

WHERE DO WE GO FROM HERE?

The last twenty-four months have been the most volatile in our experience. In 2008 the S&P 500 Index dropped 37% and in 2009 it was up 26.5%. That results in the S&P 500 still down 20.3% since the beginning of 2008. The Monroe Vos Consulting Group, Inc. model portfolio was 20% stocks and 80% bonds for all of 2009. This allocation is our most conservative allocation. This portfolio generated a preliminary return of 17.03% in 2009. This compares to the benchmark 60% S&P 500/40% BC Aggregate return of 17.80% for 2009. In 2008 the model portfolio had a -10.35% return versus a -22.65% return for the 60% S&P500/40% BC Aggregate Index. Over the last two years the model portfolio had positive returns of 2.43% per year versus a return of -4.54% per year for the blended benchmark.

David Rosenberg, Chief Economist & Strategist at Gluskin Sheff, a wealth management firm located in Toronto, Canada, is still bearish and continues to say that the economy has a good chance of falling back into recession once the government stops stimulating the economy. He says that the stock market is 17%-27% overpriced depending on who you talk to. He thinks that interest rates will fall this year, meaning that government bonds will go up in value. He predicts that the yield on the 10-year Treasury will be 2.81% by the end of 2010.

James Paulsen, Ph.D., Chief Investment Strategist at Wells Capital Management, a money manager, thinks that the economy is improving. He thinks that consumers will start spending again and that revenues will increase for corporations, causing earnings to increase. He believes that the stock market is not overpriced but that it has a good way to go up. He expects GDP to continue to improve.

The Economy

- In a recent article in Barron's, Richard Koo, Chief Economist at Nomura Research Institute said, "The only way the U.S. can turn this economy around is [with] fiscal stimulus. That's what saved Japan from entering a Great Depression." Mr. Koo says that the U.S. has experienced a "balance-sheet recession" like Japan did twenty years ago and like the U.S. did in the 1930s. In a balance-sheet recession the private sector companies are no longer maximizing profits because all the assets they bought with borrowed money collapsed in value; but the debt is still on their books, so their balance sheets are all under water. If your balance sheet is under water, you have to repair it. This applies to the consumer as well.

He says that if your balance sheet is under water, in negative equity, you are not going to borrow money at any interest rate, and no one will lend you money either. This is what we are currently experiencing in the U.S.

The only way government can turn this economy around is to do the opposite of the private sector – borrow the money the private sector saved and spend it, which means fiscal stimulus. That's what saved Japan from entering a Great Depression.

Private sector savings plus the debt repayment together become the economy's "deflation gap" – the amount of money that comes into the banking system but is unable to leave it because no one is borrowing. You end up losing demand. That's how the U.S. got into the Great Depression of 1929-1933 and lost half of its GDP in just four years.

If you look at the history of this type of recession, the only way those countries came out was through fighting wars. Japan managed to do that without fighting a war. If GDP isn't falling, people have the income to pay down debt. At some point your balance sheet will be balanced again and this problem will be over. It takes time.

If the U.S. tries to cut the budget deficit the economy will collapse and tax revenue will drop. Japan tried this twice in fifteen years with negative results.

- In their latest newsletter Van Hoisington and Lacy Hunt, Ph.D. of Hoisington Investment Management talk about the 2009 best seller [This Time is Different—Eight Centuries of Financial Folly](#) by Reinhart and Rogoff. The following is an excerpt from their fourth quarter newsletter:

In 2009 the book [This Time is Different—Eight Centuries of Financial Folly](#), by Reinhart and Rogoff, shed new light on the role of debt by compiling a database that looked at financial crises in 66 countries over a period of 800 years. The main standard in explaining more than 250 crises studied is whether debt is excessive relative to national income, even though idiosyncrasies apply in each case. They reiterate that this old rule (excessive debt) continues to apply, and this time is not different.

We glean five important factors from this work that pertain to our present situation. First, financial imbalances occur when aggregate domestic debt is excessive relative to income, regardless of whether the government or private sector is accumulating the debt. Once debt becomes excessive, countries do not grow their way out of the problem; they must go through the time consuming and often painful processes of debt repayment and increased saving.

Second, whether the domestic debt is externally or internally owed is not as critical as the excessiveness of the debt.

Third, government actions, even involving sizeable sums of money, are far less helpful than they appear. As the book states, "Infusions of cash can make a government look like it is providing greater growth to its economy than it really is."

Fourth, Reinhart and Rogoff cover countries in debt crisis with a host of different conditions, such as growth and age of population, political regimes, technology status, education and other idiosyncratic features. Nevertheless, economic damage as a result of extreme over-leverage has remarkably similar results, whether the barometer of performance is economic output, the labor markets, or asset prices.

Fifth, further increasing leverage to solve the problem only leads to greater systemic risk and general economic underperformance.

The real question for financial participants is whether all these influences result in inflation or deflation, and the authors' research details both outcomes. As is widely feared here in the U.S., they outline that many countries have had the right circumstances and mechanisms to inflate away their debt overhang, and, in fact, have done so by debasing their currency. Those particular circumstances are not currently present in the United States.

According to Reinhart and Rogoff the norm is that *major* economic contractions lead to deflation. Importantly, they call our present economic circumstances the “second great contraction.”

Thus, not only has the historical “qualitative” research on the subject of deflation chronicled indebtedness (Fisher’s 1933 “Debt-Deflation Theory of Great Depressions”), but also modern quantitative methods have now essentially confirmed the conclusion. Over-indebtedness and major contractions lead to deflation.

Presently, we view the inflationary environment as benign because: 1) the U.S. economic system is overleveraged and academic research confirms that this circumstance leads to deflation; 2) monetary policy is, and will continue to be, ineffectual as efforts to spur growth are thwarted by declining asset prices, loan destruction, and adverse regulatory influences; 3) the federal government’s spending spree will necessarily cause taxes and borrowings to rise, further stunting any economic growth. These factors ensure that inflation will be quiescent. Interest rates easily can and do rise for short periods, but remaining elevated in a deflationary environment is contrary to the historical experience.

The Markets

- Barron’s dated January 18, 2010 published what it called “Roundtable Part 1”. It contains interviews with some prominent investment professionals asking them about their views of the economy and the markets. The Roundtable consists of the following individuals:

Meryl Witmer
General Partner
Eagle Capital Partners
New York, NY

Bill Gross
Founder and Co-CIO
PIMCO
Newport Beach, CA

Archie MacAllaster
Chairman
MacAllaster Pitfield MacKay
New York, NY

Marc Faber
Managing Director
Marc Faber, Ltd.
Hong Kong

Fred Hickey
Editor
The High-Tech Strategist
Nashua, NH

Abby Joseph Cohen
Senior Investment Strategist
Global Markets
Goldman Sachs
New York, NY

Scott Black
Founder and President
Delphi Management
Boston, MA

Oscar Shafer
Managing Partner
O.S.S. Capital Management
New York, NY

Felix Zulauf
Owner and President
Zulauf Asset Management
Zug, Switzerland

Mario Gabelli
Chairman
GAMCO Investors
Rye, NY

Their views on the stock market are as follows:

Gabelli: You'll be up 5% to 10% in the first half of the year. Then the market will have a major correction, and you'll be up 5% for the full year.

Black: There is no reason stocks can't go up another 10% to 15% this year. The underpinnings of the economy aren't quite as bleak as everybody thinks.

Shafer: Liquidity and another stimulus package will keep the market up.

Cohen: We see a range of 1250 to 1300 (S&P 500), and the market might not be at the high end at the end of the year. We're forecasting S&P 500 earnings of \$75 to \$76 this year and \$90 next year.

Faber: The U.S. stock market could correct by at least 20% relatively soon. When the S&P drops by more than 150 points, the Fed will print money like crazy. The government will buy up more bonds and stocks.

MacAllaster: I'm an optimist. I expect the S&P to earn \$75 to \$80 this year. Public participation in the market will increase. The market will have a pretty good year, but it could see a selloff of 10% or 15% at some point.

Hickey: The market could go up 10%-20%, max. There probably will be a correction during the year, but it will be temporary.

Witmer: Fifteen times earnings seems about right for the market, and earnings could grow a little next year. I don't see any big moves. Fair value isn't so different from where the market is now.

Gross and Zulauf didn't comment about the stock market.

- 2008 and 2009 were very volatile years in the economy and the markets. 2010 will be challenging as well. The fourth quarter 2009 GDP should be up 3.0%-4.0%, which will be good for the stock market and not so good for the bond market. If GDP holds up because of government stimulus then the stock market should at least remain stable to up. There is a fear that interest rates may go up because of possible inflation; a rise in the Fed Funds rate; the ending of Fed purchases of mortgage-backed securities and treasuries; or the fear that China and other countries will demand higher rates to purchase U.S. government bonds. The highest probability is the Fed discontinuing its purchases of mortgage-backed securities and Treasury securities. Bill Gross at PIMCO thinks the 10-year Treasury yield will rise 30 basis points by the end of the first quarter.

Tactical Asset Allocation

We are recommending to our clients a change in tactical asset allocation to 40% stocks and 60% bonds effective January 1, 2010, with some exceptions for our conservative high-net-worth clients, corporate operating clients and insurance clients.

Our recommendation is based on the following scenarios:

1. The government continues to provide stimulus and GDP holds up. In this case the stock market could do well and the bond market could see a rise in interest rates as the economy appears to be improving.

In this case the 40% in stocks performs well and bonds possibly go down.

2. The government does not continue to provide stimulus and the GDP falls. In this case we drift back into recession, the stock market falls and the bond market does well as the economy slows down and we experience deflation.

In this case the 40% in stocks performs poorly but the 60% in bonds performs well.

3. A remote possibility is that we experience stagflation where inflation rises in a slow economy. In this case both stocks and bonds perform poorly. We will suggest going to money market if this scenario develops.

There are no sure things in investing and no one knows what will happen for sure. As you know conditions can change. We will keep you informed if our opinion changes.

We are suggesting a move to a neutral allocation from a conservative allocation. We are more concerned at the moment about a rise in interest rates versus a drop in the stock market. With a 40% stock/60% bond allocation we are positioning our clients to attempt to mitigate the negative effects of either of the first two scenarios described above.

Endowments, Foundations, Defined Benefit and Profit Sharing Funds

We recommend the 40% stock/60% bond asset allocation at this time.

High-Net-Worth Individuals

We recommend between 20%-40% stocks and 80%-60% bonds based on the individual risk tolerance and cash flow needs.

Corporate Operating Funds

We recommend a 20% stock/80% bond allocation.

401(k)/403(b) Plans

We recommend that participants in these plans allocate their assets according to their risk tolerance and time horizon. Most plans have the Asset Allocation Strategies available. We suggest staying the course and continue to dollar-cost-average with new contributions.

We look forward to seeing you at our next meeting.

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

Please visit our website at www.monroevos.com.