

Investment Outlook

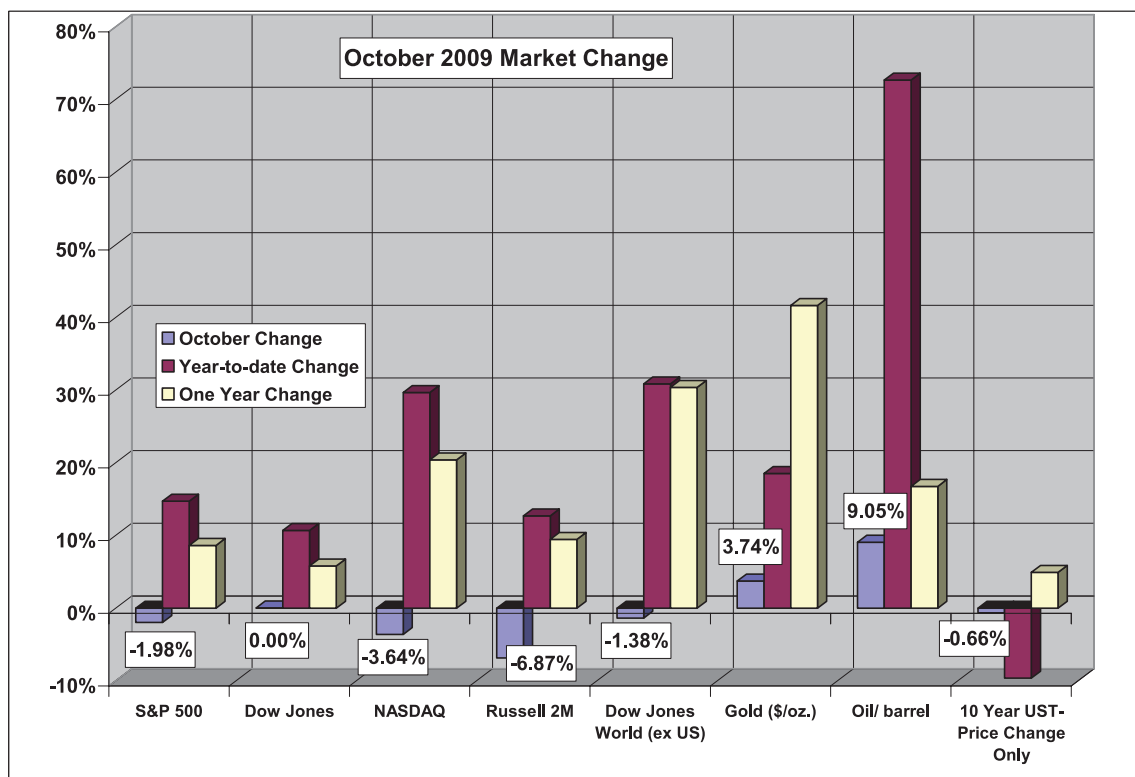
November 2009

Paths to prosperity



October Markets *Buy the rumor, sell the news...*

October generally presents some trepidation to investors as the month that marks the anniversaries of the epic market crashes of 1929 and 1987, as well as the meltdown we experienced last fall. With seven consecutive months of improving stock and bond markets on the line a pause to ponder the strength of the bull's convictions might be understandable (some might suggest past due).



Investors did get the positive economic news they were seeking with the mid-month report that GDP growth had indeed resumed during the third quarter, after four quarters of consecutive declines. Concurrently, the good news continued when corporate earnings results for the third quarter exceeded the much reduced expectations, a condition experienced in the second quarter as well.

With all of the "good news" known and stocks at twelve month highs, profit taking became prevalent toward the end of the month resulting in the Dow Industrials turning in the "best" monthly result at breakeven, while the rest of the equity indices ended in the red. Global stocks continued their lead for the year to date and yearly periods.

Commodities outperformed stocks during October with gold providing the best results over the last twelve months. As detailed on the prior chart, oil has also had quite a journey with a 9% gain during October and a 70% increase since year end. This may have negative implications for “headline” inflation as we move into 2010.

Having rallied sharply during last year’s credit crisis and “flight to quality”, the ensuing recovery has put Treasury bond prices under pressure most of this year. Again with reference to the prior chart, an investment in the Dow Industrials would have outperformed a similar Treasury holding for the one month, ten month and twelve month periods depicted as investors re-embraced risk and sought higher returns.

Commentary ***The plight of the dollar...***

Changes in the value of the U.S. dollar impacted October markets and are a key component in formulating the current outlook. The chart below shows the change in the value of the dollar over the past five years when measured against a “basket” of other currencies. Rising values depict dollar strength while lower values are periods of weakness. At the time of this writing the dollar index is at 75.871, somewhat above the low of 71.657 at the depth of the equity market bottom in March, but well off of the higher levels that prevailed this summer and prior to the current recession.



The relative value of the dollar is impacted by three areas:

- political; there are some both internationally and domestically who would like to see the dollar lose its status as the world’s “reserve currency” and also promote a weak-dollar agenda,

- economic and fiscal; the perceived strength of the U.S. economy and fiscal policies regarding government budget deficits and debt levels are reflected in the dollar as investors “vote with their feet” (or wallets) when confidence wanes,
- investment; currencies are an investment class by themselves generating opportunities for gains and loss. More recently the low interest rates that prevail in the U.S. foster a “carry trade” where dollar based loans are used to invest or “carry” other assets. The dollar is generally weakened as investments are purchased and strengthens when they are sold and loans are repaid.

In spite of any personal preference to the contrary, the convergence of these influences seems destined to keep the dollar weak for the near term. This trend will continue to make international stocks attractive as the weak dollar boosts their return when the currency conversion is considered. Similarly the foreign revenue of U.S. based multi-national companies is enhanced when converted into dollars making this asset class relatively more attractive as well.

The weaker dollar improves the competitive pricing of our exports which should boost revenues of exporters including manufacturing and agricultural companies. The same conversion will make imported goods more expensive adding even more pressure to consumer-based companies already struggling with the beleaguered households in America.

Unfortunately for most of us commodities, especially energy products, are also priced in dollars which puts upward pressures on prices as the dollar weakens. While this is a positive for energy companies, and the market in general given the 13% weighting that energy has in the S&P 500, the increase in oil prices may have an unpleasant impact on annual inflation calculations in the not too distant future. A similar calculus applies to other commodities and their producers as well.

This is already evident in retail gasoline prices which stubbornly remain above \$3/gallon locally and have taken back much of the boost to consumer discretionary spending that lower energy prices provided late last year. These conditions do not bode well for investments in companies that rely on increased consumer spending patterns.

Dollar weakness will also not be kind to bond markets. To date the Treasury has been able to fund its current deficits quite easily as the excess of dollars in global circulation find their way back into U.S. Treasury debt. To the extent that the dollar weakens further and/or inflation pressures rise, bond investors, whether domestic or global, will demand a higher return on their money. While this could be mitigated by a change in rate policy by the Federal Reserve, today’s announcement indicates that the current structure will be maintained for “...an extended period”.

Whether increased inflation pressure can lift housing prices remains to be seen; i.e. first we actually need to have inflation, then we'll need to measure its impact on housing. To the extent it can, some financial institutions may find a hidden benefit from the improved collateral value of their impaired mortgages. We wouldn't make this an investment thesis but do see it as a positive, but unintended, consequence.

Outlook and Strategy ***The shape of things to come...***

A few months back we discussed the possible trajectory of the economic recovery which some were describing as an "L" "V", "U" or "W" . While the final path is still unknown recent data seems to eliminate "V" from the various possibilities.

As discussed earlier, equity markets paused at the end of October to reassess their direction as well. The seven month recovery in stock prices have erased this year's losses and taken values to 12 month highs. While earnings have also continued to exceed "expectations" they are still 32% below last year's level, when measured by trailing results within the S&P 500. Consequently the market is currently valued at 21 times trailing earnings compared to 14 times this time last year.

There is no doubt that the outlook is significantly brighter this year than last. The question is can earnings grow fast enough to substantiate these lofty prices or is further "consolidation" required?

In the previous section we highlighted some market segments that should benefit from our present dollar weakness and monetary policies. Healthcare can also be added selectively as prices have declined in anticipation of congressional action. In the meantime the number of people consuming these services will rise under any of the plans being considered.

With bonds seeming expensive and cash offering little return except as a hedge against deflation, equity exposure is the best place for additional investment. As always acquiring it at the best price is the best practice, hence the current spate of volatility should provide some opportunities.

Those with questions, comments or differing points of view are welcome to call.

<i>S&P 500:</i>	<i>1,046.55</i>	<i>Mark Fingerlin</i>
<i>10 Year U.S. Treasury Yield:</i>	<i>3.55%</i>	<i>November 4, 2009</i>