2009 Year in Review

I don't know about you but I am glad to see 2009 end. Goodbye and good riddance. Unfortunately, as I celebrated New Year's, I was not sure if I was looking all that forward to 2010 either. The sad state of economic affairs in the US, created by 10+ years by excessive debt growth, poor financial regulation, short sighted Federal Reserve interest rate policies, and US consumers living way beyond their means, is likely to continue. The Great Deleverage is underway. Time Heals All Wounds and This Too Shall Pass are some terms that come to mind when I think of the outlook ahead. Many believe the recession has ended and that the economy should rebound with vigor from here. While the recession is likely over (statistically speaking), I am not in that camp that the economic recovery will have the term vigor associated with it. While we may have a prescription (extremely low interest rates, massive liquidity injections by the Fed, and massive stimulus spending by Congress) to alleviate the pain, a cure for the disease that ails the patient remains elusive.

2009 was split into two extreme sections. The first part was the economy and market imploding into the early March lows where the market was down over 20% at its worst level. The second part was from early March until the end of the year when the market went on an extended run to the upside. From the lows, the broad market rallied near 67% and much riskier asset classes returned in excess of 100% from the March lows.

For the year, risky assets were the place to be (if you still had any guts or optimism left by early March) to earn the highest returns for the year. The S&P 500 returned 26.5%, its 10th largest annual return in 40 years. It is interesting to note that even including this strong performance the US stock market actually generated a slightly negative return for the first decade of this century. That's what 2 bear markets in 10 years will do to stock returns. Sector return leaders were the more cyclically biased sectors such as Technology (+62%), Materials (+49%) and Consumer Discretionary (+41%). While all 10 sectors of the market were positive for the year, Financials (+17%), Energy (+14%), Consumer Staples (+15%), Utilities (+12%) and Telecom (+9%) were the laggards. The performance from the March lows was staggering, with some industry groups up over 100%.

In terms of other asset class returns, Emerging Markets were the biggest winners, with the MSCI EM Index returning close to 63%. US Small Cap stocks as measured by the R2000 Index returned 27.2%, not much different than large cap stocks for the year but up much more from the March lows. Growth style indices meaningfully outperformed Value style indices. International equities outperformed the US with the MSCI EAFE Index returning 32.5%, benefiting from the strengthening Euro impact on US dollar returns. On the fixed income side, returns were more extreme by bond standards. The riskier high yield bond segment, as measured by the Barclays HY Index, returned 58% as they typically benefit from similar trends in the riskiest segment of the stock market. Higher quality corporate bonds were also solid performers, as the Barclays Intermediate Term Investment Credit Index returned 19%. The broad US fixed income index, the

Barclays Aggregate Bond Index, returned 5.9%, held back by the performance of US Treasury bonds. My one major prediction for 2009 that turned out to be spot on was for US Treasury returns. I said in early January that the biggest bubble out there was US Treasury prices and that turned out to be accurate as long-Term Treasury bonds were the worst performing asset class in 2009, returning -18%. Cash was only king into early March, and ended up being a pauper the rest of the year as riskier assets soared. The 3 month Treasury bill, a proxy for cash, returned 0.2% for the year as the Fed kept short-term interest rates near 0% for the entire year.

2010 Investment Outlook – Uncharted Waters

Based on the performance of 2009, it is clear the stock market has looked past all the warts and continued to march higher as the year progressed. The massive rebound has given our attitudes a reprieve, as our IRAs and 401(k)s have increased from the depressing lows of last March. But, while the market has rallied more than 65%, over the same time span the economy managed to lose over 3 million jobs and personal income hit new lows. If it's so bad, it is natural to ask how the stock market could manage to generate such strong performance? Certainly, the stock market is the ultimate forward discounting mechanism. Stocks always head higher on anticipation of future improvements. But, there was a large amount of unusual factors that fueled this rally. When the government can change accounting rules in the middle of the game, take a 40% stake in Citigroup, a 100% stake in Fannie Mae and Freddie Mac, bailout both GM and Chrysler, have the Fed orchestrate a controversial bailout of AIG, allow the FHA to dominate the mortgage lending market, encourage consumption through an array of housing (First Time Homebuyer) and auto subsidies (Cash for Clunkers), at the same time the Fed increases its balance sheet by over a trillion dollars and the Federal deficit is allowed to balloon to over $1.4 trillion, then anything is possible.

That being said, here are some of the ugly facts facing the US economy and society at large today:

- An average 25% slide in home prices (in CA, AZ NV, and FL it's a 50% decline from the top); a +40% plunge in commercial real estate values; and a 20% mall vacancy rate nationwide.

- Consumer credit has contracted for 10 straight months and plunged $17.5B in November.

- 15.7 million American households, or a third of those with a mortgage, have negative net equity. 8.5% of all mortgages are now 90+ days past due or in the foreclosure process.

- 7.24 million jobs have been lost in this recession. 17.5%, or 1 in 6 Americans, are either unemployed or underemployed. A mere 3.2% of respondents to the latest Conference Board's Consumer Confidence Survey believe jobs are plentiful (probably those who work in the defense sector).

- 1 in 8 Americans and 1 in 4 children are now on food stamps and there are 239 counties where at least 25% of the population is on the program.

- Small business failures were up 44% year-over-year in the quarter ending September, despite the Fed holding short-term interest rates at virtually 0% for close to a year.

- The States of CA and NY have massive fiscal budget deficits that will likely require a Federal bailout. CA has the 8th largest economy in the world.

These statistics are unprecedented and unlike any of the recessions going back to the Great Depression which means a normal economic recovery is highly unlikely as we are coming off of a low and severely depressed base. The current situation will create a secular change in the mindset of Americans, their priorities, and what really matters in life. There will be a multi-year workout period of reduced consumption and paying down debt. The Baby Boom generation, the greatest demographic trend in our nation's history, is now hitting retirement age and this downturn could not have come at a worse time for them. The current economic difficulties will force a more simplistic life on many Americans. Home equity loans will no longer be a source of spending. Even those employed are changing their mentality. We are now experiencing quasi-socialism as the government dominates the economy and there will be meaningful social and political changes as a result of the current economic hardships many are enduring. While having the government increase spending to pick up for the lack of private spending is a good thing in the short run, we will pay for it in the out years with higher taxes and reduced GDP growth. In short, there is no easy way out of this mess.

For a perspective on how bad it is, one can review the monthly jobs numbers during the current recession compared to the past 3 recessions going back to 1980. What is most striking is the peak of job losses that hit this recession compared to the past three. The 1980-1982 recession was the worst of the 3 prior recessions and at its worst level reached -343K (July-82) jobs lost in a month. In this downturn, we hit -741K jobs lost in Jan-09. Additionally, the monthly payroll numbers have been negative every month going back to Jan-08 (Nov-09 was revised to +4K but is so pitiful as to not count) so we are at 24 consecutive months of negative monthly payrolls compared to 17 consecutive months in the 1980-82 reccession. So, deeper and longer is the mantra of this economic downturn. As proof, the average length of unemployment for those out of work has reached historical highs and Congress has been forced to extend unemployment benefits twice as a result. Many states have depleted their unemployment funds. In order to bring the unemployment rate down under 8% by the end of 2012, the economy will need to generate over +200K of jobs EVERY month for the next 3 years.

The dichotomy that exists between large, global multinational companies and the small and medium business sector has never been wider. Starting last year, large global, multinational companies aggressively cut costs (mostly jobs) to weather this downturn, have benefited from the exposure to emerging market economies which have rebounded

faster, pricing has held up, they are sitting on tons of cash, and they have strong balance sheets with access to capital markets for funding needs. Generally speaking, they are in fine shape in light of what has been the worst economic downturn since the Great Depression. On the other side of the spectrum is the small and medium business sector which is almost predominately exposed to the US economy. In this segment of the economy, growth is anemic, they are not hiring, they are having difficulties getting access to credit, pricing pressures are increasing (too many chasing too few opportunities), and they are hoarding cash in order to survive. Wall Street is focused on the prospects of the global multinationals (and why the Street is positive on the markets) but the real story of the US economy and employment outlook is the very difficult times faced by the small and medium business sector. Companies with under 250 employees make up 50% of private sector employment. The ObamaCare initiative and what it may mean to private employer costs is adding a major headwind to jobs growth in the US.

Some food for thought for those that think the US is about to embark on anything close to a normal economic recovery.

2009 was a frustrating year as the strategies I employed for your portfolio lagged the market return. Into the March lows I was feeling quite good that being defensively positioned was the correct approach as the portfolio was well ahead of its benchmark. At that time, it was all about capital preservation and surviving to stay in the game. From the March lows through year-end, account returns significantly lagged the returns offered by the broad market. While the economic data never justified getting aggressive at all during the year, the risk trade was all the rage and the portfolio did not have enough exposure to riskier asset classes. I certainly stayed much too cautious and I did not heed my own advice that Fighting the Fed can be a losers game. I am happy with the investment returns of the assets that I did hold in the portfolio as high quality stocks and corporate bonds both had very good years. After 2008, none of us will ever complain again about earning double-digit positive returns. The biggest negative was I simply held way too much cash (earning virtually nothing), waiting for pullbacks that never came and never having enough conviction in the rally to chase returns. I (and hopefully you) try to keep in mind that 2008 was a very good year relatively speaking as the portfolio did not absorb as big of blow as the market delivered.

So where do I stand in my thinking on how 2010 plays out? Still cautious, as forecasting anything in this environment remains a supreme challenge because we are in unprecedented times across so many variables that can impact the economy.

I believe there are two key investment risks in 2010. The first is a potential meaningful move higher in long-term US Treasury yields. The US government has been forced to step in as the Big Spender until the private sector can get its balance sheet and act together. The aforementioned ballooning Federal Budget deficit and the amount of debt the US Treasury will be required to sell in order to fund this spending and retire old debt could cause pressure on long term interest rates and could undermine the stock market rally. If the economy does not get any traction, and since we are in an election year, Congress could feel pressure to enact Stimulus Plan II. The U.S. government already has

a record $2.5 trillion of its debt, including bills, bonds and notes, rolling over in 2010, which equates to 35% of the outstanding level of Uncle Sam's marketable obligations. This is a tremendous amount of debt to be refinanced in one single year. Digesting this supply could add volatility to long-term bond yields, which if they head higher to quickly could negatively impact the economy and the stock market.

The second major risk relates to the timing of the Fed's reversal its low interest rate, easy money policy. It is the major policy initiative that has allowed the capital markets to rebound strongly and take the pressure of the banking system. But, this policy is extreme and rare and will eventually have to be reversed. How the market reacts and digests the Fed's decision to increase short-term interest rates will be crucial to how the year plays out. It is possible that unemployment stays too high and inflationary pressures remain low such that the Fed does not raise interest rates at all this year. The "cost" of this easy money policy could be additional pressure on the US dollar, which would negatively impact US financial assets.

Overall, I am of the mindset that, at best, the stock market will generate high single digit returns this year but that the underlying foundation for the economy remains challenged and any unexpected negative news could set back the market swiftly given the magnitude of the rally since last March. The Street (Wall Street investment firms) are generally bullish about the 2010 stock market outlook on the thesis that the Fed will keep short-term interest rates low for most of the year given the depressed consumer and housing market and the need for banks to have a strong profit environment to write-off more bad loans. The Street also has a rosy view that corporate profits will rebound strongly this year from 2009 depressed levels., forecasting 28% year over year growth. As I write, the S&P 500 Index level is trading at around 1145. Using Street consensus expectations of S&P operating profits of $77 for 2010, and apply a forward multiple of 16X to this figure would equal an S&P 500 target of 1230 or about 7% higher (the market is up 3% so far in 2010 through 1/8/10). That to me would be a best-case scenario and the main reason for my view that high single digit upside is a best-case outcome in 2010. If I am wrong and the economy shows much better growth in 2010 (real GDP of >3.5%), hiring is better than expect, and corporate profits for the year are above $80 on the S&P, then the market would trade higher and probably deliver a mid-teens percentage return. The market could see 10-15% downside risk if the economy, despite massive stimulus and easy money, only puts up subpar growth (<3% GDP), corporate profit growth is not a robust as expected (<$73), employment growth remains under duress, (unemployment >10%) or unexpected events occur (?????). If the economy experiences a double dip recession, the market will correct severely because no one is forecasting such an event.

One thing required to be a successful investor is to understand what the consensus believes and decide if going against it will be profitable strategy. The Street consensus is expecting the easy money, liquidity induced rally to continue and is generally not very concerned. Individual investor surveys register the highest bullish readings (72%) since the market top in 2007. These are signs of complacency, which is a concern in itself and a key reason I maintain a cautious stance. My bias remains on a defensive profile, a preference for high quality/large cap company exposure, and a focus on yield as an

important source of return and downside protection. For now, the bulls remain in charge. All good news is good news and all bad news is good news. So, while it lasts, enjoy your stay in Lake Wobegon, where all the woman are strong, all the men are good looking, and all the children are above average.