INVESTMENT QUARTERLY

FORECAST VS. REALITY

The new year is always a time for predictions as well as resolutions. Sometimes it is a contest to see which lasts longer. We do not try to forecast as we remember the key to achieving success in this endeavor is to not give your reasons because if your forecast happens to be right it will not be for the reasons you thought. Despite this, however, turning the page of the calendar brings with it an inevitable plethora of forecasts for the new year. The consensus for 2010 seems to be based on a continuation of the unexpected success of the market in the last three quarters of 2009. We are not sure that this enthusiasm is supported by a strong economic foundation as we suspect that a significant driver of the market's rebound to date has been the government's stimulus programs rather than sustainable economic fundamentals.

Lets look at the facts. Deleveraging, the major cause of the market's huge correction between September of 2008 and March of 2009, still continues as of late 2009. While government debt has grown and will continue to do so, corporate and consumer debt has continued to shrink. The Federal Reserve recently reported that outstanding consumer credit declined $17.5 billion (primarily credit card debt) in November of 2009, bringing outstanding consumer debt to the lowest level since July of 2007. This is the result of banks closing credit card accounts and capping home equity lines, declining real estate values that limit the opportunity for increased mortgage borrowing, and a squeeze on the ability to carry debt because of a job loss, pay cut, or concern that any of the above could happen at any time

One of the casualties of the credit crunch was the securitization of consumer debt. Bonds backed by mortgages, auto loans, and credit cards flourished prior to the meltdown, allowing lending institutions to increase their outstanding loans by pooling the loans into bonds which were then sold to yield seeking investors. In this way, the lending institutions were able to offer significantly more credit than they could if they held the loans for their own portfolio. Some studies show that this activity is down 90% from pre-crisis levels. Further to this point, leverage in our financial institutions reached record highs at the peak, with some institutions leveraged to where their equity was only 3%, a 33 to 1 leverage ratio. It didn't take much of a downturn in asset value to wipe out the equity of these institutions. As we emerge from the ashes of the melt down, this level of leverage is no longer. Last, but not least, we all remember the howls of protest when we learned that the money the government pumped into the banks did not make it back out into the market place as loans; rather it served to bolster the capital of the banks and reduce their leverage.

Why is this understanding of credit availability important at this time? A recent study by Peter Boockvaar of Miller Tabak reported that over the last decade nominal personal consumption rose 55%, the same increase that we experienced in overall GDP growth. During this same period, consumer credit rose 61%, showing how dependent our economic growth has been on availability of credit. Our national savings rate was also basically non-existent whereas today we are finding consumers giving greater attention to saving.

We are now looking at reduced credit, lower asset values (with the current exception of the stock market), and a weaker than expected job market as shown in the latest figures. Try as we might, we cannot figure how these factors can lead to a rosy economic outlook, one sufficiently bright to support the theory that there is not going to be a double dip recession and a concurrent market retrenchment.

The reaction of the stock market since the lows of last March, however, would lead one to believe that all is well in the economy and on Wall Street and that our concerns are overdone at best or incorrect at worst. One of, if not the primary, reason for the strong stock market is the huge surge in global liquidity resulting from the actions of central banks around the world to make sure there is sufficient liquidity to keep credit markets afloat. Unprecedented cash infusions and dramatically lower interest rate targets by the world's central banks to lower the threat of a serious deflation arising from this recession has more likely driven this stock market than any fundamental considerations. With interest rates so low, investors have looked to higher risk investments to garner an incrementally greater return. Money market fund yields and short-term treasury yields are non-existent. CDs, outside of the occasional promotional rate, are low, particularly for very short-term investments. Now, investors, who couldn't wait to get out of the market on the way down, are clamoring to get in to equities to grab the yields of depressed stocks, without regard to the quality, and hopefully to pick up some appreciation as the market rebounds. Investors have moved to a higher risk tolerance level very quickly as a result of the low yield alternatives in most non-equity investments.

Markets driven by excess liquidity are like momentum driven markets and geared primarily to traders. There is very little in the way of solid fundamentals to support the price of a stock in momentum markets when enthusiasm slows down or market conditions change. Valuation metrics become moot and as long as stocks continue to rise, new money flows into them. Many analysts now are comparing this recovery to more normal non-crisis recoveries and expressing comfort that the recovery has further room to go in 2010. Our view is that the liquidity factor could help support the market for a while if there are no major geo-political or financial crises. With liquidity abundant as it is, any declines will likely be small as money will rush in to buy on dips, like the early days of the decade when we went years without a correction of more than 5 percent.

At some point, inflation caused by huge government financing requirements, weakness in the dollar, or a decision by the Fed to sop up some of the excess liquidity could cause interest rates to rise and bring this joy ride to a sudden halt. If that happens, the double dip recovery will likely assert itself and markets will enter into a correction. Future conditions will be what they are and truly cannot be forecast with any degree of certainty. Alertness to changing conditions is the one resolution you will need to keep in 2010. It is a time to be realistic, not greedy. When the music stops you want to be near an empty chair. If you miss an empty chair you can help yourself by having your assets diversified so that you are prepared for future headwinds, even if it means giving up some potential return over the short run.

For the full year, the S&P 500 returned 26.5%. the Dow Jones gained 22.6% and the Barclays Intermediate Government declined 0.35%, almost a complete reversal of 2008.

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January 8, 2010 S&P 500: 1115.10