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2010 -- Near Normal

After the crisis of 2008, and the vibrant rebound of 2009, the past year marked a return to normalcy in the US financial markets. For the most part, stock prices increased, interest rates remained low, spreads tightened, commodities rose, while inflation measures continue to be subdued.

The most glaring exception to this return to normalcy is the US economy. With the great recession having ended mid-2009, we would typically expect to see real GDP growth in excess of four percent, accompanied by recovering job and housing markets, and soaring corporate profits. To the benefit of investors, the profit recovery is in full swing, with corporate profits approaching record levels; but it is driven by cost cutting and overseas growth. The domestic economy has shown only moderate signs of life, certainly far from vibrancy, despite massive fiscal and monetary stimulus. Most glaring is the depressed state of both the job market and housing market, neither of which shows anything resembling a real recovery. For the overall economy, the outlook seems to be brightening, yet the expansion is still likely to provide only moderate growth, weak employment, and a long road to lasting prosperity.

This dichotomy between a weak economy and healthy investment returns has many people confused. The explanations? Let's consider two:
First, valuations matter. Stocks and other assets fell so far in the crisis that they eventually offered compelling value, on many measures the best value in decades. To a great extent, this value gap has been closed.
Secondly, in the end, we do not invest in economies, we invest in companies. While a strong domestic tailwind would create favorable conditions for businesses, so do global growth opportunities, innovation, tight expense controls, and low interest rates. A critical consideration is that not all companies will be winners in this challenging environment; in truth, they never are, but the point is driven home when the US economy is in a funk. Investors should always ask which companies are winning, and whether this competitive advantage is sustainable. In doing so, we naturally return to the basics of investing -- finding opportunities one company at a time, assessing risk and reward, and remaining diversified.

Certainly there is a limit to the strong market/weak economy condition. No doubt we would prefer to invest in a healthier domestic setting -- with employment and personal incomes rising, industrial and service sectors robust, housing a safe haven in all respects. And it would be nice to be in a secular bull market for stocks and bonds, where every pullback created another buying opportunity, and only the bears got slaughtered. We even know the name for this environment -- it was called the '80s and '90s -- and those days are behind us.

Yet so too the recent "lost decade", where economic growth and equity returns were the worst since the great depression. Even if we accept the "new normal" of tepid growth, we should also

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consider that it reflects a condition long in place; the new normal is no longer new. If it continues as an extended affliction, all is not lost. Far from it. We still invest in companies, and after ten years of modest returns, equity valuations have returned to reasonable levels. In a world where relativism really counts, equities certainly offer better value than cash, certainly better value than government bonds, and likely better value than corporate bonds or real estate. And in the end, the economy may just surprise us -- it probably will. If that adds up to only a measured endorsement for the next few months, it also is not a bad place to start for the next decade.

Tidbits..

Federal Reserve implements "QE2" monetary stimulus. Federal Reserve bashing becomes newest craze.

First the Fed lost its secrecy, then its independence, now its respect.

General Motors, owned by government and unions, returns to public market in IPO, sporting a $45 billion tax break.

Government engineering run amok.

Bailout costs for Fannie Mae, Freddie Mac could reach $650 billion, S&P study says.

Another case of government engineering.

Municipal bond insurer Ambac Financial Group files chapter 11 bankruptcy.

From AAA credit rating to the trash heap in less than four years.

Ireland joins Greece as "broke" nation needing financial rescue package.

Euro policy: Draw a line in the sand, over and over again.

White House proposes pay freeze for federal employees, targets $2 billion in annual savings.

Savings equate to five hours of government spending. Yawn.

Commercial bank lending to businesses turns upward after two years of decline.

Baby steps, but in the right direction.

Great Atlantic & Pacific Tea Company, once the nation's largest grocer, files bankruptcy.

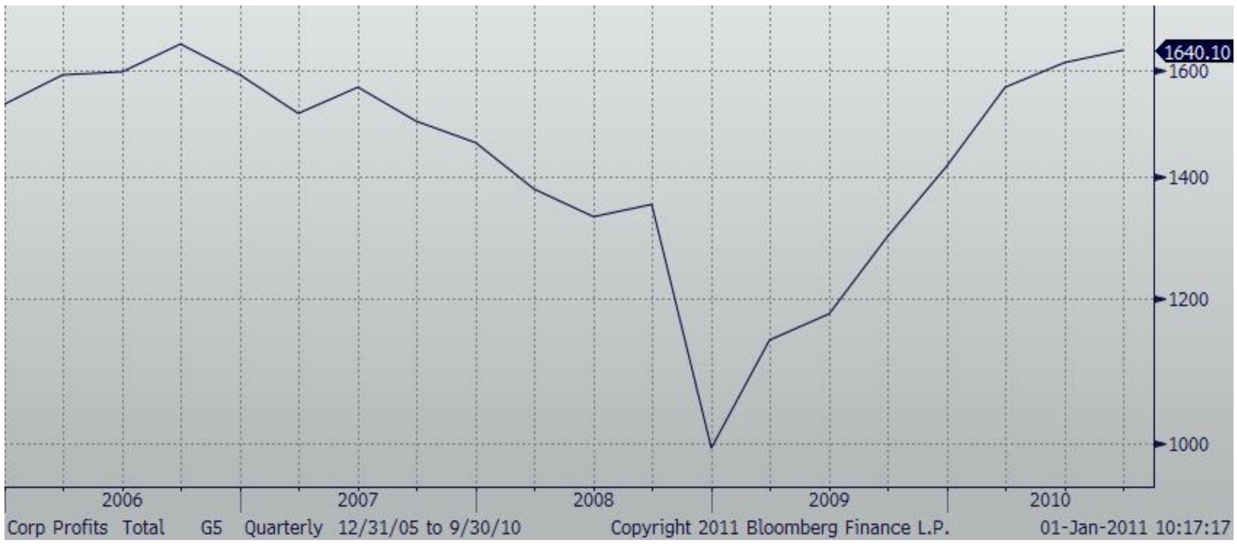
Inevitable perhaps, but any company whose origins pre-date the civil war deserves some recognition.

GOP and White House reach compromise extending tax cuts two more years.

Short term: pro-growth policy, as stimulus trumps fiscal discipline.
Long term: it's Washington, they don't worry about long term.

On the following pages we provide a pictorial review of numerous financial market and economic measures, accompanied by brief comments. For added perspective, the scope is widened to provide a multi-year view.

US Corporate Profits 2006-2010



US corporate profits fell 40% in the great recession, then recovered sharply to approach record levels at over $1. 6 trillion. S&P 500 earnings have followed a similar pattern.

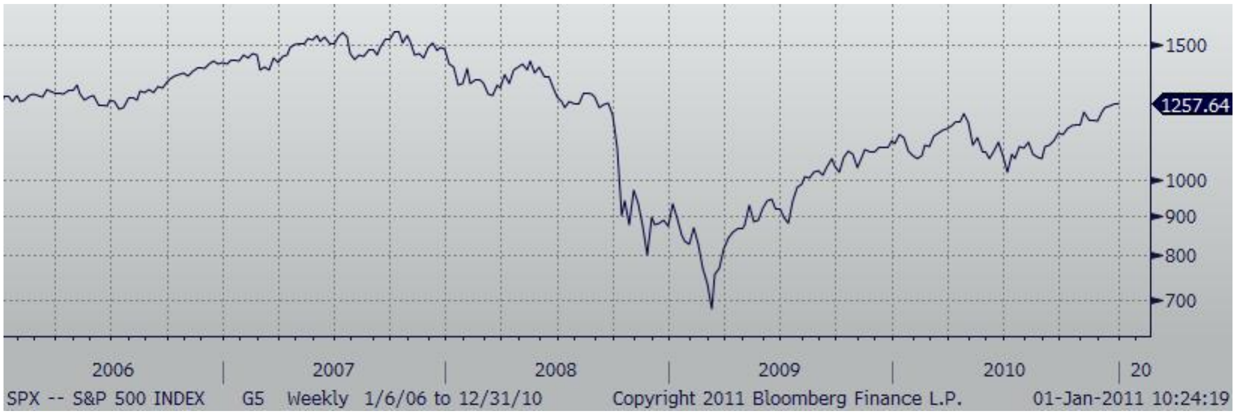
Yet it has been a jobless recovery, with over 8 million jobs lost and unemployment still double its pre-recession levels.

US unemployment rate 2006-2010

Equities

On all fronts, equity markets have rebounded sharply from the crisis lows. The crisis is over, so too the sharp rebound. More likely we are back to the basics of investing -- finding opportunities one issue at a time, and incremental gains -- rather than large, broad-based market moves.

SP 500 Index 2006-2010

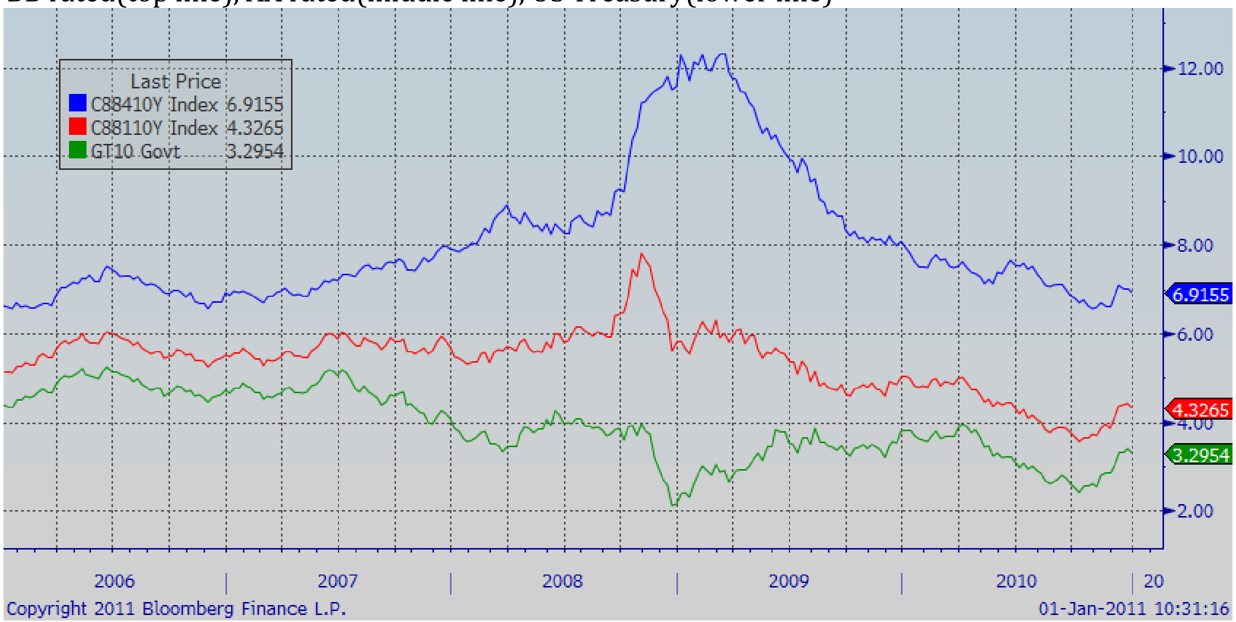


MSCI EAFE(Europe, Australiasia, Far East) Index 2006-2010

MSCI Emerging Markets Index 2006-2010

Bonds

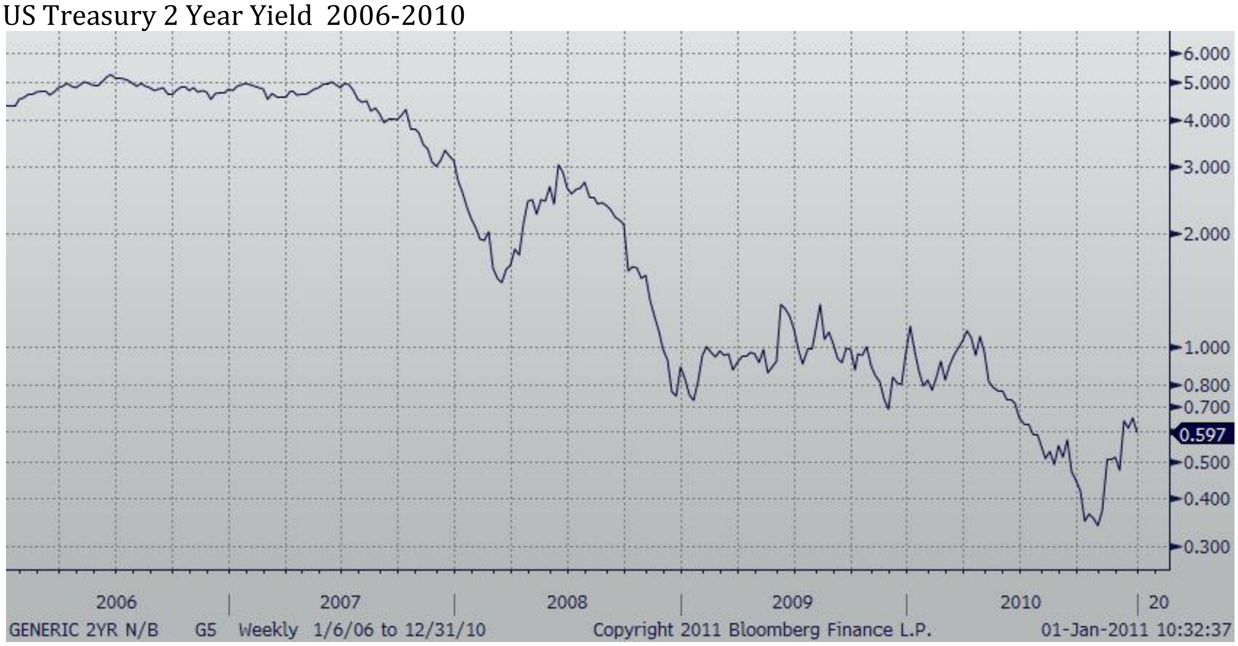
10 Year Bond Yields 2006-2010
BB rated(top line), AA rated(middle line), US Treasury(lower line)



Yield spreads have continued to narrow since early 2009. Treasury debt and quality corporates currently offer little value, and high yield corporates offer moderate value.

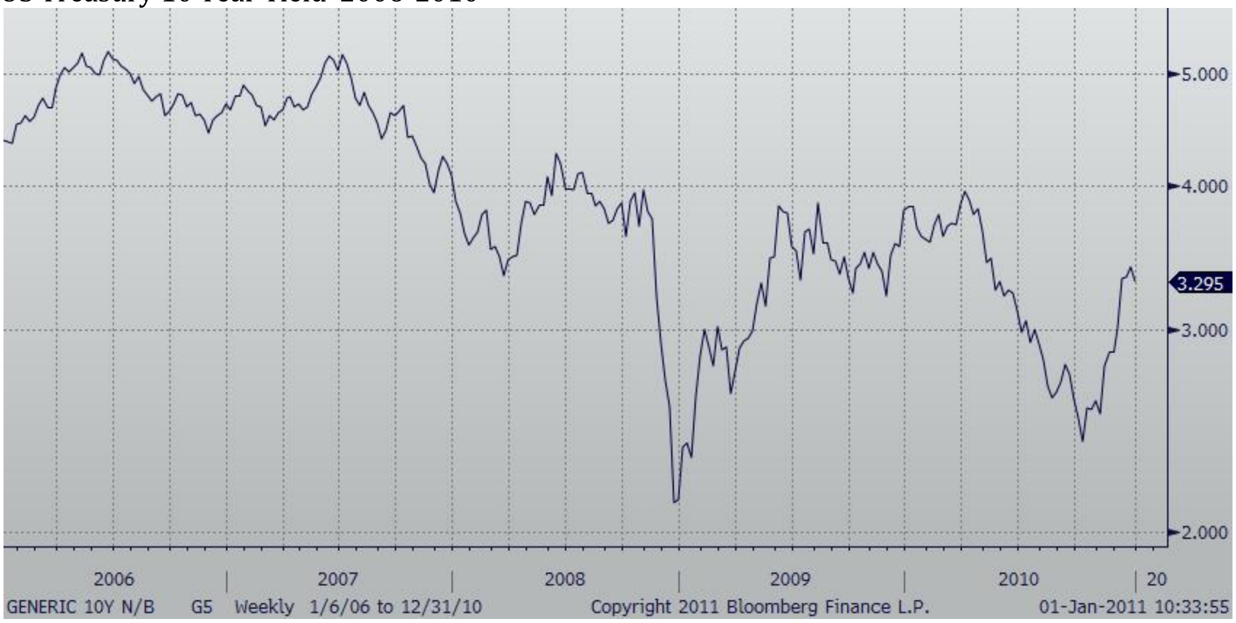
Short-term Treasury yields, with nowhere to go but up, finally bounced off their historic lows.

US Treasury 2 Year Yield 2006-2010



Longer-dated Treasury yields never threatened the lows of late 2008, and still represent a very poor risk-reward proposition.

US Treasury 10 Year Yield 2006-2010



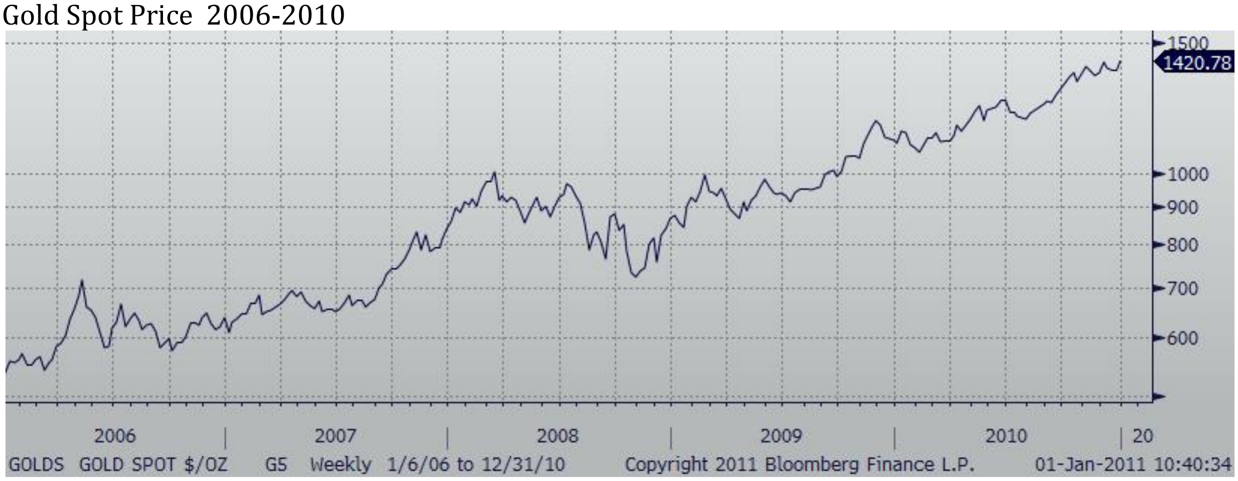
US Treasury 30 Year Yield 2006-2010

Commodities

CRB Commodity Price Index 2006-2010

Most commodities have been building strength since collapsing during the great recession, as indicated by the broad-based CRB Commodity Price Index.

Gold Spot Price 2006-2010



Gold has been leading commodities higher for years; talk of a gold bubble are premature.

Crude Oil Spot Price 2006-2010

When oil prices hit $100 per barrel, look for the familiar "speculators" excuse to reappear.

Currencies

US Dollar Index -- trade weighted basket 2006-2010

It is a great paradox that the US dollar is both a weak currency and a global reserve currency. Yet in a race to the bottom, the Euro and other currencies could weaken at a faster pace, creating the illusion of dollar strength.

Any claim that the US supports a strong dollar in the long-term is simply false, with the overall dollar devaluation since the US closed the gold window providing the best evidence.