

# The Economy and the Markets

The economy tiptoed carefully through 2011, making it through the year without falling back into recession, and finishing on a modestly upbeat note.

A string of positive economic news closed out the year. The economy generated 200,000 new jobs in December, double the approximately 100,000 per month it had been adding recently. It appears there is enough growth in jobs to keep a recession at bay.

Consumers are feeling more confident, auto sales have increased for six consecutive months, and retail sales are rising. Some credit goes to the welcome drop in gas prices, which has helped boost consumer spending while also muffling inflation.

But it's not all good news. European debt issues continue to wash up on our shores, as the varying interests of European countries prevent decisive action to address the sovereign debt crisis. This economic headache will likely continue through next year and beyond.

The Federal Reserve is watching these developments closely, concerned that they could hurt the U.S. economy in a couple of ways. First, Europe's debt problems could potentially affect our financial institutions, and create a banking crisis here. And second, a European recession would lower demand for U.S. products and put a drag on our economy.

The U.S. housing market continues to be a source of economic pain. It's been over three years since the housing bust. Foreclosures and delinquencies remain high, and home prices continue to fall. Mortgage rates have reached historic lows, but tighter loan requirements and a less efficient lending process limit the number of borrowers who are benefitting.

## Yields on 10-year government bonds

	12/31/2010	12/31/2011
Germany	2.96%	1.83%
Italy	4.82%	7.11%
Spain	5.45%	5.09%
United States	3.30%	1.88%

*The sovereign debt crisis kept yields on some European debt issues high. The resulting flight to quality drove U.S. Treasury yields down. (Source: Bloomberg)*

## Equities

Stocks fell in the final quarter, leaving the Standard & Poor's 500 Index flat for the year. The market spent much of the quarter in whipsaw mode, elated or dashed by day-to-day changes in domestic economic statistics or European debt crisis developments. Stocks rose and fell by more than one percent on 95 of 252 trading days in 2011. The past six months in particular have been among the most volatile in the market's history.

Financial stocks especially fared poorly. Stocks of stable businesses with strong balance sheets in solid sectors such as consumer staples held up. Utilities stocks in the S&P 500 were up 14.83 percent in 2011.

## Fixed Income

Investors continued to park money in Treasuries as they nervously eyed Europe and the U.S. economy. Growing demand drove yields on the 10-year Treasury down from 3.5 percent at the year's beginning to 1.9 percent at its end, unprecedented since the Federal Reserve started keeping official records in 1953.

Yields in other fixed income sectors rose in relation to Treasuries. Yield spreads increased sharply on financial institution debt. High quality industrial and corporate bonds with intermediate durations continue to be in high demand and widened less dramatically. U.S. agency mortgage-backed securities have been a safe haven.

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## Real estate

Apartments remain the strongest sector of the commercial real estate market, enjoying double-digit growth and healthy increases in rents. Much of this demand comes from the 25-30 year old demographic, who are foregoing housing purchases.

Fundamentals in other sectors of the market remain reasonably strong. High quality properties in favorable geographic areas continue to perform well, while shopping centers and office space properties wait for job and spending growth to increase demand.

Bank balance sheets have stabilized to the point where banks are now looking for lending opportunities, which they are finding mainly in medium and large size businesses.

## Outlook

The best way to describe our economy is “needy.” To significantly improve, it needs housing to turn around. It needs the European situation to stabilize. It needs job growth to remain above 200,000 per month. Those developments, unfortunately, may not happen soon. We are also entering a presidential election year, making it less likely that Washington will take significant action on economic issues.

Growth in the first quarter is likely to remain slow. Economically, at least, we don’t expect 2012 to get off to a roaring start.

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*The S&P 500 Dividend-Adjusted Index is market-value weighted based on 500 common stocks, which are traded on the NYSE, AMEX and NASDAQ. The weightings make each company’s influence on the performance of this index directly proportional to that company’s market value.*

*You cannot invest directly in an index.*

*Past performance is not indicative of future results.*

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