

Denver Business Journal - January 4, 2010
denver/stories/2010/01/04/story11.html

DENVER BUSINESS JOURNAL

Friday, January 1, 2010 | Modified: Sunday, January 3, 2010, 3:32pm MST

Economists issue predictions for 2010

The U.S. economy seems to be in recovery, and the stock market has rallied sharply off last spring's lows. But challenges remain. Business Journal finance reporter Renee McGaw asked local financial advisers about issues facing investors.

Denver Business Journal

How long can the Federal Reserve keep short-term interest rates at their current low levels before they have to deal with inflation?

Fred Taylor, Principal, Northstar Investment Advisors LLC: At a minimum, it appears to be for at least the next six months because Bernanke has signaled to the markets that the Fed is on hold until the economy starts to improve. However, this could change dramatically if GDP growth improves to the 4 percent to 6 percent range, which is exactly what happened to Alan Greenspan. Greenspan was late to raise short-term interest rates from the 1 percent level after GDP growth came in at over 4 percent in the first quarter of 2004. This error ultimately led to the speculative housing bubble, which popped at the end of 2007. Bernanke has to be incredibly careful not to make this same mistake.

Charlotte Petersen, Chief investment officer, Alexander Capital Management Group: Perhaps another six to eight months.

Gregory Robert Anderson, CEO, GRAnderson Wealth Management Group: Interest rates are likely to increase by the end of the second quarter in 2010. However, the bigger issue still appears to be that tight credit markets have not completely thawed for growing businesses. Until credit loosens, we probably don't need to worry about inflation strangling the economy.

John Trujillo, Senior portfolio manager, UMB Investment & Wealth Management: Right now, the economic numbers are exhibiting more deflationary concerns, so raising rates will be put off for the near term. We at UMB believe the Federal Reserve will start by letting programs of liquidity expire, which will be followed by a slow, measured increase in rates in mid- to late 2010.

John Goltermann, Senior vice president, Portfolio Management, Obermeyer Asset Management Co.: In our view, the Federal Reserve will likely be forced to tighten rates because commodity inflation will ignite before full health is restored to the U.S. banking system. Right now, a zero Fed funds rate functions as a massive subsidy to the banking sector to help cure its past sins, but the policy comes at the expense of both the frugal and risk-averse. This policy can't continue forever and we feel it will likely end sometime in 2010. The gold market is already telling us that the future purchasing power of the dollar is in question.

David Twibell, President, Wealth Management, Colorado Capital Bank: The problem for the Fed is that if they wait until they see inflation before raising interest rates and withdrawing liquidity, they will probably be too late to stop it. Even if they acted now, there would still likely be some inflation problems — the longer they wait, the more difficult it will be to deal with them.

Darren Markley, Managing director for Colorado, The Private Client Reserve at U.S. Bank: Approximately 75 percent of the inputs to the U.S. Consumer Price Index, a widely known inflation measure, are related to housing and employment. Neither of these inputs are currently putting pressure on the Federal Reserve's policymakers to change their stance on keeping rates low for the foreseeable future. Historically, policymakers keep rates at low levels, even in the face of potentially rising inflation pressures, as long as unemployment remains in an upward trend.

Brooks Rarden, Senior portfolio manager, Northern Trust: The Fed recently indicated they will maintain this very low-interest-rate environment for some time. Essentially, they are saying until the economy shows signs of stability, and sustainable positive GDP growth, be prepared to be in a low-rate environment. We don't expect inflation to surface for at least 12 months, but it could be for a longer time period, depending on the rest of the world.

Warren Olsen, Chief investment officer, First Western Trust Bank: I believe that the Federal Reserve has only another year to year-and-a-half of an effective 0 percent interest rate before it will be required to raise rates. Although a weak economic recovery and sustained high unemployment might argue against this, a weakening dollar could lead to an environment of both stagnant economic growth and rising inflation, or a period of potential "stagflation" similar to what we saw in the 1970s.

MEDIA



What does consumers' "new frugality" mean for company shares going forward? Which types of companies will gain or lose as a result?

Taylor: This new consumer frugality is bifurcated between the super wealthy and the middle class. Since the depression scenario has been taken off the table because of the tremendous improvement in the fixed-income markets and the massive stimulus plan by the U.S. government, the wealthy are spending money again but looking for a bargain. The middle class is paying down debt, saving more and shopping at discounters. Both the luxury high-end stores and the low-end retailers should benefit as long as these companies are price-conscious and can operate without a lot of extra inventory or employees. This is why unemployment could stay above the 10 percent level for much longer than economists expect, and keep the Fed on hold in terms of raising short-term interest rates.

Petersen: Remember the story of the grasshopper and the ant? Consumers' "new frugality" is being externally imposed. If the economy continues to improve, we suspect the grasshopper will return, bloodied but not bowed. The heyday for the American consumer has passed, but there is room for improvement on the value and luxury ends of the spectrum. Companies that cater to the middle are less attractive.

Anderson: "Getting back to basics" is the new mantra for investors. The winners include basic materials, utilities, energy and technology, as these sectors become the essential drivers in the economic recovery. The losers will be consumer-discretionary and health care because of reduced willingness to take on consumer debt and uncertain regulatory reforms respectively.

Trujillo: Consumer prudence is a concept we as a nation have been forced to re-learn, and this necessarily will decrease spending. However, this does not imply that we are worse off — rather, it's quite the opposite. In times of reckless spending, the price of assets become unrealistic, and with the ease of financing, consumers just paid more and more. This leveling of spending will likely lead to more accurate pricing, and consumers will be far better off as a result. The companies that gain will focus on pricing and efficiency, and refine their business model to account for the economic landscape.

Goltermann: It means that industries that are in overcapacity and depend on the expansion of credit will face very strong headwinds. Conversely, industries that are capacity-constrained and produce goods necessary for basic needs will likely have a tailwind. Industries with too much capacity include automakers, real estate, financial services and many technology companies. Capacity-constrained industries include health care, utilities, global infrastructure, and energy and agricultural production. The days of momentum investing and speculating in the stock market are probably over for a while, and the days of investing by applying the fundamental principles of finance are back.

Twibell: It is unlikely U.S. consumer spending comes roaring back [in 2010] for a variety of reasons. Foreign consumer demand is likely to be much more robust, though, particularly in emerging and frontier markets. U.S. companies that can tap into this growth should do well going forward, particularly if we continue to see pressure on the U.S. dollar.

Markley: Consumers in the U.S., and in most developed countries, have pulled back their spending and continue to stay on the sidelines. Their spending is focused more on companies and products that appear to provide value at the right price, with commodities, staples, etc. This contrasts sharply with the consumers in emerging market economies (Brazil, Russia, India and China) who have become the drivers of consumer spending, economic growth and recovery.

Rarden: Consumer "frugality" simply means retail and consumer America will struggle with top-line revenue. Corporate America is very efficient. It has had to find every nickel in the company in savings to survive over the past two years. That part is done, so the next challenge will be prices. This helps, in part, to keep inflation under control as well.

Olsen: As always, and in any environment, companies that can size their cost structures to protect appropriate profit margins and demonstrate a continuing value proposition, as opposed to selling only on lowest cost, will thrive. Companies with bloated infrastructures and bureaucratic decision-making processes that preclude decisive action will lose.

Given the stock market rise we've seen since March, is a correction likely? If so, how bad will it be?

Taylor: Even in new bull markets, corrections of 5 percent to 10 percent should be expected and welcomed. This 60 percent bull market rally in the S&P 500 index since March 9 will be no exception. Bull markets always climb a proverbial "wall of worry," which means that there will be negative surprises for the markets, but the good news should continue to outweigh the bad. However, investors still face a lot of uncertainty going into 2010 in the form of a weaker U.S. dollar, massive government debt with weekly bond auctions at potentially higher interest rates, and rising unemployment. These fears will cause corrections from time to time that could last a few weeks to a couple of months. Nonetheless, on a relative basis, large-cap dividend-paying stocks are attractively priced compared to the 10-year U.S. Treasury bond yielding only 3.6 percent. This is especially true if you have a regression to the mean, since large-cap stocks lost money this past decade and were the worst-performing asset class.

Petersen: A correction of 10 percent to 20 percent is quite possible, but the lows of March will not be tested.

Anderson: We have seen a great rise in small and mid-cap stocks this year. However, the larger caps have lagged behind. As the waters become choppy in the coming months, investors will move to higher-quality stock issues. That movement toward the "safe" haven of large-cap companies could help offset the propensity for the market to experience a correction.



Trujillo: Historically there has been anywhere from a 5 to 10 percent pullback following large market increases. This is an average, so any pullback, if there will be one, could be lower or higher. The important issue to remember is that a healthy market will always test highs and lows to find the appropriate level. This market mentality has been the driver of our economy and, if let alone to work without too much intervention from outside, the market will move toward correct pricing.

Goltermann: A big sell-off is always a risk from any level. This year's rally has been a function of the government's success to date in re-liquifying financial markets, but whether that liquidity stays in the U.S. to keep local asset prices propped up is an open question. Capital will remain in areas where it is treated with respect, and our fear is that political factors might get in the way of the global appetite for U.S.-based assets. It's a very tricky time to be an investor because of the political uncertainty and rising populism in the U.S.

Twibell: At some point we will have a substantial correction; the real issue is when and from what level. If the economy continues to improve, we could see markets move higher during the first part of [2010]. But if the economic data starts to soften, or if the Fed starts to aggressively raise interest rates, the downside could be substantial.

Markley: The recent rise in the stock market has been a welcome relief to investors even though many individual investors remain cautious, expecting a pullback at any moment. Institutional investors have been the larger benefactors of the rally, having moved into equities (and other risk assets) over the past several months. Unfortunately, a turning point in the stock market, downward, will likely coincide with individual investors finally "believing the rally" and getting in at the wrong moment.

Rarden: We don't expect a correction. This recent market recovery is right out of the textbook. Yes, the size may be larger than the typical bear market/correction, but the timing and the recovery were right on schedule. The market started to move six to nine months ahead of GDP growth, as has historically been the case. We do, however, believe the equity market will trade in a band over the next six to nine months until consistent and sustainable growth is confirmed.

Olsen: If the last couple of years have taught us anything, it's that the stock market does not move in a linear fashion, and there is no one who can consistently, accurately predict short-term moves, including corrections. Investors who try to find peaks and valleys (which can be only determined in retrospect) consistently underperform. I don't believe investors should focus on potential corrections, but they should maintain a disciplined, long-term focus, looking at fundamental valuation for stocks.

What investment sectors likely will perform best in 2010?

Taylor: Surprisingly, health care may be the best-performing sector in 2010 because of the passage of the health care bill. Once that cloud has been lifted, investors could be attracted to large pharmaceutical companies that pay solid dividends and have cheap historical valuations. Technology, energy and materials sectors also could do well if China, India and Brazil continue their rapid growth rates and the middle classes in these countries demand a higher standard of living from their governments. Large U.S. companies that export 30 percent to 70 percent of their products overseas should benefit because of a weaker U.S. dollar, their ability to sell corporate debt in the fixed-income markets, and no competition from new companies because banks can't make loans to small businesses.

Petersen: Initially, later-cycle sectors with above-average exposure to foreign economies such as technology, industrials, materials and energy should be leaders. It's too early to make full-year projections.

Anderson: We continue to see additional opportunities in energy and real estate. Both sectors have lagged behind the rest of the market. Valuations are down, but with an economic recovery comes stronger returns in these sectors. The demand for energy on a global scale is much stronger than in the past, and commercial real estate will benefit from a stronger economy as well.

Trujillo: UMB will continue to focus on late cyclicals in 2010. Specifically, we would overweight information technology, energy and industrials.

Goltermann: Because of economic liberalization in the developing areas of the world that have billions of people, assets that enable standard of living improvement in these areas are the most attractive investments. These include global infrastructure firms and select energy/ natural resources producers (specifically those with unhedged energy and base-metal reserves in politically secure areas). This is a multidecade thesis, so it requires patience and diligence on the part of investors. Our approach is not to identify investments that will perform well in just one year; we instead focus on identifying those companies that are well-positioned to benefit from sustainable global trends over the next five to 10 years as liquidity, relative currency moves, and emotions/perceptions can negatively affect high-quality assets in the short term.

Twibell: This depends on the economy, but assuming we see world economies continue to strengthen next year, technology, energy, base metals, and international stocks and bonds all should do well. Absent an economic tailwind, though, it will likely be tough sledding for most sectors. **Markley:** We see sustainable growth occurring overseas in emerging market economies, and see a strong connection to this and success in the commodities markets. We also favor hedging strategies across all asset classes to take advantage of markets moving both up and down.

Rarden: Technology has already shown to be the strongest sector.

Olsen: I think equities will outperform bonds in 2010, and higher-quality equities will outperform lower-quality equities. I also think that high-quality international equities will perform very well in 2010 in U.S. dollar terms.

Should investors be concerned about the federal deficit?

Taylor: In the short run, no; in the long run, very much so. The U.S. government had no choice but to provide massive amounts of

liquidity to the banks and insurance companies in this country. They also had to restore investor confidence in the credit markets and in the money market funds. Had they failed to do, so this country would have faced another depression in the form of a run on the banks, a collapse in the stock markets here and around the globe, and a return of the protectionist policies of the 1930s. On the downside, these large deficits will cause a weaker currency and a possible downgrade of our national debt. Both of these outcomes will make our interest rates go much higher in order to attract buyers of our debt, and saddle our children and grandchildren with trillions of dollars in budget deficits far into the future.

Petersen: That's a \$64,000 question because the answer is "yes," but the "when" is unknown.

Anderson: Yes, investors should be concerned, because we will have to pay for the federal deficit via higher taxes — as will our children and children's children. Higher taxes will sap the capital that could have gone toward continued economic growth.

Trujillo: Yes. Excessive debt does not support strong economic growth.

Goltermann: Yes. The reality is that the size of the national debt can't be serviced by the tax base alone. We've done the math and feel that the only way that it can be serviced is by printing money, meaning that hard goods could adjust upward significantly in nominal terms. Those investors whose portfolios are over-weighted in dollar deposits could suffer disproportionately in real terms.

Twibell: Absolutely. The projected deficits are staggering and will almost certainly lead to higher interest rates and inflation if left unchecked. Neither outcome is particularly good for most investors, particularly those with substantial bond holdings.

Markley: Not yet. Deficit spending has been necessary to stimulate the U.S. economy. As the recovery progresses, we would expect the deficit to subside. Excessive deficit spending may result in higher long-term interest rates, a dramatic drop in the value of the U.S. dollar and a decline in foreign purchases of U.S. debt.

Rarden: Investors (and everyone else for that matter) should be concerned with the federal deficit. The size and recent growth of it should cause anyone to be alarmed. On the other hand, since borrowing rates [for the government] are relatively low, we can survive this for a short time. The concern ramps up when interest rates begin to increase, and spending has not subsided.

Olsen: Yes, right now the U.S. government can finance huge deficits, because there is no place else for major lenders such as the Chinese government to place money, and the Chinese need to finance our consumption of their products. If the deficits continue to grow at this alarming pace, we are going to reach a tipping point where the dollar essentially gets downgraded as the world's currency, forcing much higher interest rates and adding to an already significant interest-rate burden.

What economic indicator are you watching most closely now, and why?

Taylor: There really is no single indicator to watch to determine whether to invest in the stock market or not. There are several that are important. The most obvious ones are: the Fed Funds interest rate; the unemployment number; the prices of gold, oil, and copper; monthly GDP and CPI reports; the strength of corporate earnings; investor sentiment surveys; the 10-year U.S. Treasury bond rate; and the leading economic indicators coming out of China-India-Brazil. On any given day, these various indicators can move the stock and bond markets here and around the globe. We are truly living in a flat world, and events like 9-11 or the recent Dubai debt crisis can roil markets everywhere in a nanosecond.

Petersen: We're watching the components of the various employment reports. There has been good progress in initial unemployment claims, but we need to see follow-through on continuing unemployment claims, household employment and the length of the average work week, to name a few indicators.

Anderson: We continue to view employment as a key indicator, followed by housing. In the past, these two indicators have provided an insight into the imminence of economic recovery. Without strong employment, the economy languishes at best. Without strong housing, we lack the cash flow that allows an economy to thrive.

Trujillo: We at UMB are watching several economic indicators, as any one does not tell the entire story. However, if I were to pick one we watch closely, it would be the 10-year Treasury, as it is a market indicator of the direction of inflation. The erosion of wealth through inflation and reduction in purchasing power is a primary concern for our clients.

Goltermann: Because there is often a disconnect between current economic activity and future asset returns, we pay more attention to liquidity as an important variable for future investment returns. To that end, we look at developments within the credit markets for signals of improvement or deterioration like the TED spread, the Euro/Yen cross and the KRE index. On the economic side, the Baltic Dry Index provides an interesting data point, but no single data point in isolation has any predictive value. We are also aware that the unemployment rate drives Fed policy because it has become politicized.

Twibell: We are watching two indicators very closely: the TIPS spread (the difference between yields on fixed-rate Treasury bonds and inflation-protected bonds) and the U.S. savings rate. The former will help give us a better idea on where inflation is headed, and the latter will give us a sense of whether U.S. consumers are going to start spending again. **Markley:** The headwaters of global economic activity have come largely from a globally synchronized set of government stimuli. Therefore, while normally not a market indicator per se, watching Federal Reserve and central market policymakers' actions and posturing will be an excellent near-term indicator for the markets. Data reflecting the direction of the housing market and changes in employment will indicate economic health or ills for investors as well. **Rarden:** Unemployment is the key right now. Not that it is the marquee indicator, but when the unemployment rate is 10 percent, and the underemployment rate is over 17 percent, this means revenue will be sluggish, and hence earnings will be lighter. Offsetting this

to some extent is the globalized nature of the economy. A diversified economy is better than one dependent solely on one or a handful of economies.

Olsen: Employment figures. Unemployment is a huge political issue for an incumbent party, currently the Democrats. I am very concerned that the administration will do economically stupid things to try to artificially help employment for politically expedient reasons, especially with midterm elections fast approaching. We have already seen an example of this with the auto industry bailout.

All contents of this site © American City Business Journals Inc. All rights reserved.