

Will 2010 Do It Again? Forecast for the New Year

As the calendar turns it seems a fitting time to take stock and attempt to divine the future or at least the next twelve months. Many forecasts are made. Few are accurate. Fortunately for the forecasters, most investors tend to forget the inaccurate forecasts and focus on the handful that come to pass. Unfortunately for the investors the fortunate few prescient forecasters are then given a level of credibility that often is not justified beyond randomness. By committing a logical fallacy (if the last forecast is right so will be the next one) investors tend to be led off the beaten path if they are lucky and off a cliff if they are not.

Still, all investing is predicated on assumptions. Investing is by definition acting on incomplete information, using past history of similar circumstances as a guide to assessing probabilities while at the same time diversifying so as not to be done in by the occasional perfect storm. The period between late 2008 and early 2009 was the closest thing most of us alive have seen to a perfect storm across almost all asset classes and strategies. The event that comes closest to being similar is the Panic of 1907, which was quelled by the force of the personality of one J.P. Morgan. Realizing that Morgan would not live forever, wise souls created the Federal Reserve System to act in his place. While acting with perhaps less grace and aplomb than Morgan, the Federal Reserve did do its job of extinguishing the panic before it consumed the entire financial system. The political fallout is far from over and more time will have to pass before the situation can be viewed in its entirety. Still the system did work after a fashion, which is good because there was no other system in place if it did not.

Since the March lows we have what is in effect the most despised stock market rally in memory. In early March about \$1 trillion was deposited in public money market funds. At last reading the figure has declined two percent. In spite of getting practically no interest on their funds, investors are content to stay in funds with no principal risk.

That may change when annual returns are reported in January. While the year still has almost three weeks to go, it appears that stocks are up around 20-22 percent for the year and non-investment grade bond indexes are up over 65 percent. These returns are not from the lows of March 6 but January 1, 2009. In other words these returns are a

reversal of the 20-odd percent decline the first two months of the year and then some. In the face of this data preserving principal begins to look a bit pale.

While forecasters are all over the lot for 2010, it would seem that any negative forecast would assume some sort of financial failure coupled with a loss of value of the currency. The events of the past year have shown that the financial system can deal with financial failure, however ungracefully. The collapsing dollar scenario is predicated on some variation of the US becoming a second Weimar Republic, the hapless government of post World War I Germany whose money printing unglued the country and paved the way for the rise of Hitler.

The fact that is often overlooked about the printing of American dollars is how few of them stay in the country. US dollars are the international medium of exchange by everyone from drug lords to oil sheiks. As such, there is a vast amount of American money in circulation outside the US. To the extent it goes out and stays there it has no domestic economic impact. If the funds came back to the US all at once it potentially would be inflationary. The chance of that happening is actually not very high due to the US dollar's role as international currency and its need for international transactions.

Furthermore, there is really no viable replacement for the dollar as world currency. The Chinese Yuan cannot fulfill that role due to restrictions on capital flows in and out of the country by the Chinese government. No rational international investor is going to put his wealth in a currency that cannot be easily converted. The Euro is backed by a number of countries that are often at each other's throats. Serious minds wonder if the Euro will even exist twenty years hence.

So the worst case scenarios do not look too realistic. What is the alternative? It is a case for moderate growth, higher exports, and an ongoing demand for services from a population that is both slowing down its rate of growth and increasing its average age. Unless immigration rules are revised, by 2018 over a quarter of the US work force will be 55 years old and older. How this impacts the country in terms of demand, supply and political priorities will be the factors that will shape investment threats and opportunities. Those investors making decisions based on what did and did not work in the past will not be prepared for the future.

The Economy

The economy is following the classic script for recovery. Factory activity is up, retail sales are firming, businesses are restocking inventories, and employment numbers show signs of bottoming and going back up.

The pace of the economy will be slow if Government spending slows. Right now rising deficit spending by the public sector is offsetting the decline in private debt as consumers pay down loans faster than assuming new ones.

The Federal Government will get a windfall in 2010 as investors convert traditional retirement plans to Roth plans and pay a lump sum of taxes in the process. To the extent this catches on the tax receipts will be far higher than otherwise. This may have the effect of reducing the Federal deficit in a way that few are forecasting.

State and local governments are generally in more precarious shape. A decline in property and sales taxes coupled with ongoing demand for services and retirement benefits for former workers will result in either tax increases or municipal defaults. The latter could roil the municipal bond market as such defaults have been a rare occurrence compared to what can potentially happen.

Interest Rates

Interest rates will go up. However, it does not appear that 2010 will be the year that they will go up significantly.

If the Federal Government gets a windfall from Roth conversion tax payments, it could take pressure off the credit markets to finance the Government deficits. At the same time, trends in consumer spending do not suggest a return to the leveraged ways of pre-2008. The more stringent terms of credit will prevent consumers from leveraging up if they wanted to.

A moderate economic recovery will generate little credit demand from businesses. Indeed corporate America in the aggregate currently holds more cash investments than debt at this time. Such cash will be used to finance expansion before credit is needed.

On the supply side, at some point investors will have to admit that cash will not return them enough to reach their financial goals and they will invest in bonds and stocks in order to get some of the cash returns of three years ago.

Indeed the most pressing investment issue is not the demand for credit but the demand for returns. This is an increasingly pressing issue as the world's population ages and more investors both domestically and internationally seek assets to live on in retirement.

Inflation

The year to come will be another year in which inflation will not be expected to be a material issue. While economic activity will increase, there will still be a fairly abundant labor pool to draw workers from as well as keep wages in check.

Going beyond 2010 the inflation issue becomes more problematic. The demographic forces mentioned previously will meet a shrinking pool of workers who will demand higher wages for their services. While it is not expected to be an issue until 2013-15, it is coming and needs to be addressed in any long-term strategy.

The Stock Market

As mentioned previously, the current stock market rally is perhaps the most despised and discredited in memory. Almost no one wants to admit that they panicked and got out at the bottom. In fact, volume trends would tend to support the idea that prices so far reflect more an absence of selling than buying by the investing public. Only professional investors have been buyers in large numbers.

At some point the public will capitulate and the market will find its way to a higher level. This is not to say the way will be smooth or retreats will be rare. Far from it. One byproduct of fewer investors in the market is greater price volatility, as swings are exaggerated by the lack of liquidity more investors represent.

Still, with cash having such a low yield and Government and investment grade bonds not much better the case can be made for stocks, if only by process of elimination.

Not all stocks will do well. Financial stocks in general still have a lot to account for, while there is arguably still too much lending capacity relative to demand. Health care will produce its own winners and losers, depending less on merit and more on political perception. Still, there will be opportunities for those who have competitive advantages over their peers. The trick is to find them.

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