

# Investment Update



December 2009

## 2010 Outlook – Cloudy with a Chance of Sun

I now recognize that the term “fall” aptly describes the millions of leaves that descend into my yard this time of year. My feelings toward the ensuing cleanup, however, fluctuate. One year I vowed to do it myself, only to decide the following year to pay someone else to do the work. This year, my daughters begged me to do it myself so they could jump into the pile, only for them to become missing in action when the time came to clean up their mess. For economists and investors alike, this season brings a similar set of mixed feelings, with economists striving to be more reliable than weather forecasters in their annual projections, and investors endeavoring to determine what the seasonal cascade of commentary really means for them.

While one’s view of the economic forecast very much depends on where one stands, with great assistance from the Fed and the massive global stimulus, the economy appears to have entered a sustainable recovery. Improvement may be subdued by historical comparison, however most signs indicate a more positive outlook for 2010.

Gradually falling but still very high unemployment, combined with significant excess global capacity, should constrain inflation in 2010. Corporate earnings should continue to improve, enabling further, more modest, equity advances. Growth will be stronger in many areas outside of the U.S., most notably in emerging markets. The combination of lower U.S. growth and very low short-term rates should sustain the dollar’s decline through most of 2010. This decline, however, appears to be in the later stages. As U.S. economic growth improves and the Fed moves closer to tightening, the period of U.S. currency weakness may end. Short-term interest rates likely will remain low. We do not expect intermediate and long-term rates to skyrocket, but as the year progresses, the multi-year trend is expected to increase within a range of 3.5% to 4.5%.

## Sustained Improvement

Our portfolio recommendations continue to echo our constructive view on equities overall. We believe that equity markets are reasonably valued. Based on our growth and U.S. dollar expectations, we have recommended

an increased allocation to emerging market equities. Most portfolios also should continue to have an increased emphasis on other non-U.S. investments. Additionally, many of the trends that improved commodity prices appear to remain in place. Therefore, despite the 2009 gains, we feel that some commodity exposure is warranted.

We believe that several of the opportunities we realized during late 2008 and 2009 have diminished as economic and market improvements have become reflected in prices. Somewhat limited opportunity exists in high grade corporate bonds, municipal bonds and TIPs. We caution against reaching too far for yield. We expect modestly higher interest rates, and consequently we will watch for opportunities to shorten maturities. At the same time, we do not see shortened maturities as an imperative need. High yield bonds have recovered amazingly well and now appear fully valued. As such, while we are not ready to recommend selling our high yield positions, we also are not advising additions at this time. Cash remains quite unattractive, and should only be employed for those with near-term needs or extreme risk aversion.

While signs of the economic and market recovery have helped us sleep better, many worries conspire to keep us restless. To paraphrase a good quote, risk is the future, which is unknowable. While this can be scary, far more so is the fact that market movement is influenced by the decisions of investors who believe that they know exactly what is going on. While we are reasonably confident that equities will continue to rise for at least the first part of 2010, the rate of future ascent likely will be slower than what was seen following the March 2009 lows.

The uncertain market and economic landscape must be factored into our portfolio construction. Expressing an excessively confident view of how circumstances will unfold holds great risk. As we have noted in previous *Updates*, markets likely have transitioned from anticipating improvement to reflecting improvement. Further gains will be driven primarily by how well embedded expectations pan out. If the recovery falters, if inflation picks up sooner than expected, if earnings improve less than anticipated, or if the dollar strengthens rather than declines, market progress may not materialize to the degree we anticipate.

The past year's extremely strong gains in many asset classes were fueled by several factors. Investors became more willing to increase risk exposure as signs of a recovery intensified.

Helping to drive these gains was the confluence of extremely low rates, huge amounts of excess liquidity and the weak U.S. dollar. The Fed intentionally has made holding cash painful. As we explained in last month's *Update*, a carry trade occurs when a weak dollar allows leveraged players to borrow cheaply and invest in almost anything else. Normally many diffuse factors impact various asset classes in unique ways, causing differing results. This dynamic is the basis of diversification's advantage. However, the movement of almost every asset class since the March lows has had this carry trade at its root. Bond yield spreads, U.S. equities, emerging market securities and even gold and oil prices all have been boosted by the carry trade. Because the Fed is facing very high unemployment and low projected growth, short-term rates will remain low for most or all of 2010. As a result, investors should continue to benefit from our recommended shifts in allocation towards some of the above-mentioned beneficiaries.

### **Are Markets in a Bubble?**

Bubbles form when investors extrapolate underlying rationale for an asset class to price levels that leave no margin for error or sudden change. In other words, a bubble can be defined as an overvalued market at an unsustainable level. A recent example of this was the 2002–2006 housing market.

While we do not think that the markets are in a bubble, a carry trade that is allowed to continue for too long could lift asset prices into bubble territory. Currently, fundamental economic improvements are driving markets higher. However, it will be increasingly important to monitor the degree to which asset valuations are based on underlying fundamentals rather than outsized expectations.

When returns appear easy to obtain, the temptation is not only to reap them, but to magnify them with leverage. This is akin to picking up nickels in front of a steamroller: they are right there in plain sight, but potential doom is not far behind. As Federal Reserve Bank of Dallas President Richard Fisher recently said, "Carry trades usually end in tears." Such trades may feel good on the way up, but the recent aftermath of the housing bubble burst should remind us that, much like leaf raking, the clean up can be painful and time consuming.



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