

2009 Economic and Market Summary

Overview

In many ways 2009 was a year of transition. The year began in the midst of a financial panic not seen since the Great Depression. The country transitioned to a new presidency and a new Democrat controlled congress. President Obama and his team immediately ushered in the largest government stimulus plan ever devised in an attempt to avoid a second great depression.

There was a mix of old and new: Ben Bernanke remained Federal Reserve Chairman and Timothy Geithner was appointed Secretary of the Treasury but was not well received and did not boost public confidence. The stock market subsequently fell another 30% before making a bottom in early March most likely in anticipation of the stimulus' impact later in the year.

President Obama shifted focus of our troops overseas beginning the withdrawal of thousands of soldiers from Iraq only to redeploy troops to Afghanistan. As a matter of public policy, the way in which we fight the "War on Terror" continues to divide America. Iran continued to defy the U.N. with its race toward nuclear power and President Ahmadinejad was re-elected in a controversial and highly contested election that stirred a revolt ending in tragedy.

We survived a new and uniquely deadly flu virus named H1N1 (swine flu), but tens of millions were infected and there were over 10,000 deaths in the U.S. alone. We did however have a few inspiring moments despite all of our struggles, one of which was Captain Chesley Sullenberg's heroic landing of a passenger jet in the Hudson River. An American hero was born that day.

The great healthcare debate rose quickly to the top of the national agenda, and while very few would argue that we need serious healthcare reform in this country - with its skyrocketing expenses, inefficiencies, and significant coverage gaps - few of us actually agree on what to fix and how to do it. So the debate will rage on long after any bill may be passed.

Optimism has returned to many Americans but it has been said before, "It's only a recession until you lose your job, only then does it become a depression". Furthermore, the pessimism and mistrust that has resulted from the unwinding of the financial follies we've seen develop over the last three decades will take more than a few months to sort through and reconcile.

As you will read below, I don't think it's too late for America to pull together and revive its economic and political superiority, but I must say I'm not overly optimistic we will. That being said, I'm still a believer that the United States of America is one of the best places to live, and we are still afforded more freedoms and opportunities than most can even imagine. We are fortunate indeed to live in such a place at such a moment in history - despite the turmoil and uncertainty that surrounds us.

The U.S. Economy

Ben Bernanke said he believes the Great Recession is over, and while the numbers could be worse they're still alarming as unemployment remains above 10%, and the U.S. Bureau of Labor reports the rate of underemployment including those who do not qualify for unemployment benefits to be above 17%. Simply put, it will take many years to develop the new technologies needed to create new jobs that will replace those that have been lost forever.

GDP has bounced back but the numbers are largely attributed to the government stimulus affect. The real question is, "Can the economy recover and manage growth without government intervention?". President Obama, Congress, the Treasury Department, and the Federal Reserve are all betting it can, but it appears to me that this strategy is an "all or none" gamble. Others believe the stimulus is only serving as a band-aid on a wound that needs major surgery, and that pumping the world economy with more greenbacks will only exacerbate the problem.

The U.S. debt is approximately 56.4 trillion dollars when including the government's promise to pay Social Security and Medicare benefits. The current annual U.S. deficit is now approaching 2 trillion dollars. As we've noted in past newsletters, China is now our largest creditor and foreign creditors now hold more than half of our debt. If America does not remedy this imbalance soon it really will be the end of the era of economic dominance. History shows very clearly that empires rise and fall based on their military strength and their fiscal responsibility. While we still maintain the world's most powerful military, we have taken huge steps backward financially.

State debts and deficits are also reaching points of critical mass. The ten states with the worst financial problems, as reported by the Pew Center, are California, Arizona, Rhode Island, Michigan, Nevada, Oregon, Florida, New Jersey, Illinois, and Wisconsin. Consequently, not only would I not invest in municipal bonds in these states, but I would not invest in municipal bonds in any state right now - at least not until the crises is over. Federal and corporate deficits effect state governments which effect local and municipal government - it's trickledown economics.

The U.S. Government is hoping to bring consumer spending back in order to end this "great recession". Without further credit expansion this is not going to happen, and despite the infusion of liquidity into the system, money is not flowing as Americans tighten their belts and banks clean up their balance sheets and tighten their lending standards simply in order to survive.

People are however still spending money by using credit they shouldn't have, and I believe it's likely because of one or more of the following reasons: people are in denial and don't believe the day of reckoning is here; people are ignorant of fiscal common sense; people are undisciplined and need a traumatic event in order to change behavior; or people are spending now because they know the end is upon us and they chose to spend while they still can - damn the consequences.

The Bush administration was able to keep the economy rolling even after the dot.com bust by keeping interest rates low, easing credit, and allowing a regulatory environment that not only allowed risky real estate loans but encouraged them. A real estate bubble was created and allowed to grow enabling the economy to continue expanding albeit on fumes. Of course all bubbles eventually burst and this one was no different.

The current stimulus and printing of money is in my mind a last desperate attempt by the government to keep the economic boat afloat, but it will not work. The day of reckoning is upon us. We will survive as a nation, but we will see more difficulty and hardship than our generation has known over the next few years. Bear in mind that this is all part of the economic evolutionary cycle that begins at birth, then grows, then matures, eventually dies, then gives way to re-birth. When this is all over, I suspect the youngest of our generation will pass before we see another financial meltdown of this magnitude; after all, it takes a generation to forget.

Market Summary

Most equity markets offered investors a wild ride last year crashing in the first quarter, rallying strongly in March through May, then gradually rising over the second half of the year. The U.S. market fell approximately 30% from January to its most recent bottom in early March completing (for now anyway) a 60% decline from the October 2007 high. Investor sentiment fell to all-time lows in March when only 2% of options traders were going "long" the market (a reading that had never before been registered) - we had indeed hit bottom.

The market then proceeded to rally 65% from the bottom to finish the year with a 28% gain as measured by the Wilshire 500 Index. The S&P 500 Index was up 26% while mid-cap stocks gained 37% and small caps gained 28%. As expected, growth outpaced value 43% to 17% during the rally. Emerging Markets outperformed the Developed Countries Index 74% to 31%.

Secular bear markets of this caliber have always experienced large "bear market rallies" as shakeouts take years and even decades to complete. So the question remains, "Is this a bear market rally or is this the start of the next expansion?". Common retracement percentages in bear market rallies often occur at or near 38%, 50% and 62% retracements (also known as Fibonacci series), and we've just touched then fallen back from the 62% mark; therefore it appears we may find out the answer to our question in fairly short order.

Volume, market breadth, and relative strength have all been declining since Summer. Furthermore, we're seeing more volume on distribution days (net sales days) than we are on days in which the market advances. These are bearish market indicators indeed.

Conversely investor confidence estimates as measured by individual investors, money managers, and options traders, have already increased to levels not seen since the March 2000 and November 2007 tops. Many feel that this sense of optimism indicates there are simply not enough new buyers to keep this rally going.

The VIX (volatility index) is showing more and more apathy in a modestly rising market which is also a bearish indicator. Complacency is almost always a warning sign in the stock market.

Let's take a look at the fundamentals of this market. Believe it or not, stocks appear to be expensive when looking at traditional valuation methods such as the price to earnings (PE) ratio. Currently the broader market is selling for a little over 20 times earnings when the historic average PE ratio is 16. Other fundamental ratios such as price to book, price to cash flow, etc. look similarly high or worse. If profits fall from here, those PE's will go even higher.

Some analysts believe we are in a major market cycle (one measured in decades not years); and as such, we're experiencing what some have called an "all the same market" environment. This simply means that most equity categories are moving in tandem with each other (i.e. experience high correlation). The three major equity types: stocks, real estate, and commodities; the more common asset classes: U.S. stocks, developed country stocks, emerging markets stocks; and alternative investments: global real estate, energy companies and commodities were all rising together during the mid to late 2000's and all went down hard between 2007-09. This phenomenon does appear in tact with the possible exception of gold and other precious metals.

Lastly let me mention that irrational behavior can exist for long periods of time and months can turn into years before corrections begin and/or complete. That means this rally could last longer. Technical analysis and market history however argue that this rally should be close to an end. While market timing decisions are difficult indeed and some argue impossible, I do not feel it is prudent to adopt or maintain a buy and hold equity strategy at this time.

Looking Ahead

Taxes

Income tax rates will rise beginning this year although only modestly, even for high income earners. I expect this gradual rise will continue and those in lower brackets will ultimately be dragged up to higher brackets as well. Usage taxes are being researched and analyzed as many politicians feel this may be the tax road of "least resistance". Expect to hear more about these proposals as we head into the summer session and beyond.

Capital gains tax rates will rise from 15% to 20% in 2011 unless Congress retroactively raises the rate for 2010, and I expect we'll see the old 28% rate reappear in very short order. The estate tax situation is a real mess. The House passed a bill making the existing \$3.5 million estate tax exemption permanent, but the Senate refused to pass it along the President; therefore, we currently have no estate tax with the old \$1 million exemption coming back next year. I do not expect however that the old rate will return next year, but rather Congress will pass law this year imposing the estate tax with some level of exemption (probably \$3.5 million per person).

US Growth Going Forward

Demographics are an important element when analyzing U.S. economic growth. Clearly the baby-boomer generation is aging and will need more healthcare which will largely be paid for publicly. No doubt, there will also be a gap in both economic productivity and investing that we have already begun to witness. This financial slowdown will continue for another decade or so.

Generation X is not a large group and immigration won't fully plug that hole. Looking down the road however, Generation Y is another huge group of workers, and I expect the U.S. will enter a new era of growth and prosperity in the 2020's or beyond. We're just going to have to wait it out.

Inflation vs. Deflation – a growing debate

There is still disagreement between economists over whether we are still working through deflation or if inflation, and maybe even hyper-inflation, is just around the corner. I believe deflation still has its strangle hold on the country - admittedly there are fewer and fewer of us in this lonely camp. Clearly we have been experiencing deflation for nearly two years watching prices fall in most business sectors, most goods and services, wages, and commodity prices.

While we have seen some "re-flation" I do not expect the impact of deflation is over. Re-flation is much like the tide reversing course and heading back out to sea during a tsunami... people feel the danger is over after only one wave has come onshore, only to be surprised if not devastated by the tide when it rolls back in. The temporary re-flation and recent market rally have made people feel this sense of safety, although I expect more carnage is to come.

A note on inflation: increasing the money supply is only half of the equation in terms of determining rising prices going forward (i.e. inflation). The rate at which money circulates through the system, also called "money velocity", is the other half of the equation. Despite the huge infusion of cash into our system last year, there is currently less money moving "through" the system than before this crises began. This means that inflation should not yet be a concern.

Don't misunderstand me, ultimately we will see inflation and most likely even hyper-inflation with the value of the dollar plummeting to new lows. First however we will continue to experience the very unpleasant affects of deflation until we hit the rock bottom of this financial tsunami - in other words, it's not over yet.

Global Economy

Most developed countries are arguably as bad off as we are here in the U.S. and in some cases much worse (Europe is still in real trouble). Going forward I think most investors expect most of the more significant growth to take place in the emerging countries, but that's where we'll also see bubbles grow and bubbles burst so discretion will be necessary to avoid the nasty sell-offs that are certain to accompany such exciting advances. Buy and hold strategies do not work well in declining economies nor do they work well in emerging markets.

Looking back through history it's very interesting to note that the top two economic powers (by far) 200 years ago were: China and India - Western Europe would be third if you combined several countries (England, France, Germany, etc.). In life we see all types of things go through cycles of growth to demise to growth once again. I believe we are witnessing this economic cycle make its way around right now. It should only be a matter of decades now before the cycle is complete and the East is once again the dominant world power.

Bringing things back to the present however, China has begun to tighten its fiscal and monetary policies in an effort to create more consistency and prevent another bubble from forming - a good strategy but it may be too late.

Everyone knows that China is still an export driven economy and that building a large enough middle class to alleviate this pressure will take years if not decades. Therefore, if the U.S. consumer does not begin buying again, and I don't think it will any time soon (as referenced above) the Chinese economy will continue to struggle. Already with much capacity available, China is in a precarious position right now - too dependent on the U.S. and the west and still holding too many U.S. dollars.

On a more positive note, China is now in the beginning phases of allowing more open investment strategies for both nationals and foreigners alike. In the recent past there was really only one way to trade in Chinese stocks and that was "long". Options trading was limited and short positions were not allowed in many stocks. Of course this created a controlled and arguably artificially inflated market where price was not allowed to move freely based on supply and demand (arguably the same issue with its currency). It is certainly a good sign however to see China moving toward a more fluid capitalistic market system even though I suspect we'll see even more volatility in their markets near term as it adjusts to more natural market forces.

Perspective Revisited

Is "buy and hold" dead? This is a common question being asked of investment advisors today. I believe the answer is "yes", at least while we stumble through this secular bear market. Most buy and hold strategies would not have worked well in the three secular bear markets we've experience since 1900. And remember that these are 10-25 year periods of time where the typical buy and hold investor would have made little to no money over decades while taking unnecessary risks and experiencing the volatility that comes with investing in equities. Not an attractive risk reward trade-off for most.

Traditionally investment strategies have been characterized by three distinct methodologies: asset allocation (i.e. diversification), fundamental analysis, and technical analysis. Most investment advisors and money managers subscribe to only one or maybe two to a lesser degree. I ask a simple question, "Why don't we use all three of these methods in concert with each other?", after all they certainly are not mutually exclusive.

Can't we better manage risk using wisdom found in each? We have begun using all three methodologies to form our strategies and tactics. We also use short-term (weeks to months), intermediate term (months to years), and long-term (years to decades) market history and analysis to help build proper perspective in managing our clients' funds.

A macro, global, long-short, hedged investment strategy appears attractive to me given the issues discussed above. Clearly knowledge of market history (e.g. secular vs. cyclical bull and bear markets) is the perspective one needs in order to implement such strategies. Of course investing for growth is very rarely easy and mistakes are made. Successful investing, whether in stocks, real estate, or commodities, is a matter of probability and risk management. You seek to effectively access your own goals and tolerance for risk, then manage the risk the best you can.

Portfolio Management Analysis

U.S. Fixed Income Investments

Currently we are only recommending short/intermediate term treasuries and money market funds at highly reputable and solvent financial institutions. We believe the greatest risk we are facing now is still "default risk" - not the risk that interest rates will rise. Thus we place a maximum premium on safety with regard to liquid assets.

International Fixed Income Investments

We are not recommending international bonds or bond funds right now given our predisposition toward safety in this period of extremely high risk. We still see a considerable chance for economic instability around the globe, and therefore believe most risk should be avoided.

U.S. Equity Investments

We are actively allocating appropriate funds to certain U.S. sectors, but we are hedging most positions and have risk management applications (such as "stops" and "limits") placed on most of our investments. As noted above, we believe there is significant risk of a second market drop, and we are much more concerned about "return of capital" compared to "return on capital".

We have also taken short positions on U.S. stocks in the past and expect to do so in the future. Most short positions are taken through contra exchange traded (ETF) funds. These funds are complicated investment vehicles, and we would recommend only be used by professionals and highly experienced investors.

International Equity Investments

Like U.S. stocks, we are investing on an active basis and may move out of any region, country, or sector at any time given our bearish outlook for most equity markets worldwide (i.e. the "all the same market" effect). And like the U.S. market we have used short positions and expect we will do so in the future as well.

Alternative Investments (Real Estate & Commodities)

We are not currently investing in real estate as we believe there is much more potential downside risk associated with both the broader residential and commercial real estate sectors. We believe most of the shorting opportunities are over but do not feel most major markets have bottomed. The second major cycle for mortgage adjustments lies just ahead in 2010, so we likely will wait to see what happens in the coming months before acting further.

We are very interested in energy for the long term but are cautious near term as "everyone" seems to acknowledge the upcoming demand for energy resources in the coming decade - thus it appears almost all investors are "bullish" on energy right now and that's often a historic marking

of a top . It is this "over enthusiasm" that concerns us and indicates higher volatility in price action going forward.

Precious metals have soared (most notably gold) due at first to the run up in virtually all equities in the mid to late 2000's and secondly in reaction to the financial crises and subsequent loss of confidence in even the most stable economy in the world: the U.S. We feel gold is most likely seriously overbought in the near term and certainly overhyped. Remember the doc.com craze followed but the real estate bubble and all of those late night commercials? Who now can avoid the gold commercials today? Smells like a top to me, but as we've noted before, there is a "safe-haven" quality to gold, and that may keep prices from falling if we experience another panic.

Final Thoughts

Not to despair. Despite the economic turmoil and uncertainty ahead, I believe it will be possible to make money this year and in the years to come. First and foremost is the need to determine what assets should be considered critical to your goals and objectives. These assets should be set aside in a relatively risk-free investment such as a money market account or short-term U.S. treasuries in a sound bank or financial institution.

For assets with which you feel you can take some risk in an attempt to grow your wealth, we believe the macro, global, long/short hedge strategies are worth considering. Regardless of strategy and tactics, an investor needs to be active and diligent. Make no mistake the market will take away your money if you are not careful. As Warren Buffett puts it, "...the market is the great 're-distributor' of wealth...".

The bottom line for the next several years will be: PROTECT YOUR WEALTH - even to the extent you do not grow your assets in value. We believe more trouble is likely coming, and you don't want to get caught in the next wave when you had the opportunity to ride it out on higher ground. I'm not saying that investors should not take prudent risks or look for growth opportunities right now; I'm simply saying only do so with assets you can afford to lose.

Even in a deflationary cycle, there will be great opportunity for those with wealth and for those who make wise choices. There will however be an increase in the have-nots and you don't want to be in that camp. Despite the newly found enthusiasm of the market, make your defensive plans now, be prepared, and be ready to take action. You will be greatly rewarded.

Thank you for your continued trust and support.

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