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Optivest Outlook

Third Quarter 2010

Summary- The US Economy is in the midst of a shaky hand off between the end of government stimulus spending and private sector's slow growth. We expect this hand off will ultimately be successful, but anticipate a few more scares over the next 6-9 months that will provide additional market dips to be taken advantage of. Continued above average corporate spending should finally provide some much needed solid labor market gains by year-end. We expect low growth and low inflation in developed countries, and higher growth and higher inflation in the important emerging countries; California still lags the national economy and cannot gain much ground until construction picks up in 2011/12.

Contact Us

24901 Dana Point Harbor Drive
Suite 230
Dana Point, California 92629
949-363-8686

or visit our website:
www.optivestinc.com

US Economy- We are now one year into our recovery from a deep financial crisis driven recession. After a torrid initial rebound fueled by a return from panic and giant government stimulus, the economy has slowed to what is likely to be a halting, grind out, multi-year economic stabilization and 3% annual GDP growth. US corporations, unlike governments and US households, are not overleveraged and overall have healthy balance sheets. CAPEX (Corporate Capital Expenditures) has grown 8 of the last 9 months and is offsetting still weak consumer/household expenditures. Amazingly, US corporate net cash flow (funds available for dividends, spending and saving) hit a record $1.7 trillion in the first quarter and is estimated to exceed that amount in Q2. It is also a record high 12% of our GDP (Deutsche Bank). Historically, peaks in CAPEX have led payroll increases by one quarter and as such, we anticipate better non-government job growth in the second half of this year. However, we are watching the risk of slipping back into negative growth next year if the expiration of the Bush tax cuts provide the historical average drop in GDP from raises in taxes.

Global growth is shifting: from 2000-2009, developed countries contributed 59% of global GDP vs. 41% for emerging countries. From 2010-15, the emerging countries are expected to take over with 57% of the GDP vs. 43% for developed countries. In fact, the China, Brazil and India economies are already back to 2007 levels and expected to hit new highs this year. This is an important trend as the global playing field continues to level, and US/Euro dominance diminishes.

Both household and corporate cash holdings are at their highest level ever and as a percentage of GDP and the US Stock Market. The last time they were near this high was 1982, after a 14-year doldrum in the stock market. Then over the following 18 years, cash holdings dropped as people/businesses invested into rising stock and real estate markets until reaching very low cash holdings levels in 2000. We believe this roughly 30-year cycle will again be repeated over the decades ahead. In fact, every 30-year cycle since the 1950s has had a similar mix of good and bad stock market years.

US Stock Market- The second quarter 13% drop in the stock markets was caused by the 10-year Treasury yield hitting 4%, 30-year mortgages reaching 5.5%, oil moving from $70 to $90, PIGS (Portugal, Italy, Greece, and Spain) solvency risks and China deliberately slowing its economy and potential housing bubble. Currently, the 10-year Bond is under 3%, 30-year mortgages are down to 4.2%, oil is in the mid $70s, PIGS are instigating "austerity" (higher taxes, raising their "social security" retirement age and cutting spending) and China has devalued their Yuan and raised down payments on homes to 30-40%. All of which will help the economic recovery and stock markets.

Fundamentally, stock valuations based on earnings yields vs. bond yields, P/E ratios and book/market ratios all indicate that US Stocks are undervalued by 20-25% today vs. historic norms. I believe these discounts reflect the anticipation of the end of the Bush tax cuts on 1/1/11 and the future cost of Obamacare. A change in either of these, or big gains by Republicans in November, would help the stock markets. Technically, we continue to see major stock market support at the 950-1000 level on the S&P 500 and expect a volatile, but mostly sideways market for the next few months. Jobs will be the key and initial jobless claims need to fall below 400,000 per month before the stock market can make any meaningful gains.

Fixed Income- High-grade corporate and healthy developed country debt markets have followed the rise in price (and drop in yields) of the US Treasury Bonds. The 10-year Treasury Bond is now hovering around 2.7%. This is unusually low and since 1962, we have only been below this level late 2008 and beginning 2009. Unless we have a deflationary recession in 2011 (unlikely), these low levels are unsustainable and interest rates will be slowly climbing back up. US corporations' actions agree as they issued the largest amount of debt ever for a month in July. (IBM issues $1.0 billion at 1% for three years.)

We have profited from this move through our high-yield corporate, EM and municipal bond holdings as well as our investment philosophy regarding developed vs. emerging economies. Our largest Schwab holding, a conservative PIMCO fund, has also reached new highs by profiting from anti-dollar investments. These strategies should outperform Treasurys when rates rise with a better future economy. For additional protection, many of our accounts are successfully utilizing a specialty manager's hedged high-yield investment strategy.

Real Estate- According to The Wall Street Journal, 27% of national private sector job losses since 2007 were in construction. Add in mortgage lenders, real estate agents, etc., it is closer to a third of the total and in California, it is closer to one-half. California home prices are down by 36.2% (Case/Shiller) and with home loan interest rates at historic lows, the "affordability index" is at a 20+ year high. However, there is still a backlog of existing homes for sale and a "shadow" inventory of delinquent and bank owned homes. This combination will likely keep home prices stable and substantial new construction further delayed until mid 2011. Pent-up demand, healthier household balance sheets and higher home prices should lead to a sustained construction boom from 2011-15, along with much needed California jobs.

Commercial/investment property transactions are still a fraction of their pre-2008 levels and pricing/valuations are unusually mixed. A record $500+ per foot was paid for a new Chicago office tower last month and pristine trophy properties are still commanding surprisingly high prices. At the same time, failed new development projects, having gone back to the banks, are being scooped up at a fraction of original construction costs. Most properties are down 10-30%, with appraisals of little use because of so few true "equally motivated buyer and seller" sales taking place. Lenders are usually extending loans on properties that still have good debt coverage, regardless of appraisals that may show losses. However, non-performing loans, on low occupancy buildings, are being taken back by lenders who are cutting great deals. As they say, "it is good to be the first son, the second wife and the third owner of real estate." We are investing into new "no legacy" real estate funds, with highly experienced managers, who can buy these troubled properties at steep discounts for "all cash" or at below market financing. Cash flow is often delayed, but there is significant upside potential after the properties are stabilized and markets normalize in the years ahead.

Commodities- Historically, commodities play a very small role in the kinds of accounts that Optivest manages. However, with the global economy changing and the US dollar vulnerable, gold and other "hard" assets are likely to play a more important role this decade. Fortunately, there are income producing commodity funds and we have been adding these to our accounts on price dips while they are out of favor. The US dollar is sought after during times of panic, but it is only the "cleanest of the dirty shirts" for developed country currencies. As emerging countries' economies rapidly expand and create local higher inflation, raw materials and food will cost more in dollar terms, even without wage/CPI based US inflation. The world's population is growing at 78 million people per year and becoming more urban. Population and urban growth requires infrastructure spending that requires commodities. Commodities are a finite resource - prices will go up.

Investment Strategies- Bonds, especially high-yield and EM, should continue to out-pace stocks until solid job growth finally happens late this year. Unfortunately, anti-business policies, deficit spending and higher taxes will mute our economic recovery unless significant changes occur in the November elections. Emerging Markets and discounted real estate buys are currently the brightest spots for growth investing. We remain focused on preserving capital, increasing income and watching the economy closely.

Mark Van Mourick
CEO