BULLS VERSUS BEARS

Two of the professionals in the investment industry that I respect are David Rosenberg, Chief Economist & Strategist at Gluskin Sheff, a wealth management firm located in Toronto, Canada (David was the Chief Economist at Merrill Lynch) and James "Jim" Paulsen, Ph.D., Chief Investment Strategist at Wells Capital Management, a money manager. David is bearish on the economy and the stock market while Jim is bullish on both. In my thirty-seven (37) years in the financial services industry I have never seen such a wide divergence of opinion about the direction of the economy and the stock market. We are not in normal times.

David says that "we're halfway through a secular bear market that began in 2000. It's another one of the Dow's 18-year cycles that date back 100 years...Sure, there will be cyclical bull markets like there was in the U.S. in the 1930s and in Japan in the 1990s, but we're likely in for another disappointing decade."

Jim thinks that we are in an earnings-driven bull market and that earnings appear set for a significant period of growth. He says that the stock market may already be up significantly from the crisis low of March, but still far below the peaks it will ultimately reach during the economic recovery.

Paulsen points out in his latest publication called "Perspective" that there are six forces for economic growth:

First is massive and unprecedented economic stimulus.

Rosenberg says that stimulus is artificially keeping the economy going and when it stops the economy will drift back into a recession.

Second is the reversal of U.S. corporate purging of inventories, payrolls and capital spending.

Rosenberg says that the purging of these has helped corporate earnings in the short run, but companies can't keep doing this forever. He points out that top line revenue growth is negative and, until sales pick up, sustained earnings will not follow.

Third is a slow, steady rise in economic confidence.

Rosenberg points out that consumer sentiment fell in October to 47.7% This is a big negative because the consumer is 70% of GDP.

Fourth, after constantly subtracting from economic growth, housing and autos will likely "add" to third quarter real GDP growth for the first time since early 2006.

Rosenberg points out that auto sales were up in the third quarter because of "Cash for

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Clunkers" and sales for the rest of the year will be lower than they would have been without this stimulus. He says that housing still has a way to drop because banks are delaying foreclosures to avoid flooding the housing market.

Fifth, domestic net exports are now boosting U.S. real GDP growth.

Rosenberg says we will have a slight rise in GDP in the third quarter and then it will flatten out indefinitely.

Sixth, two major negative forces for the recovery—rising mortgage rates and surging energy prices—have stalled in the last four months.

Rosenberg says that mortgage rates have been held down because of the Federal Reserve's $1 trillion purchase program of mortgage-backed securities and its $300 billion purchase of Treasuries. When this stops interest rates could go up. He also points out that oil is at $80/ barrel.

Paulsen argues that these items should foster a recovery that continues to surpass expectations. He expects GDP growth to average around 4% in the next 18 months, without a high probability of a double-dip recession. Rosenberg says that GDP may be up 3% (annualized) in the third quarter because of stimulus ("Cash for Clunkers") but will be flat to down after that. Best case he says 1%-2% GDP growth. He expects a high probability of a double-dip recession.

Paulsen says that many expect a sluggish recovery because they believe the U.S. consumer will be forced to deleverage. He thinks it is too early to evaluate whether the U.S. consumer will respond to policy stimulus and boost spending or whether spending is likely to stay subdued despite stimulus as households embark on balance sheet restoration. He does not expect healthy consumer spending until job creation returns. He thinks that a couple of quarters of positive real GDP growth and at least a few months of job gains are required before judgment can be passed on the post-recession state of the U.S. consumer. He suspects that most will be surprised by a revival in the old "spending culture" of the U.S. consumer.

Rosenberg points out that total debt to GDP at the end of the second quarter was 373.4%. The last time it was this high was in 2003 at 301.1% and in 1933 at 299.8%. Private debt was over 320% at the end of the second quarter. This is a record. He says it will take a long time for this to be paid down, and in the meantime, the consumer will have no money to spend except on essentials and debt repayment. He says the bulls are ignoring this mountain of debt. He also points out that unemployment continues to rise. He thinks we are in for a Japanese-type economy that has gone nowhere for twenty years.

It appears that Paulsen wants to focus on the positive and Rosenberg on the negative. We think that somewhere in the middle is prudent.

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MONROE VOS STRATEGY

As you know, we suggested lowering equity exposure last July, 2008 and in October, 2008. By the end of the year we were recommending 20% equity and 80% fixed income for pension plans and endowments/foundations, and that has been our position so far for 2009. High-net-worth individuals and excess operating funds were more conservative at 10% equities and 90% fixed income. These recommendations were Tactical to avoid losing your money in the credit crisis. As the crisis evolved in 2008 and into the first two months of 2009 we watched the equity portion of your portfolio continue to fall, but the high exposure to fixed income appreciated in value as interest rates fell. The stock market (S&P 500) bottomed in early March, 2009 and has gone up 57% from March 9, 2009.

This sounds great, but the S&P 500 at September 30, 2009 was only up 19% from the beginning of the year. The BC Aggregate (the fixed income benchmark) was up 5.7% year-to-date. A 60% S&P 500 / 40% BC Aggregate index was up 14.9% at September 30, 2009 and the Monroe Vos Model Portfolio was up 15.6%. This was accomplished because the equity money managers exceeded the S&P 500 and PIMCO (our largest fixed income manager) was up 13%, more than doubling the return of the BC Aggregate.

Our thinking throughout the year has been that we actually were more exposed to the stock market than 20% because PIMCO has had 19% exposure to high-grade corporate bonds and high-yield corporate bonds that have delivered equity-like returns. We consider these bonds as surrogates for the stock market. When you add this to the direct equity exposure we have been approximately 35% in stocks and 65% in fixed income.

We continue to worry about a pullback in the stock market if GDP growth does not occur, as well as the possibility of a double-dip recession. We do not believe that inflation is a problem and there is a good chance that interest rates will go lower. If the Federal Reserve raises rates any time soon it will kill the economy and the stock market. We do not think this will happen.

We look forward to seeing you at our next meeting.

Jamison Monroe, CIMA®
Chairman & CEO
Director of Corporate Values

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