



By: *Jeffrey J. Schappe, CFA*  
*Chief Investment Officer*  
*Sterling Capital Management LLC*

How many people would have guessed that for 2011, the top performing major asset class in the world that we follow would be U.S. municipal bonds? The Barclay's Municipal Bond Index returned 10.70% during the period, helped by Meredith Whitney's apocalyptic prediction of billions of dollars of municipal bonds defaulting last year. The municipal bond market tanked after this late 2010 prediction, offering strong-kneed buyers (including Sterling's own portfolio managers) the opportunity of the year. Everything else was either single digits or negative.

The S&P 500 managed to eke out a 2.11% annual return (the Dow a much better 8.38% due largely to strong returns of its top four holdings) accompanied by wild swings along the way. Utilities, consumer staples, and healthcare were the top performers, reflecting the more defensive nature of the market. Financials, materials, and industrials were the worst performers, reflecting global growth concerns, the "Euromess," and a much tougher operating and regulatory environment for financials, especially banks. Bonds generally outperformed equities, and the U.S. outperformed its international indices' counterparts.

The year started with investor perceptions of an accelerating U.S. economy which, when coupled with the earthquake and tsunami in Japan, soon reversed to a growth scare near the beginning of the second quarter as leading and coincident indicators pointed to a slowing economy. In reality, forward indicators we follow already revealed a looming slowdown before the quake. During the summer, concerns mounted that the U.S. was not going to raise its debt ceiling as politicians remained in stalemate. Indeed, a real possibility of a debt default was raised, and the whole debacle, combined with Standard & Poor's unprecedented downgrade of America's AAA credit rating, caused the stock market to swoon, and fears of a recession multiplied as the economy appeared to be at stall speed or worse. The European crisis also worsened considerably as policymakers were unable to forge a workable solution. Thus, Treasuries rallied despite the downgrade as a safe haven and because of recession fears.

Starting early in October of 2011, a spate of better-than-expected economic news and the perception that European policymakers were starting to address the Euro's issues instigated a risk-on market rally in the U.S. Indeed, the S&P 500 rose almost 12% for the fourth quarter, while small and midcap stocks were also up double digits - over 15% for small caps and 12.31% for midcaps as measured by their respective Russell indices. As during the year, international equities and bonds underperformed their American counterparts as Europe's troubles continued to make the U.S. more attractive to investors. Interestingly, emerging market equities lagged the U.S. for the quarter as well because concerns mounted over China's slowdown.

Our investment and economic outlook is largely unchanged from our third quarter 2011 Quarterly Perspective and our most recent monthly Market Overview, although China has shifted to a modestly pro-growth posture and European leaders have taken some constructive steps to ease liquidity pressures which is perhaps buying them a limited amount of time. These efforts, however, are not enough to mitigate the risks. In the U.S., housing prospects appear to have bottomed and have even shown some signs of life, but it's still going to be a long slog back.

To summarize, we continue to forecast a synchronized global economic slowdown, with much of Europe in recession with a sovereign and banking crisis as a kicker, a likely recession this year in the U.S. (it could be mild), and a slowdown of unknown magnitude in China. We are not expecting a repeat of the severity of the 2008 recession and credit crisis in the United States, since the banking system in general is in much better shape with higher capital levels and much reduced risk profiles. Nonetheless, our economy, business conditions, and consumer fundamentals should worsen this year as many of the main drivers of the global economy enter recessionary conditions. The Federal Reserve would then most likely initiate quantitative easing (expanding the money supply by buying assets), which is typically bullish for financial assets. However, it's too early for investors to discount that. Although a trite phrase, we expect things to worsen before they get better.

Recent better-than-expected economic data are mostly coincident or lagging indicators and are not inconsistent with an impending recession. While much of the recent data in the United States beat consensus (raising our discomfort level with our prediction - who said investing is easy?), we would note that third quarter 2011 GDP, after an initial 2.5% reading, has been revised down twice to its current 1.8%. Industrial production in the U.S. also contracted in November. In addition, Gross Domestic Income (GDI), which in theory should be the same as GDP, is telling a different story.

GDI reflects all income generated in the U.S., while GDP measures how it's spent. According to a recent Federal Reserve paper and to ECRI (Economic Cycle Research Institute, a private research firm), for at least 20 years, GDI has been a more accurate coincident reflection of economic activity. In other words, GDP numbers have tended to be revised to GDI rather than vice versa. GDI growth has in fact been decelerating on a quarterly basis for well over a year, and for the third quarter registered a barely positive 0.21%. The same author of the Federal Reserve analysis (Jeremy J. Nalewaik, "Forecasting Recessions Using Stall Speeds," April 14, 2011) points out that the economy's stall speed appears to be about 2% (annualized) sequential quarterly economic growth.

We reduced our tactical allocation to equities in our balanced model by another 400 basis points (4 percentage points) for a total 800 basis points decrease the past several months to reflect our outlook. We reinvested these proceeds into 4% cash (in late September) and then on November 30, boosted our fixed income allocation by 400 basis points. We are currently invested at our long-term strategic weighting for equities in our balanced (moderate risk tolerance) asset allocation model and modestly underweight fixed income (400 bps in cash instead).

One of our biggest bets over the past year was our underweight to international stocks and concomitant overweight to U.S. equities - which paid off handsomely as international equities dramatically underperformed the major domestic equity indices. On a long-term basis, we think equities are attractively valued at about 13 times earnings (hence the strategic weighting), but current market consensus in our opinion is more optimistic than we are for the next 6 to 12 months or so. Indeed, corporate margins, generally at historically wide levels, are poised to compress in our opinion due to the global slowdown as well as eventual mean reversion.

Additional changes to our allocation models during the quarter included tactically boosting our weighting to growth versus value stocks from 40%/60% to 50%/50%, respectively. Companies that can manage to generate secular growth despite the challenging economic environment and offer more defensive characteristics should perform at least as well as their value brethren. We especially favor the healthcare and technology sectors for these reasons. We also tactically eliminated our allocation to international bonds, reinvesting the proceeds into domestic fixed income because of the crisis in Europe. If even Germany had trouble rolling some bonds over, we have been reluctant to take the other side of that trade with a portfolio that included riskier securities.

Although we are in a very difficult investing environment (to say the least) and expect the coming year to present additional daunting challenges, it is possible to outperform or at least mitigate short-term losses with the appropriate investment strategy and asset allocation. In fact, extremely volatile markets, corrections, or even bear markets can create the best opportunities for long term investors. To that end, our team is always prepared to take advantage of mispriced assets and to help our clients achieve their investment goals.

Thank you for your confidence in and support of Sterling Capital Management.

*The opinions contained in the preceding commentary reflect those of Sterling Capital Management LLC, and not those of BB&T Corporation or its executives. The stated opinions are for general information only and are not meant to be predictions or an offer of individual or personalized investment advice. They also are not intended as an offer or solicitation with respect to the purchase or sale of any security. This information and these opinions are subject to change without notice. Any type of investing involves risk and there are no guarantees. Sterling Capital Management LLC does not assume liability for any loss which may result from the reliance by any person upon any such information or opinions.*

*Investment advisory services are available through Sterling Capital Management LLC, a separate subsidiary of BB&T Corporation. Sterling Capital Management LLC manages customized investment portfolios, provides asset allocation analysis and offers other investment-related services to affluent individuals and businesses. Securities and other investments held in investment management or investment advisory accounts at Sterling Capital Management LLC are not deposits or other obligations of BB&T Corporation, Branch Banking and Trust Company or any affiliate, are not guaranteed by Branch Banking and Trust Company or any other bank, are not insured by the FDIC or any other government agency, and are subject to investment risk, including possible loss of principal invested.*