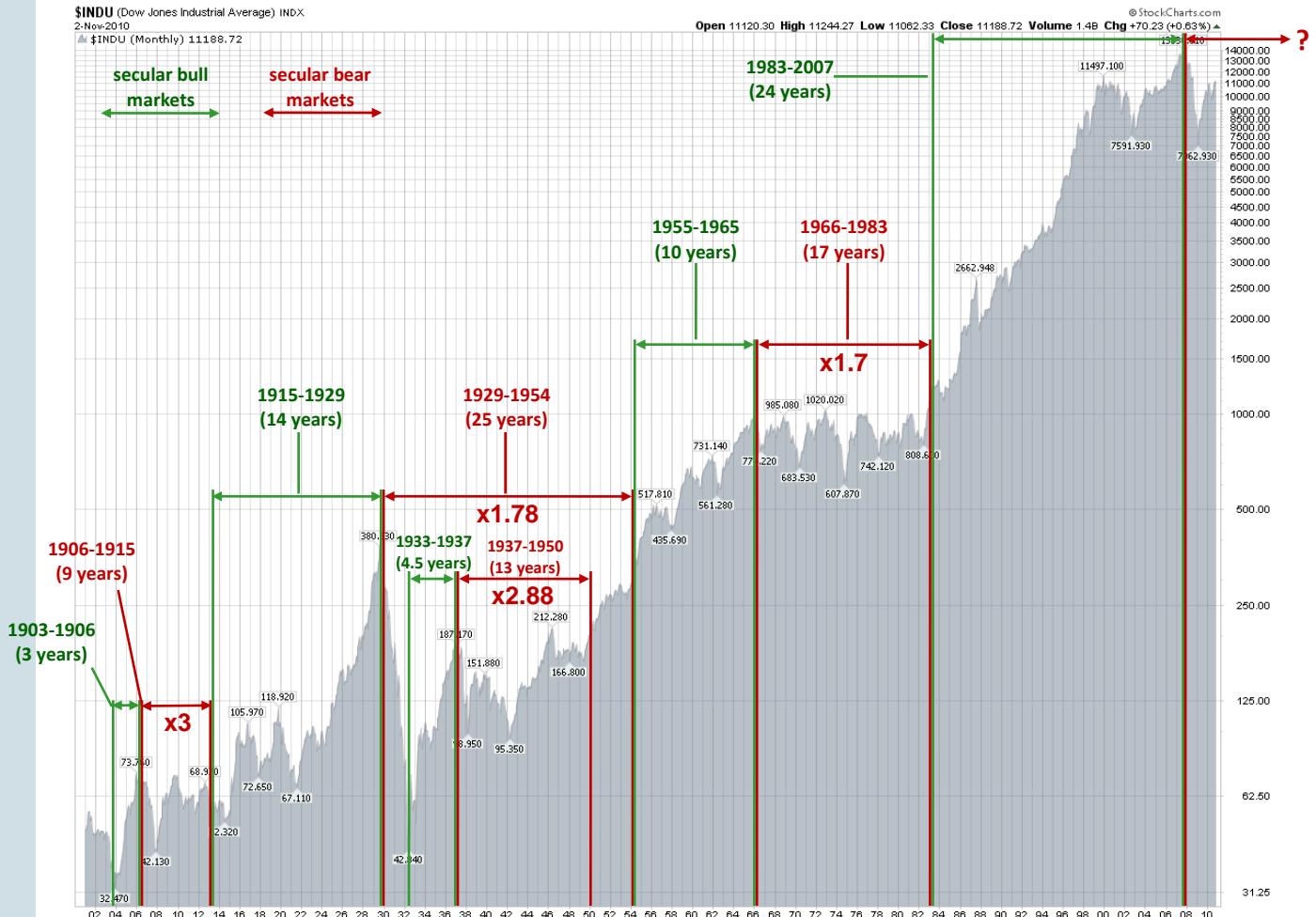
➤ **Price trend in the market is upward sloping**

Just looking at price trends in the market, the price trend for the major indices is higher.



GMAG Outlook – A Sideways Market - How much longer can this last?

At GMAG we feel it could last until at least 2019. Our view is based upon an analysis of the following chart:



The chart shows the Dow Jones Industrial Average (DJIA) from 1900 – 2009. It shows that the Dow Jones goes through periods where the index goes up (secular bull markets) followed by periods where the index essentially moves sideways (secular bear markets). An interesting observation is that whenever there is a period of rising markets, it has been followed by a period of a sideways market that is at least two times in terms of duration (length) of the previous secular bull market. Even if the current secular bear only lasts ONE-HALF as long as the preceding secular bull, it would mean that this secular bear market would last until 2019. While a return to the March 2009 low in the DJIA at 6469 is a possibility, it is not likely.

As of the date of this outlook, For 2011, we expect the Dow to trade between 9700 and 13,500, a high to low swing of nearly 40%! Corresponding levels for the S&P 500 would be 925 and 1280. In such a market, we would look to opportunistically add to equities under 1000 on the S&P 500 and look to start taking profits as the S&P 500 rises back above 1200.

For 2011, as in 2010, we will look to selectively increase equity exposure primarily towards equity investments that:

- ▶ Are in sectors that have a history of paying/increasing dividends, as well as those sectors that can increase their earnings relative to other sectors
- ▶ Pay dividends which tend to be larger, more mature and stable companies. The dividends they pay serve as a hedge against deflation. Typically, such companies are found in the Consumer Staples, Healthcare and Utilities sectors
- ▶ Are in sectors that are increasing their earnings shares relative to their market cap. For example, the Energy sector in 2011 is expected to generate 18% of the earnings for the S&P 500 but is only 12% of the market capitalization of the S&P 500

Fixed Income

With interest rates low and spreads to Treasuries at normal levels, the primary risk in fixed income is that rates increase. As 2010 drew to a close, there was a trend change in terms of asset flows. In October, for the first time since the start of the financial crisis fixed income funds had a net investment outflow. This suggests investors are more willing to take on risk due to the low yields currently being offered. As a result, we may look to reduce exposure to fixed income in 2011.



Global Bonds

Like most fixed income categories in 2010, the sector saw huge inflows as yield hungry investors looked beyond the US for opportunity. While we expect to maintain exposure to this sector, we may look to book profits on positions here if we see signs that investors are starting to withdraw funds from this category.

High Yield Corporates

While the asset class has performed well in 2010, two things give us reason to consider to continue paring back this investment in 2011 even though the economy is expected to continue show improving growth.

- There was a record level of new bond issuance in 2010. Much of this went towards redeeming existing debt that was due to mature over the next couple years, extending maturities.
- Junk bond defaults, according to Moody's, had declined to 3.3% in November 2010 and they expect it to decline further to 1.8% by November 2011.

Demand for high yield corporates have benefitted from the low level of interest rates as investors seek yield. Large scale issuance typically happens near the top of the financing cycle when rates are low. Combined with expectations for even better improvement in credit quality going forward, this sector is likely flashing a yellow sign.

Inflation Bonds

Inflation fears drove prices of inflation-adjusted bonds (TIPs) higher to where at one point the 5-year TIP bond had a NEGATIVE yield to maturity. The market was saying that it preferred to have the inflation adjusted principle in 5 years versus the income. To us, this means that after a long period of overweighting this category, TIPs are overpriced and we will look to allocate less to this bond sector in 2011. Should the real yield on 10-year TIPs reach 1.5% (1% currently) we may look to increase exposure.

Investment Grade Corporates

This sector has also benefitted from the trend of investors seeking yield. Unless interest rates decline from here, there may not be significant upside. As discussed earlier, as the economy improves investors may look to sell fixed income and increase exposure to equities.

The current yield spreads for investment grade corporate bonds remain at a high level relative to their historical average. The current average spread between an investment grade corporate bond and a comparable maturity Treasury bond is 264 basis points. While this is higher than last year's 236 basis points, it is also nearly 75% higher than the 153 basis point historical average.

While the credit spread continues to be attractive, when opportunities present themselves we will look to divest some of the corporate bonds that have had dramatic appreciation from when we purchased them, locking in those gains and re-deploying capital to new investments.

Municipal Bonds

As we discuss in our review of 2010, the issues facing municipal bonds in 2011 are essentially the same issues we faced coming into 2010. It is estimated that fewer than one-half of the municipal retirement systems have the assets to pay even 80% of promised benefits.

There are a lot of reasons to be doubtful about the health of the municipal market right now. Tax revenue is down, public pension and health care liabilities are up, the federal government's bailout money to the states is running out and the changes that those funds will be replenished are remote.

We have already started our process of reallocating municipal bond portfolio and ensuring we are holding only short term high quality general obligation state issued municipal debt.

We continue to recommend being very selective about choosing municipal bonds, favoring larger general obligation issues that have more resources to address budgetary pressures and those that offer greater liquidity.

States perceived to have systemic risk:

California
Florida
Georgia
Illinois
Michigan
New Jersey
New York
Ohio

The states with the least amount of systemic risk:

North Carolina
Texas
Virginia
Washington

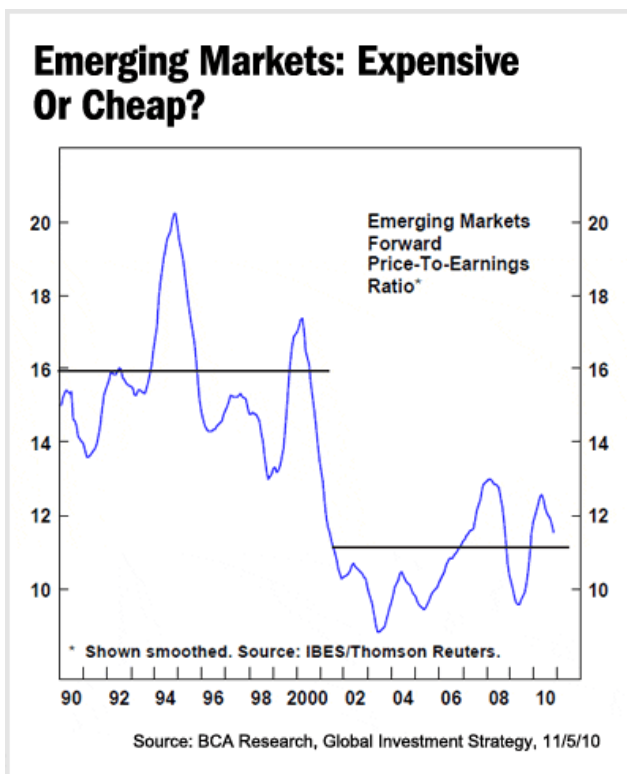
Additionally, we recommend maintaining broad diversification across geographies and sectors. The ongoing surveillance of credits is important, so investors can't simply "set it and forget it."

Absent a new recession, we do not expect to see state defaults however we do expect to see increased state counties, cities and towns making the choice to renege on their bonded debt. .

In summary, we expect municipal bond to continue facing significant pressures through 2011 and beyond. We will remain vigilant and prudent when selecting municipal bonds.

Emerging Markets

After couple of false starts that hurt investors (1997 Asian Contagion; 2007 decoupling) we feel emerging markets may become ready for prime time in 2011. Emerging market economies are expected to grow at an average pace of 6% annually over the next two years. This is almost four times the expected GDP growth rate of the developed markets. This growth is expected to be driven by their relatively young population. One of the primary determinants of potential GDP growth is population growth and the percentage of that population that is of working age. Compared to developed countries, emerging markets have a young working age population that, by US historical standards, is on the cusp of their peak income earning years. The rise of this new middle class is expected to produce strong growth. Already in Latin America there is talk of the 6 C's: casa, carro, celular, comptadora, cable, cinema – a home of one's own, a car, cell phone, computer, cable TV and trips to the movies. The emergence of the emerging market middle class is also expected to drive demand for commodities. As more and more people move from countryside to the city, demand is created for housing units, electricity, roads and other infrastructure improvements.



In addition to following the growth, investors follow the money. Money flows typically follow performance. Finally, valuation is attractive. The chart nearby shows that the forward PE for emerging markets is 11.5x versus prior peaks of 15 – 20x earnings.