The Good, the Bad and the Ugly.

The end of one year and the beginning of a new one is typically a time when market strategists flood the airwaves with their Top 10 lists of predictions for the coming year.

We are often asked to do the same but find mixed value in the exercise. On the positive side, it’s an opportunity to step back and take stock of where we’ve been and where we’re going, and to think forward for a longer span of time than the typical 24-hour news cycle.

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Is 2011 going to be another good year for the economy and financial markets? Probably, but this is not a very useful question. The answer involves a range of crosscurrents from good to bad to ugly that will play out through the course of the year. A lot can change between now and December 31st, and we would prefer to focus with the here and now in the context of these longer-term currents.

Based on what we observe today, we suspect that in the near term, the good – economic recovery and increased confidence - will continue to outweigh the bad and the ugly – inflation, sovereign and municipal debt.

This should be positive for the U.S. economy and stock markets, as well as for developing economies and markets, at least for a while longer. Europe will have a tougher time as austerity measures kick in and sovereign debt challenges
build. It should be a less favorable environment for bonds and other fixed income instruments that are sensitive to both rising interest rates and a loss of purchasing power. The municipal bond market may be especially dicey as more communities face liquidity and solvency problems.

The Good.

2010 was a much better year than many people, including ourselves, had expected. We started the year on an optimistic footing, but Sovereign debt worries in Greece spilled over into a larger crisis which by mid-year, had economists and investors worried about a full-blown European credit contagion, the demise of the Euro and even the European Union.

In the U.S., Economic fundamentals continued to improve throughout the year, although more in some sectors than in others. But by early July, the arc of improvement looked to be slowing. With the first round of quantitative easing due to expire, concerns about a double-dip recession brought investor confidence and the equity markets to the low point for the year.

Because of these concerns, in August, Ben Bernanke and the Federal Reserve came to the rescue, announcing a new $600 billion quantitative easing initiative (aka QE2) and giving new meaning to the term “Freedom of the Press.”

The announcement had an immediate and positive effect on both the stock market and on the broader economy. Since August, the stock market has rebounded 20% and, more importantly, most economic indicators have shown a robust upswing.

The November election and eventual extension of the Bush-era tax rates have also engendered a more constructive tone in Washington and beyond. Regardless of the merits of the tax code or Health Care Reform, there is at least a greater sense of clarity upon which individuals and businesses can make decisions. The devil you know is better than the one you don’t.

There is also, at least for the moment, a more positive attitude in Washington towards business. This is a requisite ingredient for new investment, new hiring, and for a sustainable recovery.

The economic recovery in the U.S. has been broad-based, with the industrial, technology and consumer sectors showing strong improvements in final demand, at home and abroad. Consumer discretionary spending has been especially impressive.

Outside the U.S., the divergence between
developed and developing economies continues to grow. China just reported GDP growth of a whopping 9.8%. Although Chinese government statistics are to be taken with a big grain of salt, as are our own, the growth is impressive. Too much growth is a higher-class problem than too little, as is the case in Europe where growth is slowing as debt-laden countries embark on austerity programs. The one standout is Germany, whose economy grew 3.6% last year. It is doubtful that Germany can keep this up as long as it is inextricably tethered to its heavily indebted neighbors.

Companies in the U.S. and around the world are in good health. Over the past two years they have paid-down or refinanced their debt, cut costs, and streamlined operations. They have also stockpiled trillions of dollars in cash reserves. If the recovery continues, we expect companies to put that cash to work in the form of increased capital spending, acquisitions and buyouts, share repurchases, and distributions to shareholders.

Credit and financial markets have also improved, at least in the corporate sector. Reuters reports that there was over $2 trillion in Mergers and Acquisitions in 2010, the highest level since 2007. Dozens of companies went public, and corporate bond issuance also topped levels not seen since 2007. With the flow of credit and capital restored to worthy borrowers and a renewed appetite for risk and opportunity, venture capital and private equity firms are back in the game, looking beyond the next shoe to drop, to the next big deal.

To be sure, much of the domestic recovery is based on artificial and unsustainable stimulation. We are still trying to borrow our way out of debt, as are the Europeans and Japanese. At some point soon, Quantitative Easing programs will reach diminishing returns, if not a point of no return, and someone besides the sovereign governments of the world will need to buy all the debt, both new and reissued, and they will likely demand a much higher interest rate than the Federal Reserve.

But much of the recovery is also based on real demand and real growth in the developed and developing world economies. Many companies throughout the economy are posting record profits and sales, well in excess of their pre-crash levels. So far, the fourth quarter earnings season is off to a strong start.

The $64 trillion dollar question is whether the debt-laden developed economies will be able to run under their own power and support their debt loads once the stimulus ends. We doubt it. Eventually, public debt will need to be repriced or restructured. It’s not a question of whether, but when and in what form.

In the mean time, the flood of monetary medicine continues to find its way into the capital markets, producing both desired and unintentional consequences. Long term interest rates remain artificially depressed, stock prices are rising, and the engines of economic growth are revving faster.

The Bad:

Which leads us to the not so good.

Housing and employment remain two stubborn problem areas in the domestic economy, although housing is stabilizing and employment is improving.
We expect the housing sector to take a long time to recover. There is a large excess inventory that needs to work its way through the system. On the positive side, it’s a great time to buy a house, especially if you can borrow cheaply and lock in rates for a long time. The money you owe will very likely become worth less and less relative to the value of the property, which should increase.

Employment numbers are gradually getting better. Private sector job growth has moved back into positive territory although not at a level where it is making much of a dent in the unemployment rate. We expect the pace of change to pick up this year.

Temporary hiring has been very strong over the last twelve months and it tends to precede permanent employment growth by one to two quarters.

Inflation is a growing concern, especially outside of the U.S. Although it hasn’t yet shown up in the official numbers which are skewed towards wages and housing, agricultural commodities, energy, metals and other raw materials costs have risen steadily over the past year. Some of the trillions of dollars of stimulus coursing through the world’s financial markets are finding their way into commodities, driving prices sharply higher. Although it’s still a rather benign problem here, it is causing unrest in other parts of the world as people struggle to deal with shortages and rapidly rising food prices.

The final “bad” factor is that investors are becoming increasingly complacent about risk. Optimism and greed are rising with the markets. While this is as it should be and valuation levels are not alarmingly high (The S&P 500 is 13 to 14 times our estimated earnings for 2011 of $94.00), stocks are also, by and large, no longer cheap. The stock market is therefore more vulnerable to the ugly shocks that routinely come along while everyone is thinking pretty thoughts.

The Ugly:

Which leads us to those big unpleasant elephants in the room that everyone is hoping will just go away and yet clearly can’t fit through the door in their present form.

The two most obvious elephants we see are the Sovereign Debt problem in Europe, and the public debt problem in this country, especially at the State and local government level.

The European debt mess is not over by a long shot. We have written about it extensively in past commentaries and won’t dwell on it here. The question is not, in our opinion, whether countries like Greece, Portugal, Ireland and Spain will default, but how and when. We noted above that Germany is growing strongly, but German banks are loaded with troubled loans from troubled countries. Germany cannot possibly carry the weight of the European Union on its shoulders. Nor can it easily extract itself from the E.U. without causing an economic chain reaction and wreaking havoc in its own banks. So for now the political solution is to kick the can down the road, but time is running out. Problem debt will have to be written off and restructured to put the system back on solid footing, but the European banks are not ready to absorb these losses yet.
At home the municipal bond train wreck is starting to occur in slow motion. The conventional wisdom is that everything will be just fine. States have rarely if ever defaulted on their debts since the founding of the Country. Besides, the Federal Government will most certainly bail them out. But States have not been in this bad a situation since the great depression, if not before that, and public support of bailouts is growing thin, especially to support rich benefits that most private sector employees would kill for.

State and local government spending represents 12% of GDP in this country. State tax revenues, which are heavily tied to housing, are down about 12% from their peak and cannot realistically keep up with the hemorrhaging benefits liabilities to state employees.

Something has to give, and so it is. Governors like New Jersey’s Chris Christie and even California’s Jerry Brown have announced bold budget cuts. Meanwhile Municipal Bond investors are getting worried and starting to sell.

Our fear is that this may quickly become a disorderly process where perception trumps reality. But even if many municipal bonds are likely to return full value at maturity, between now and then we could see turmoil as the drama plays out in the media and holders of municipal debt head for the doors. As selling pressures build, borrowing rates go higher, only making the stresses greater.

**Investment Strategy: Sink, Float or Swim.**

For now, the good is likely to trump the bad and the ugly and stocks should grind higher, both on the strength of the recovery, improved investor sentiment, and as bond investors seek better returns in the stock market.

We also see inflation and rising interest rates trumping deflation as the dominant trend and challenge. We therefore favor assets that have the ability to float or swim, (i.e. maintain or increase their intrinsic value) such as commodities and stocks, versus those that don’t or can’t, such as bonds.

Stocks are attractively valued, especially in certain sectors, and especially relative to bonds. We have increased our allocation to domestic equities, with a focus on industrial cyclical and technology stocks.

We still find the developing economies attractive. They have come under pressure over the past few months as investors worry about China overheating, but the longer-term potential of developing economies is enormous and we want to maintain a significant weighting towards them.

Although Europe and Japan both have challenges, many European and Japanese multinational companies are attractively valued and will also benefit from global growth.

Commodities and resources are also an important part of our strategic asset allocation, both as a store of value and inflation hedge, and as a beneficiary of global growth. There are simply more people in the world competing for a limited amount of scarce resources including food, water, energy, and metals. Global growth should be good for commodities.

The defensive portion of our model includes gold, bonds and cash.
Our bond allocation is primarily divided between domestic corporate bonds, emerging economy bonds, and treasuries, with a strong focus on shorter maturity holdings.

Corporate bonds, both investment grade, high yield and bank loans, offer reasonably attractive yields against a backdrop of improving credit quality.

Emerging economy bonds offer similar or better yields than domestic bonds, with improving economic fundamentals and undervalued currencies.

As we noted above, with Municipal bonds, we do not foresee a significant amount of defaults, particularly at the state levels. Nevertheless, these investments face many headwinds from rising rates to possible credit rating downgrades.

We do not feel the valuations on Municipal bonds are compelling enough (yet) to want to have a meaningful position. If the worries get overblown, an opportunity may present itself.

Finally, we hold a cash position to both act as a cushion and to provide capital for new investment when opportunities present themselves.

The following is a summary of our current portfolio strategy:

**Lean towards stocks:**

- Favor high quality over low.
- Favor industrial cyclicals and technology and other growth areas.
- Favor Asia and developing markets.
- Favor deep value in Europe and Japan.

**Lean away from bonds:**

- Avoid intermediate and longer-term Treasuries.
- Municipals have a lot of headline risk. Perception is worse than reality, but avoid the train-wreck for now.
- Emphasize shorter-term corporate bonds, bank loans and high-yield.
- Emphasize developing and resource-rich developed economy bonds.

**Lean towards commodities:**

- Maintain exposure to gold as a currency and inflation/deflation hedge.
- Maintain exposure to other commodities including industrial metals, energy and agricultural products that can hold intrinsic value and benefit from global growth.

**Maintain cash as a defensive cushion and for opportunistic investment.**

**Concluding Thoughts:**

For 30 years, the investment landscape was “relatively easy” as the U.S. stock markets seemed to go nowhere but up and bonds were assumed to be safe. Most typical investment portfolios consisted of primarily domestic stocks and bonds.

The world has changed. Investment strategy needs to change with it.

Countries around the world are facing a plethora of changes and challenges over the next few years. Many “blue chip” economies
are now faced with significant structural and competitive challenges that may hamper growth for years to come. Emerging economies are becoming highly developed and are growing rapidly. Financial markets and economies are global and more dependent on each other for better or worse. Interest rates have been artificially depressed by unprecedented monetary policies around the globe. Powerful forces of innovation are also at work changing the way we think and work, providing solutions to problems, reshaping industries and creating new ones.

Portfolios need to reflect these changing conditions and not just blindly follow historical notions that stocks appreciate and bonds are safe. At times, this may be true and at other times, these truisms may be completely false.

It is therefore critical to position investments to both take advantage of rising markets and protect from adverse ones.

Our approach is to develop a sensible and forward looking view of the world and allocate client portfolios selectively across the global capital markets according to this view and their specific needs and objectives.

We focus on areas of improving conditions and reasonable valuations while trying to avoid or underweight deteriorating conditions and extreme valuations. While we believe in diversification, we do not believe that we need to be allocated to every investment category, or to mimic conventional, backwards looking benchmarks. We want to be focused in the most strategic areas relative to our clients’ needs and objectives.

On behalf of the entire team here, we wish you a healthy and prosperous new year and if we can be of assistance with any of your investment needs, please don’t hesitate to call us.

Jurika, Mills & Keifer.