

January 4, 2010

## Observations Regarding the Economic and Financial Market Outlook

**A notice to our readers: We have recently established a blog on our website, [mariettallc.com](http://mariettallc.com), where we will provide updates on our Outlook and timely comments on issues of interest to investors.**

There are no substantive changes to our October 1 *Outlook*. We continue to think the world economy is in the recovery stages of a multi-year expansion, which will grow progressively stronger and have a long-term trend rate of 3.5% to 4.0%. We also continue to predict that this expansion will be led by the leading emerging economies of China, Brazil, and India with growth rates ranging from 6.0% to 10.0%, and we continue to expect the expansion to be retarded by modest, subpar growth of 2.5-3.0% in the U.S., Europe, and Japan. In these forecasts we are now supported by *The Economist Intelligence Unit*, who foresee global GDP growth of 3.2% in 2010, 3.4% in 2011, and 3.8% in 2012 (cited in *The Economist, The World in 2010*). The expansion will bear resemblance to but not be as robust as the expansion of 2003-2007, yet we expect it to be strong enough to support a multi-year bull market, with intermittent corrections, in global equities.

Recent encouraging data in the U.S. has prompted us to bump our 2010 U.S. growth forecast to the upper end of our 2-3% range, but we are holding to our 1-2% GDP predictions for Euro area and Japan. As we pointed out in our October 1 *Outlook*, the major concern in the U.S. will be consumer spending, which will continue to be held back by high debt levels, high unemployment, and restrictive bank lending policies. Any recovery in the housing market is likely to be anemic, and banks will continue to be plagued with bad consumer loans, housing forfeitures, and a looming commercial property market crisis. Europe has many of the same problems as the U.S., particularly with high unemployment and shaky banks, and Japan seems to be hopelessly bogged down in a multi-decade slump. Envisioning a weak, jobless recovery in these 3 key economies, John Micklethwait, editor-in-chief of *The Economist*, has taken an appropriately British view in a sobering article titled *The Hard Slog Ahead*: "... subdued growth seems the most likely path next year; [but] it is enormously better than the alternative – heading back into the storm." (*The World in 2010*, 15).

Prospects in 2010 are considerably brighter for the leading emerging economies of China, India, and Brazil, where we forecast 2010 growth rates of 9.5%, 7.5%, and 5.0%. In past *Outlooks*, we have provided reasons for their superior growth during the past expansion, their outperformance during the global recession, and their projected booming prosperity in the future. The sharp contrast between the U.S. and China is especially striking. With car sales down in the U.S., China has emerged as the world's largest market for automobiles. In November, Chinese consumers bought more than 1 million cars, which was almost double the sales of the year before. Whereas the U.S. housing market is searching for signs of life, the Chinese real estate market is hot and prices are soaring. The Chinese government may need to take steps to prevent a bubble. Lastly, U.S. banks remain troubled and the number of failures will almost certainly climb in coming months; Chinese banks are enjoying a lending boom and non-performing loans are at a 10-year low. In late December, Li Fuan, Director General of the China Banking Regulatory Commission, boasted: "By number and by nature, our banks are stronger and healthier than at any time in history."

The key economic and financial market question going into 2009 was whether the massive and synchronized stimulus packages implemented by all major governments and central banks would stave off the global credit crisis, avert deflation and depression, and engineer an economic recovery. Our view last January was that they would be successful, and in the process launch a new bull market. Now that the global recovery is gaining traction, the major investment question heading into 2010 is whether these same policy makers will be able to exit their stimulus programs successfully and usher in a sustainable expansion. If they act too slowly and too cautiously, they risk fomenting inflation and creating

asset bubbles. If they act too quickly and too aggressively, they risk an economic relapse into recession. Either of these policy missteps could trigger a global equity market retreat. Our forecasts indicate that we think the policy makers will opt for growth. The determining factor, in our view, is that governments are convinced that recession, and especially deflation, is far more politically destabilizing than inflation. We expect central bankers to be subjected to intense political pressure to remain accommodative and keep rates down in 2010 even if it comes with the risk of higher inflation in 2011.

How will investment markets react to this new environment of rising interest rates and reduced government spending? We expect the stock market rally dating back to last March to slow considerably and possibly stall. There are several precedents. In the aftermath of the recession of 1990-1991, the Greenspan-led Federal Reserve in 1992 and 1993 kept federal funds at a low rate of 3-4% (down from over 8% in 1990) in order to create jobs and spur growth. During these two years, the Standard & Poor's 500 Index rose 12 % without a correction. With the economic expansion gaining strength and momentum through 1993, the Fed decided in January 2004 to initiate a restrictive policy that raised the fed funds rate 300 basis points to 6.1% in January 1995. The 3-year stock market rally halted immediately, and in 1994 the S&P 500 Index declined -1.5%. A similar pattern is evident following the 2000-2002 recession. In a determined effort to restore growth during this recession, the Greenspan-led Fed forced down the fed funds rate from over 6% in mid 2000 to a multi-generational low 1% by late 2002. As the economy began to recover in 2003, the Fed held short term rates around 1% waiting for job creation to put the economy on a solid footing. In early 2004, the Fed indicated its intention to be less accommodating and by November the fed funds rate was back to 2% and rising. The stock market rally, which had commenced in March, 2003 and risen 31% without a correction by the end of the year, promptly stalled: from early January through November, 2004, the S&P 500 Index was off 0.1%. There were already signs in December trading activity that investors are moving into a "good news is bad news" period; that is, when surprisingly good economic news increases fears that the Fed will raise rates sooner and higher than expected, which is bad news for the stock market.

The successful formula for U.S. common stocks in 2009 was to remain fully invested with an emphasis on the cyclical beneficiaries of economic recovery in the materials, consumer discretion, information technology, and energy sectors (see our *Review of the 4th quarter and Year 2009*). In contrast, investments in the large, blue chip stocks were mostly disappointing: the non-technology stocks among the 25 largest capitalization stocks in the S&P 500 gained, on average, a paltry 2.0%. Now that the investment landscape is changing, will the stocks that led the 2009 rally continue to be the top performers? In 1994, with uncertainty mounting regarding the Fed's higher rate policy, the previously overlooked blue chip stocks returned to favor. In 2004, on the other hand, investors continued to prefer lower-quality, more speculative securities and blue chips continued to lag despite the Fed tightening. The difference, in our view, is that the Fed was fairly aggressive in 1994 and more cautious in 2004. Thus, we think the deciding factor in 2010 will be the strength of the economic rebound on the one hand and the aggressiveness (or lack thereof) of the Fed to raise rates. In other words, we suggest that investors remain broadly diversified among industry sectors and investment styles pending a resolution to these issues.

We continue to recommend strongly a global perspective in equity portfolios. In its *2010 Investment Guide, Business Week* urged readers to "figure out where wealth is being produced in the world and grab a piece of it" and added that "going global is a good, sensible theme for 2010." Our understanding is that international stocks currently comprise only about 11% of U.S. investor equity portfolios, and a recent Business Week poll of U.S. investors shows that 40% of them expect to increase their exposure to international stocks. When asked by Business Week what country's stock market will produce the best returns in 2010, international investors picked China (22%), India (18%), and Brazil (18%) and finally the U.S. (only 10%). We frequently hear the opinion that Chinese stocks have gained so much in the frothy market of 2009 that they are no longer good investments; we point out that over the last 2 years the ETF that tracks the China 25 Index has slightly underperformed the S&P 500 Index and provides good value.

We are unenthusiastic about bond investments. The yields on bonds are relatively low, and yields typically rise (and prices fall) as economic expansions accelerate, inflation fears grow, and the Fed raises rates. U.S. Treasury securities, which set the tone for the broader bond market, are especially unappealing due to the Treasury's need to auction off over \$100

billion per month to finance the government's gargantuan budget deficit. We continue to prefer high quality, A-rated corporate bonds with 2-5 year maturities for tax exempt portfolios, and A-rated tax-exempt general obligation bonds with intermediate maturities for investors in a high tax bracket.

The strong performance of commodities received considerable attention in the financial media in 2009. We think that gold will continue to attract investors, but we expect the investment rationale to shift away from a weaker dollar and toward fear of future inflation. We also expect the price of gold to be supported by rising consumer demand, especially in Asia, and additional purchases by governments such as India. Oil prices are notoriously difficult to predict because supply is vulnerable to geopolitical and weather developments, but we expect demand to increase gradually as economies accelerate and keep an upward pressure on prices. A nearly insatiable demand for industrial commodities to complete massive infrastructure projects in China and elsewhere in Asia should elevate industrial commodity prices, and the growing ranks of the middle classes in the emerging economies should be beneficial for agricultural prices.

*We wish our clients and friends a happy and prosperous New Year!*