OPTIVEST

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# Quarterly Newsletter


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*Fourth Quarter 2009*

*U.S. Economy-* It has been a little over a year since the Wall Street/banking meltdown took what should have been a garden variety recession into a "second great depression" free fall. In retrospect, what happened? In addition to the underlying toxic real estate loan problems, I believe two key factors put the "panic" into this recession: 1) banking problem transparency – high level, public discussions of potential nationalization, closures and fire sale mergers of large financial institutions became a self fulfilling prophecy. If you announce that a big bank could be under-capitalized if depositors withdraw their money, people **will** pull their money out and it **will** become undercapitalized; 2) Top politicians predicting Armageddon - fear of a near term depression caused businesses to quickly prepare for one. Mass layoffs, purging of inventories, and necessity only spending turned the threat into a reality. Likewise, consumers stopped spending, even the 91% with jobs. Consumers and businesses hunkered down, confidence indexes hit all time lows and our GDP had two consecutive negative 6% quarters ($4^{th}$Q '08 and $1^{st}$Q '09) instead of what otherwise might have been -2 or -3%. The stock and bond markets crashed as well, eventually wiping out 12 years of price gains.

In response, the government came up with a "cure" and enacted T.A.R.P. ($700 billion) in mid September to save the banks, stepped up the FDIC and the Fed flooded the market with liquidity. So far, these bail out funds have totaled over $2.5 trillion. The government only has four tools for managing downturns: monetary policy, fiscal policy, spending and taxing. They had nothing to combat the fear and flight of capital perpetuated by the politicians themselves.

A year later, the "Great Recession" is officially over with -0.7% GDP in the 2nd quarter, and +3.5% in the 3rd quarter of 2009. Estimates for the 4th quarter are for at least +2.5% as well. The stock and bond markets have had one of the sharpest rebounds in history and the Case-Shiller home price index is up 7% from the bottom after four months of increases. Consumer confidence, the stock market and other indicators have rebounded to where we would be at the end of a normal recession, but the damage from the "panic" and the massive spending "cure" remains.

As we enter the fourth quarter of 2009 we have a mixed array of economic data. On the positive side, we have stabilization, be it at a low level in autos and housing – two of our worst drags on the economy. In addition, corporate earnings are better than expected, inflation remains low, government stimulus plans are in full swing, a weaker dollar is helping exports, large banks have stabilized their capitalization and the business spending outlook is rebounding.

On the worry front, we still have considerable damage to household net worth, which is driving debt reduction and high savings (and low spending) by consumers. These are definitely a plus in the long run, but they are hurting the economy in the near term. Home foreclosures and dispositions are still high and likely to remain so for several years. Unemployment is approaching 10% and will likely stay there throughout most of 2010. Commercial real estate continues to drop and commercial real estate debt is expected to hurt small banks and CMBS investment pools for 1-2 more years. Stimulus spending will wind down by next summer and economists are predicting a weak second half of 2010 (some even a double-dip recession).

With all of the above already baked into the financial markets, the stock market is indicating a strong 2010 recovery with building inflation; yet the government bond market with a 10 year yield still only in the mid 3% range is pointing to a weak 2010 recovery and falling inflation. Both cannot be right, at least not at the same time.

*Economic Forecast-* While the consensus for when the recession would end was uniformly correct, top economists and financial market forecasters are quite mixed on the strength of our recovery. Very credible scenarios can be made for a strong recovery and also for a return to negative GDP. Our forecast is in the middle as we believe that easing trade deficits and the re-building of business inventories will keep us out of a second recession. At the same time, weak consumer demand, further commercial real estate damage, slow job growth and anti-business fiscal and tax policies will keep the U.S. GDP held to a modest 3.0% in 2010. Inflation and short-term rates should continue to be very low until late next year, however the financial markets will react by early 2010 in anticipation of higher inflation. Orange County and national housing, as previously discussed in our Second Quarter Newsletter, should continue to recover quickly until it's up 10-15% from lows, then stall for a couple of years until the excess supply is absorbed. Other local housing markets in California, Arizona, Nevada and Florida will continue to drop into next year. The dollar will remain weak vs. the Euro (staying around $1.50), but will fall more dramatically against resource based developing countries (more about this below).

*Economy 2.0-* Main Street vs. Wall Street – Main Street, or local small and medium businesses, have felt this recession from early 2007 and are still not seeing business improvements. Meanwhile Wall Street, the S&P 500's large companies, had a short but severe drop and recovery that lasted only 12 months. U.S. consumers are the difference and will be for at least the next few years. U.S. households have seen their net worth significantly damaged, mostly from the large erosion in home equity exaggerated by leverage.

Rightly, U.S. consumers are rapidly reducing debt and spending while increasing savings (interestingly, defaults and walk-a-ways speed this process). This has reduced revenue for most main street companies and will limit our GDP rebound from this recession (recovery years have averaged +5% GDP vs. normal years of +3% GDP).

Local banks, which finance most Main Street companies, are still not lending. They can borrow at 0.25% from the Fed and invest in 3% treasuries, making a profit spread and earnings, without making new loans. This is likely to continue for awhile as they try to rebuild their balance sheets as they suffer further losses on heavy commercial real estate loans. This severe lack of financing for Main Street will extend their struggles.

In a typical U.S. GDP year, consumer spending is +3%, business is +1% and our trade deficit is -1%, which equals net +3%. Next year, consumers will probably be only +1%. Fortunately, business to business spending should recover to +1%. The trade deficit is the key. Our weaker dollar, combined with an undamaged middle-class from Latin America, Asia (China & India) and Australia is rapidly reducing our trade deficit and will likely add 1% to our GDP. This is how we will get back to +3% GDP.

These young, emerging middle-class households want what Americans have had and are reducing their high savings and buying cheaper American goods. This is a long-term trend that is part of the peaking of America's "super nation" status (like England in 1920). According to the IMF, the US share of global growth was 60% 10 years ago, 5% in 2008 and negative in 2009. North America, Japan and the Euro zone have a prosperous but aging population. China's, Mexico's and India's middle-classes alone are the size of the U.S. They have healthy balance sheets and are the future consumers from whom the large S&P 500 companies derive more than 55% of their sales. This disparity between Wall Street (worldwide sales) and Main Street (local U.S. consumer markets) is the New Economy 2.0. Recognition and investing alongside this new long-term trend will increasingly become important.

*Fixed Income-* With our current slack in manufacturing capacity, high unemployment and saving oriented consumer, the CPI (inflation) should remain low throughout 2010. However, three factors will probably cause bond rates, all but the shortest, to begin rising by early next year. First, the Fed has been buying back medium and long-term bonds. $1.0 trillion so far, to help keep rates low on home financing. This has artificially kept home loans about 1% below where they would be otherwise (5% vs. 6% without). This bond buy-back program is scheduled to end in the spring of 2010. Secondly, the Fed will keep short-term borrowing levels at near 0% longer than optimal to ensure a recovery. However, the reversal of this monetary policy, particularly if done in a stronger economy, will cause higher rates because of simple supply and demand for bonds. Lastly, 5-7% inflation in a few years would dramatically help reflate assets and pay government and household debt with cheaper dollars. Our huge government deficits and spending should create this outcome. The combination of these factors will result in bond rates climbing ahead of real inflation.

There are several ways to successfully invest in this future rising bond rate environment. The first traditional way is to shorten your bond maturities and avoid future price decline. However, with today's very low short-term rates (under 1%), it is a strategy few can "live" on. A second traditional way is to ladder your maturities over 1-10 years, buying new 10 year bonds when the next year's bonds mature. In this way, your income would rise every year if rates keep climbing. You will still have "unrealized" price declines on longer maturities, but if held to maturity, no "realized" losses. Another strategy is to use TIPS (Treasury Inflation-Protected Securities) which pay about 1.5% above inflation for 10 year bonds (still only about

3% currently). We are considering all of these strategies for our corporate and municipal bond accounts, and are adding inflation/weak dollar investments such as dividend paying commodity pools, foreign and emerging bond funds, foreign TIPS, high-yield bonds, oil & gas trusts and Swiss Francs in moderation to increase overall yield and provide inflation/weak dollar protection.

*U.S. Stock Market-* The stock market's rebound since March has propelled the riskiest stocks (third world, damaged financial companies and low priced NASDAQ) up the fastest, returning 80-150%. The S&P 500, comprised of larger, multi-national companies, also rebounded but a more "modest" 65% (S&P 500 1,100) from the lows. This has surpassed our S&P 500 forecast of 1050 from last December. In fact, we have thought the stock market has been ahead of itself since around the S&P 500 1,000 level (Dow Jones 9,500) and have been taking selective profits and raising some cash.

We believe that the easy money has been made. If we continue at this pace of advancement we will be at new all time highs in less than 6 months. Opportunities exist for certain sectors of the market, but as a whole, we believe it will spend the next few months digesting our recent gains and pull back 5-15%.

Longer term, we expect the U.S., Japan and Europe markets to advance but at a slower pace than emerging countries. We have had a P/E expansion gain over the last two quarters which we believe will hold here. Further gains will come from actual earnings as they rotate through our recovery. We continue to favor natural resources, high dividends, world-wide distribution channels, high tech and business to business equities.

*Strategies for Economy 2.0-* We are thankful to be on the recovery side of our "Great Recession" and believe for all but commercial real estate, the worst is behind us and will not be revisited. However, we do not believe we are in a "V" shaped economic recovery as the current stock market is currently indicating. We expect positive but modest stock and bond returns for the next year as the U.S. economy crawls forward and future inflation looms. On the brighter side, stock investments into faster growing economies, natural resources and technology should outperform. Likewise, carefully crafted corporate and muni bond portfolios can be structured to create increasing cash flow portfolios as rates rise.

However, the best investments over the next few years are likely to be long/short and global/macro hedge funds, hard-asset lending (taking advantage of the lack of bank financing) and selectively buying depressed commercial real estate. These assets are still in dislocation to intrinsic values and will benefit from future inflation and weak U.S. growth.

Mark Van Mourick
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