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THE FSAG ADVISOR

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Market & Economic Update

As a way of discussing economic and market views for the coming year, we present BlackRock and Goldman Sach's predictions for 2011:

BlackRock

1. U.S. growth accelerates as U.S. real GDP reaches a new all-time high.

2. The U.S. economy creates 2 to 3 million jobs in 2011 as the unemployment rate falls to 9%.

3. U.S. stocks experience a 3rd year of double-digit percentage returns for the first time in more than a decade as earnings reach a new all-time high.

4. Stocks outperform bonds and cash.

5. Commodities and emerging market currencies outperform the U.S. dollar, the euro and the Japanese yen.

6. Strong balance sheets and free cash flow lead to significant increases in dividends, share buybacks, mergers and acquisitions and business reinvestment.

7. Investor capital flows move from bond funds to stock funds.

8. The cyclical recovery should continue, but at a less-than-normal pace due to the structural problems that continue to face most of the developed world.

Goldman Sachs

1. Will we finally see a "real" economic recovery? Yes. For the first time in at least 5 years, our 1-year-ahead GDP growth forecast is well above the published consensus. It is also well above our estimate of the economy's potential growth pace of 2¾%. What has made us so much more optimistic? Most importantly, a sharp improvement in the economic data.

2. Will the housing market recover meaningfully? No. The housing market is the only major sector of the economy where the news over the past few months has failed to improve materially. Indeed, it has gotten a bit worse, and we now expect house prices to fall another 5% during 2011. The reason is the still-large excess supply, as we have only unwound about 1/3 of the pre-bubble increase in the homeowner vacancy rate so far.

3. Will the trade deficit shrink substantially? No. In the next few months, the deficit is likely to narrow a bit further as inventory accumulation slows and the apparent seasonal adjustment distortions in the petroleum import data abate. But over the year as a whole, a meaningful improvement is unlikely.

4. Will the unemployment rate fall? Yes. We expect a decline to 9% by the end of 2011 and a further drop to 8¼% by the end of 2012. The relationship between changes in real GDP and changes in the unemployment rate remains as close as it ever was. Growth in line with our forecast would almost certainly bring down the unemployment rate meaningfully, although the level will remain high for years.

5. Will inflation move back toward 2%? No. In contrast to both the Federal Reserve and the consensus of forecasters, we expect core inflation to stay well below 1%, and indeed see a small further drop to ½%. The main reason is the still-large amount of slack in the economy. For at least 5 decades, core inflation has never risen when the unemployment rate was above 8%.

2010 Returns

DOW	*14.04%*
S&P 500	*14.79%*
NASDAQ	*18.02%*
Russell Small Cap	*26.85%*
Russell Mid Cap	*25.48%*
MSCI EAFE	*7.75%*
Barclay US Agg	*7.00%*
Barclay Muni.	*2.70%*

6. Will the 10-year Treasury note yield end 2011 above the current level of 3.4%? Yes. We expect a moderate increase to 3¾% by the end of 2011 and 4¼% by the end of 2012.

7. Will the state and local budget crisis derail the recovery? No. To be sure, the situation is unlikely to get better quickly. State governments still need to cut spending and raise taxes to offset the loss of federal stimulus funds, and cities are likely to see their property tax base shrink in lagged response to the house price collapse–with property tax rates and other local fees likely to move up in many jurisdictions.

Sources: BlackRock, Goldman Sachs

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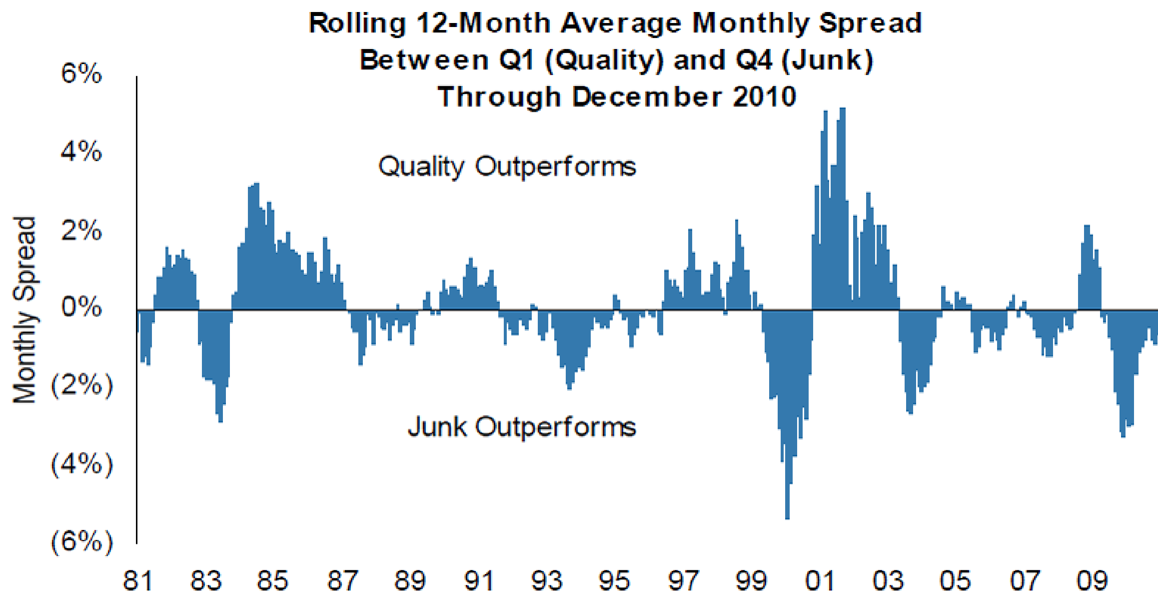
Chart of Interest: Junk Stocks Have Outperformed Since the Early-2009 Lows



Note: Stocks characterized by low-quality, low yield and high risk outperformed those ranked higher in quality, yield and stability.

Source: Factset, Morgan Stanley Research

Ask the Experts: Can I roll my traditional 401(k) plan distribution to a Roth IRA?

In general, yes, but there are some important exceptions. You cannot roll over required minimum distributions (RMDs). You also cannot roll over hardship distributions from your 401(k) plan, or certain periodic payments you receive from the plan. Most other distributions are eligible for rollover.

A rollover of regular 401(k) assets to a Roth IRA is similar to a conversion of a traditional IRA to a Roth IRA (and it's often referred to as a conversion). You'll need to pay taxes on the amount you roll over to the Roth IRA, except to the extent your distribution includes your own after-tax contributions (you receive those back tax free). But a special rule applies to rollovers in 2010 only--you can elect either to pay all of the conversion taxes in 2010, or instead include half of the resulting income from the conversion on your 2011 federal tax return, and the other half on your 2012 tax return.

Your rollover can be either direct (the 401(k) plan transfers the funds directly to your Roth IRA for you) or indirect (the plan distributes the funds to you, and then you roll the funds over to the IRA within 60 days).

A direct rollover is almost always the best way to transfer the funds. If you choose to make an indirect rollover, you run the risk of missing the 60-day deadline. More importantly, the plan will be required to withhold 20% of the taxable portion of your distribution for federal income taxes. If you want to roll over the full amount of your distribution, you'll need to come up with other funds to make up for the 20% that was withheld (you'll get credit for those withheld funds when you file your income tax return).

Qualified distributions from your Roth IRA will be tax free. To be qualified, your distribution must satisfy a five-year holding period and must be made after you reach age 59½, become disabled, or have qualifying first-time homebuyer expenses (up to $10,000 lifetime). The five-year holding period begins on January 1 of the year you first opened *any* Roth IRA (either by a regular contribution, rollover, or conversion).

(Note: special rules apply if you inherit a 401(k) plan account or IRA.)

Tax Update

On December 17, 2010, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 was signed into law. In addition to providing a 13-month extension of benefits for the long-term unemployed, the legislation includes a long-anticipated extension of the "Bush tax cuts" that were scheduled to expire on January 1, 2011. Other significant provisions include a new alternative minimum tax (AMT) "patch," a major modification of the estate tax, and a new 1-year 2% employee Social Security payroll tax reduction.

Income tax rates
The Act extends existing federal income tax rates for 2 additional years. As in 2010, the federal tax bracket rates for 2011 and 2012 will be 10%, 15%, 25%, 28%, 33%, and 35%.

Tax rates for long-term capital gain and qualifying dividends
Existing tax rates for long-term capital gains and qualifying dividends are also extended through 2012. As a result, long-term capital gain and qualifying dividends will continue to be taxed at a maximum rate of 15%. For individuals in the 10% or 15% marginal income tax bracket, a special 0% rate will generally continue to apply.

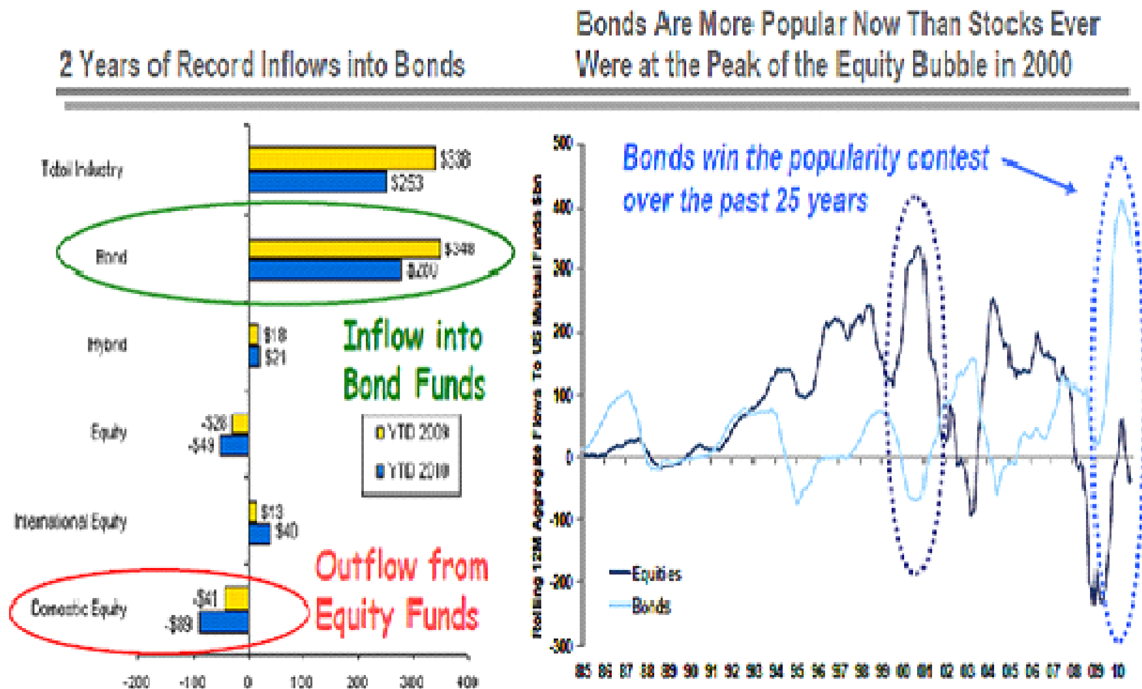
Alternative Minimum Tax
The Act includes another temporary "patch" for the AMT--this one good for 2010 and 2011. AMT exemption amounts are slightly increased ($74,450 exemption for Married Filing Jointly), and personal nonrefundable tax credits will be allowed to offset AMT liability through 2011.

Estate tax
The Act makes several major, though temporary, changes to the federal estate tax, including:
For 2011 and 2012, the estate tax exemption amount will be $5 million per person; the top estate and gift tax rate for these years will be 35%. The $5 million exemption amount and 35% top estate tax rate will apply retroactively to 2010 as well, but for individuals who died in 2010, an election can be made to choose the estate tax provisions effective prior to this legislation (i.e., no estate tax, but modified carry-over basis rules); an extended due date is provided for individuals who died on or after January 1, 2010, but before December 17, 2010.

Beginning in 2011, the gift tax (reunified with the estate tax) will have a $5 million dollar exemption amount; the generation-skipping transfer tax, with a $5 million exemption effective January 1, 2010, will have a 0% tax rate for 2010, and a 35% rate for 2011 and 2012.

For 2011 and 2012, when one spouse dies, any unused portion of that spouse's estate tax exemption amount may be transferred to the surviving spouse.

Chart of Interest: Bonds Are Historically Overbought as an Asset Class



Source: Morgan Stanley - The Investment Company Institute (ICI). ICI's weekly estimates for mutual fund flows cover 95% of the Industry.

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ETF in the News: WisdomTree India Earnings (EPI)

WisdomTree India Earnings (EPI) exchange-traded fund (ETF) is currently one of a handful of U.S.-listed ETFs to provide broad large-cap exposure to India stocks. This fund tracks the WisdomTree India Earnings Index, in which companies are weighed based on their earnings. The fund holds 125 companies and is fairly concentrated, with the top 10 holdings constituting about 43% of the portfolio. The top five holdings are Reliance Industries (11%), Infosys Technologies (8%), Oil & Natural Gas Corp (6%), State Bank of India (3%), and ICICI Bank (3%).

For a U.S. investor there are diversification benefits to investing in India. Prior to the 2008 global financial crisis, which has driven up the correlations across asset classes, there was not a strong correlation between the performance of India stocks and the S&P 500. And relative to other emerging-markets countries such as Brazil (which has a heavy exposure to commodities) and Taiwan (which has a heavy exposure to hardware exporters), India has a more domestic-oriented economy. As such, an investment in an India ETF can serve as a good vehicle to play the anticipated consumer and investment-driven growth in India.

In the earlier part of this decade, India's annual economic growth averaged close to 9% a year, thanks to ongoing economic liberalization, which included the opening up of foreign investment and trade, privatization, improved industry regulations, and capital market reforms. Even during the recent global financial crisis, India was able to continue growing at around 6%, as it benefited from the country's relatively lower exposure to exports, stimulative fiscal and monetary policies, and stable growth in domestic consumption. This strong GDP growth helped support an impressive 13% 10-year annualized return of the Bombay Stock Exchange benchmark, SENSEX. In the near term, the Asian Development Bank and the World Bank forecast India's GDP to return to a high single-digit rate, driven by private consumption and investment. A global recovery and normalizing capital markets will likely result in improved capital flow into India for manufacturing capacity expansions and much needed infrastructure investment.

In the longer term, India's young population and educated middle- and upper-class citizens should help support continued domestic growth.

Source: Morningstar

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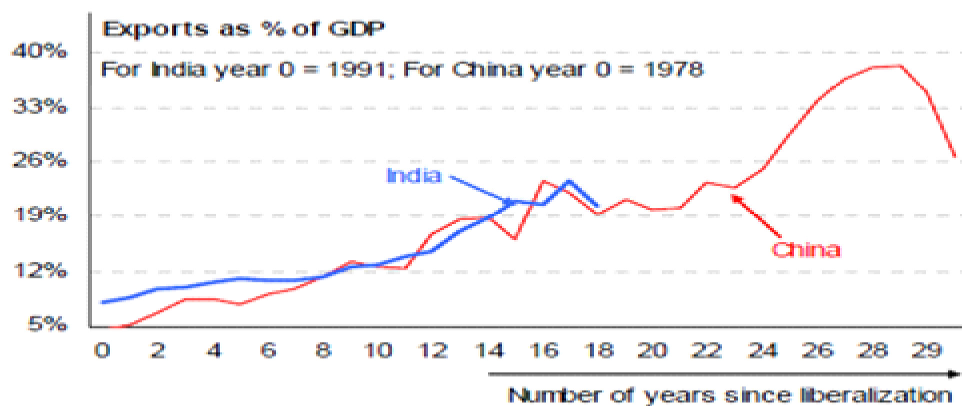
India Another China?



Source: Chetan Ahya and Tanvee Gupta, *India and China: New Tigers of Asia*, 13 August, Morgan Stanley Research

While China's trend growth seems set to slow, Chetan expects India's to accelerate. In fact, as outlined in India and China: New Tigers of Asia, Chetan expects India to grow faster than China over the coming decade. India started economic liberalization almost 20 years after China did. Since then, it has seen a similar increase in export share of GDP. There has likewise been a significant trend increase in infrastructure spending (although as a lower share of GDP compared with China). Chetan argues that three factors point to structurally higher Indian growth: 1) improving demographics (a decline in the dependency ratio); 2) structural reforms, and 3) globalization, reflected in the rising share of exports and direct investment (which now exceeds China's as a share of GDP) and in reduced tariff barriers. Chetan expects Indian growth of 9-10% by 2013-15-higher than China's new trend growth of 8%. China has been an increasingly important influence on commodity markets over the past decade. The prospect of slower, more consumer-focused growth in China implies slower Chinese demand for commodities. India's prospective acceleration, however, provides an important offset.

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