

PLANNING | RESOURCES

Your Wealth Management Team



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Special Forecast Edition

2010 Economic & Capital Markets Forecast

It's time to put ourselves on the line (again) and make our economic and capital markets forecast for 2010.

As a reminder, the way we manage money is to take a top down – bottom up approach. Our purpose is not to attempt to look into a crystal ball and divine the future but through our process try to get a better understanding of what is really going on around us. We feel that this type of process gives us a better chance of finding the best investments possible to help maximum returns while minimizing risk.

I would also like to add that never before in my almost 20 years as a broker, financial consultant, and portfolio manager has this process been so difficult. The reason is because I've never seen the government statistics used in these types of calculations be more "managed" (to put it kindly). I have very little, if any confidence in the data from the government. This has created a huge problem for us because like they say in computer land "garbage in – garbage out." So we have worked extra hard this year trying to sort out fact from fiction and hopefully came to some reasonably intelligent conclusions.

Gross Domestic Product – We think that when the numbers come out for the fourth quarter of 2009, GDP will be up. We feel this will be true because companies have been very busy replenishing the inventory they cut back on during the peak of the economic slowdown. We are raising our full year forecast for 2010 from 0% to 2.22%. Our upbeat forecast will depend primarily on company's ability to continue to gain efficiencies through cost cutting and a weak dollar helping exports for the multinational corporations.

Jobs – First let me state for the record that I do not believe in a jobless recovery. Last year we expected unemployment to hit 10% (as reported by the government – but in real terms it's closer to 17% by our calculations). We believe that unemployment will peak this year at around 13% (according to the government) and in real terms around 20%. In our opinion, this is the key metric for real sustainable gains in the economy. The unemployment situation will present very real problems not only economically but politically as well.

Taxes - We believe (for those of us that can still pay taxes), that our taxes are going up...way up. According to the Tax Policy Institute and the Brookings Institution, we could see the top tax rate brackets increased, capital gains and qualified dividend tax rates increased to 20% or more for high income tax payers, and itemized deductions further limited. We expect individual states to find ways to raise taxes as their budget shortfalls continue to be a problem. Because there are fewer individuals paying taxes and corporate revenues are down, the tax collection business (like most other businesses) will suffer. The shortfall in taxes will have the net effect of increasing the deficit as the Government “borrows” more to pay the bills, helping to drive up inflation and lowering the value of the dollar further. In our view, the capital markets will not like higher taxes.

Inflation – As we have pointed out time and time again, this is perhaps the most mutilated economic statistic published by the government. By our calculations (using the accepted methods prior to all the changes the government made) current inflation is around 10%. We believe that in the next two years (unless a miracle happens) inflation will hit 20%. This will force the FED to reign in its spending and raise interest rates. Because we believe inflation will soar, this will be the next crisis faced by our country; probably not in 2010, but most likely in 2011 and beyond.

Housing – This is the other key metric to a “real” recovery. We believe housing will continue to be weak. I find it almost silly to expect housing prices to firm up with so much inventory coming on the market as a result of the current weakness in jobs and the largest pool of adjustable rate mortgages in history coming due in 2010. The “good news” is that interest rates still remain low and we expect them to stay low for the time being as the government continues to “buy down” mortgage rates. The problem with this type of “monetizing” is that it’s like a kid on a sugar high. It’s only a matter of time before the stimulus runs out. The longer we keep putting this off with more “sugar” the worse the inevitable hangover will become.

The Dollar – We believe the Dollar will continue to be weak as inflation and government deficit spending continue to ravage the economy. Currencies are usually evaluated in pairs. In other words, how one currency is trading vs. another currency. In our view, the Dollar and the Euro (in real terms) will continue to be weak as other countries continue to defend their own currency against what they see as reckless behavior by the United States and many European countries like Great Britain.

Commercial Real Estate – This could very well be the next big shoe to drop on the banks. Like residential real estate, many of these properties have been leveraged to the hilt, with many of the same derivatives we’ve seen unwind in the residential market. Already, we have seen some very high profile defaults and we will see many more. Publicly and non-publicly traded REITS may be the most exposed as they continue to raise more and more “new money” to pay dividends that have not been earned to current investors. This is a huge ponzi scheme and cannot continue forever. We believe that we will see some distressed sales as companies sell everything just to stay alive and banks take another huge balance sheet hit. As a result, there will be some tremendous buying opportunities, but U.S. buyers will be at a big disadvantage as foreign investors have more “valuable” currency to work with and credit here in the United States remains tight.

Commodities – Most commodity markets began 2010 with sharp gains. The Bellwether Reuters/Jefferies CRB index climbed 24% last year, copper, rubber, and sugar more than doubled, as well as a 78% rise in crude prices. Aluminum and Silver gained 50%, and we had a ninth consecutive yearly gain for gold (still they want us to believe that inflation is less than 2%). Heading into 2010, it's going to be about buying on the relative cheapness in the market. We believe that commodity stocks could very well be some of the best (long) performers in 2010. One good reason to be bullish on commodities would be that if the FED continues to print dollars (as we expect), then anything tangible, like industrials metals, gold and silver, is going to be worth more.

The U.S. Stock Market – With more risk to the downside than to the upside, we believe the U.S. Stock Market will trade sideways for the year. We see the best opportunities in small to medium sized companies that might be good acquisition opportunities for larger companies with a strong capital structure. We also see Wall Street pushing these transactions hard as they look for ways to replace lost revenue from the sale of derivatives and other structured products. We also like large multinationals that have strong capital structures, generate much of their revenue from outside the United States and pay good dividends that are sustainable.

U.S. Treasuries: The Next Big Bubble - I see U.S. Treasuries as being the next big bubble. It is inconceivable to me that anybody would continue to lend money to the U.S. Government for 30 years at a 3 - 5% interest rate. Bonds over the last decade returned approximately 84%, while stocks (for the same period of time) returned less than zero (accounting for inflation, taxes and expenses). That's 8.4% per year (backed by the full faith and credit of the U.S. Government). The last ten years have been the best decade in history for bonds (that I know of).

As we have written about many times in the past, investors could lose trillions of dollars in bonds as they exit the stock market fearing another big selloff and chase the returns and perceived safety of U.S. Treasuries. It could very well turn out to be the biggest example of buy high and sell low in our lifetimes, because remember as interest rates go up, the value of lower interest rate bonds goes down.

Major Foreign Markets – China's accelerating economy and its voracious appetite for agricultural commodities, crude oil, base metals, and other industrial raw materials, is transmitting inflationary pressures worldwide. On January 5th of this year, China's central bank Chief Ahou Xiaochuan said, "We will keep a good handle on the pace of monetary and credit growth, guiding financial institutions towards balanced release of credit and avoiding excessive turbulence."

If the 2010 expected 17% target for M2 growth in China is to be taken seriously, the Chinese Central Bank would have to aggressively soak-up Yuan thru T-Bill sales, or force banks to lend less, in order to contain inflation.

Because China is the major locomotive for the world economy, any slowdown in their economy would have ripple effects throughout the world.

Emerging Markets: A big positive for 2010 - As emerging markets become more dependent on each other and less-so on the developed countries, they become a stabilizing force and a robust market that we can export products, intellectual capital, and technology to. Most emerging market economies are big exporters of commodities. Providing that Chinese and Indian markets don't enter into a serious recession and continue importing huge amounts of base metals and other commodities, emerging market economies should thrive.

Summary

We see a lot of opportunity in the year ahead for our portfolios. I've told a lot of people that if we are wrong we should keep pace with the market with less risk. However, if we are proved to be right, the next year or two could be very profitable for our investors.

I'm often asked what we view as our biggest mistake for any given year. I think our biggest mistake in 2009 was being too cautious for too long. The vast majority of investments that we owned, significantly outperformed the markets – but we owned too little of them.

To learn more about our specific investment strategies for 2010, please call me at 503-227-7744 or email at mchrysler@planningresources.com.

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