Market Commentary
Year-end 2011
Prepared December 31, 2011

Dear Clients and Friends,

<u>Conditions are Still Bullish</u>. The market volatility experienced in the second half of 2011 was attributable to two significant economic events: 1) The August 2011 failure of our federal government to agree on a credible plan to reduce the out-of-control budget deficit; and if that wasn't enough, 2) The European debt crisis. Both of those issues deal with the same fundamental problem – governments across the globe do not seem to have read Tiffany's insightful analysis of the guts of the problem - that you can't spend what you don't have. Don't get me started…..

From a stock market perspective, these events have served to interrupt, but not terminate, the bull market that began in March 2009 in consideration of the following factors:

- Major bull market rallies are borne out of depressed economic conditions. The economy has been in stall mode for most of 2011. With interest rates low, consumer balance sheets improved, and recent economic statistics showing improvement over the past couple of months, the economy should accelerate from here and along with it the stock market;

- If the interim market top registered on April 29th, with the S&P 500 at 1,364, was the top to the entire bull market, it would have been a rarity that a major top was made in the face of continuing equity mutual fund redemptions and low retail investor participation. In fact, equity mutual funds have consistently flowed out of the market, and even accelerated, in the fall of 2011 - not typical bear market behavior. This type of black investor sentiment is more likely found prior to stock market advances;

- Predominance of Exchange-Traded-Funds (ETFs) trading at a discount to Net-Asset-Value (NAV). One measurement of prevailing investor sentiment is the premium or discount that ETFs trade at relative to their NAV. The market price of an ETF is determined by actual buyers and sellers, regardless of the market value of the its underlying holdings. Over time, prices oscillate between trading at bearish discounts and bullish premiums to NAV, a reflection of investor sentiment. I have noted that many equity ETFs have stubbornly traded at significant discounts to NAV throughout 2011, even during rally phases. This is a reflection of bearish and fearful investor sentiment, which from a contrarian's standpoint, is bullish. I would expect that prices of equity ETFs will flip from trading at discounts to premiums before the market registers its next major top.

- Valuations are reasonable. The PE ratio of the S&P 500 is approximately 13, below the long-term average of 15+, and good yields on high quality stocks can still be found. So what's not to like?

- There is a tremendous amount of "fearful" capital that is tied up in no-to-low-yielding CDs and money market funds that is beginning to find its way back to the stock market. This sideline capital is a source of future stock market buying power.

Technical Condition of the Market. While the market has rallied during the 4th quarter 2011, market technicals have not kept pace. By this I mean that stock participation as measured by new 52-week highs/lows statistics, net stocks advancing versus stocks declining, and number of stocks trading above their 200-day moving averages have performed poorly. Specifically, the number of 52-week highs during the current bull cycle peaked at 672 on April 26 2010, and haven't come close to reaching that level since. The highest number of new highs registered during the December rally was 138. Also, various AD lines are indicating a narrowing of stock participation as 2011 concludes. The AD line for the narrowly based (30 big-cap stocks) Dow Jones Industrial Average has nominally exceeded the 2011 peak reached in July, while the S&P 500 (less narrowly based index comprised of 500 stocks) AD line has failed to reach the July peak, and the AD line of the broader based New York Stock Exchange Index (7,500 traded securities of all sizes) has failed to reach the July peak by a wider margin than the S&P 500 AD line. Finally, as 2011 closes, the number of stocks trading above their 200-day moving averages sits at 47%. This percentage should normally be expected to be in the range of 70-80% in a broad-based rally, once again representative of waning participation. If the major market averages make new bull market highs during the next few months, I would be greatly encouraged if the market internals discussed above were to show commensurate strength.

On the positive side, in the past four months, the DJIA has trading within the pattern of an "ascending trianglee" whereby corrections have been making higher lows, with resistance at the level of 12,250 (+ or -). Ascending triangle patterns are bullishly resolved more often than not. A decisive breakthrough through resistance would be a bullish event.

Seasonality/ Election Year Patterns. November through April is historically a seasonally strong period for the stock market, while the May through October period is a historically weaker period. The seasonal tendency of strength during the winter months should limit the extent of stock market corrections during the winter of 2012.

There is a belief that Presidential election years are bullish for the stock market. The actual results of Presidential election years prove this belief to be a myth. Since 1920 (23 presidential elections), the market has rallied 66.7% of election years, virtually identical to the long-term pattern of the stock market - 68% for all years.

Bank Failures and Bailouts are Historically Bullish. It is now fashionable to be bearish because of the potential of failure of a large European Financial Institution, or even worse, a European country. If those events happen, won't the dominos begin to fall, and then won't the long awaited day of financial Armageddon finally arrive? Since 1974, those movies have been seen before, and each time the event of failure/bailout has preceded a sharp stock market rally. Here's the record:

October 8, 1974 – Franklin National Bank failure: This failure took place near the end of the ferocious bear market of January 1973 to October 1974. Investor sentiment was especially negative in October 1974. This bank failure occurred concurrent with the culmination of that bear cycle. Stocks rallied by more than 50% by July of the next year.

July 5, 1982 – Penn Square Bank failure: This failure took place within one month of the kickoff of the greatest secular bull market in U.S. history. At the time of the failure, investor sentiment was negative to an extreme, interest rates were in the double digits, and the famous Business Week cover citing the "Death of Equities" had hit newsstands. Stocks rallied by 90% within 12 months of the failure.

August 1982 – Mexico default: The default of Mexico soon spread to 26 other countries in 1982. The default occurred concurrent with the kickoff of the 1982-2000 "super bull-market".

July 23, 1984 – Continental Illinois Bank failure. The market had dropped 12% for the year up to the date of the Continental failure. News of the day centered around the idea of the end of America capitalism as we knew it. The failure occurred within one week of the stock market bottom that jumped by 30% by July of the following year.

July 28, 1988 – First Republic Bank failure: By July 1988 the market had begun to recover from the 1987 crash when the First Republic Bank failed. A small stock market reaction led to a bottom within 30 days and then a subsequent rally of more than 50% by July 1989,

January 7, 1991 – Bank of New England failure: This was the era of the Savings and Loans crisis - the banking problems were far greater than now. Following a 19% stock market decline lasting 5 months, the Bank of England failed. The stock market flinched, and within a week embarked on 30% rally into yearend.

September 8, 2008 – Lehman Brothers failure: This was the mother of all failures, sure to result in the collapse of the banking and economic system. For awhile it looked like it just might happen. Within two months of the failure the market began to heal internally and a final bear market bottom was registered on March 9, 2009. The lag time from the point of failure to stock market bottom was six months.

January 2012 – Greece, Italy, Spain failure? The history of institutional and sovereign failures indicates that such events are eventually resolved bullishly. So, while the "easy" and "fashionable" path is to think and behave in a bearish fashion, the historical odds favor an eventual bullish outcome.

Bull Market Scorecard. Major stock market averages closed 2011 at the following levels: Dow Jones Industrial Average - 12,218 up 5.5% for the year, S&P 500 Index 1258, flat for the year. The bull market high for each of these indices was reached on April 29, 2011, with the DJIA closing at 12,811 and the S&P 500 closing at 1364 on that day. A rise in those indices into a bull market high (more than 5% for the Dow and 9% for the S&P 500) would confirm that the bull market is still intact. The bull market will reach its third anniversary on March 9, 2012, and aged bull market by historical standards.

The Italian Excursion. Our long-time friends, Gabe and Ruth, accompanied Barb and me on a wonderful 10-day trip to Italy this November. We visited Como, Rapallo, Florence, Montespertoli, San Gimingano, Siena and Rome**.** I had never been to Italy and had only heard of the reputation of the Italian worker as being unproductive and generally over-appreciative of break-time. I found that to be a bad rap – every interaction we had with an Italian worker of any kind (waitress, ceramic shop owner, cabby, hotel manager, bed-and-breakfast proprietor, tour-guide, etc.) were, without exception, indicative of individuals who are extremely sharp, well-trained and highly competent in the execution of their duties. American workers take note! The Italians are functioning at a high individual level within the confines of a dysfunctional government structure.

The country is one of the highest taxed countries in the world. With an 18% national sales tax, nosebleed gasoline tax (gas is nearly $9/gallon!) and income taxes nearing 50%, the tax burden is stifling. As a result, there is a flourishing underground economy. This should be the natural expectation when levels of taxation become unreasonable.

The four of us as assisting two Tuscan farmers with the fall olive harvest.

Dining with Italian friends, Ricardo and his family in Rapallo, Italy.

On our way out on New Year's Eve to the Speakeasy!

21ST CENTURY'S website describing the company's practices, policies, strategies, and past commentaries can be accessed at: www.21stcenturyequityadvisors.com.

Wishing you a Merry Christmas and a Happy and Prosperous New Year!

John Hegler
21ST CENTURY EQUITY ADVISORS CORPORATION