



## A Stock Pickers Market

"It's the beginning of a new year, traditionally a time when investment managers make their forecasts for the next twelve months. It's a bit of a mugs game but the reality is you have to have a view on the prospects for the future if you're going to make sensible investments.

So, let me declare that I'm bullish in that I believe what we buy in 2009 will be cheap and will set us up for compelling returns going forward. That doesn't diminish the prospects of further declines in this market as it reacts to bad news, but I think one wants to take advantage of the sell-offs from this point forward.

So why be bullish now you might ask, isn't the economy going into the tank?

Yes it is, and badly, but there is also an enormous pool of liquidity sitting on the sidelines, and in my experience "liquidity" wills out over "economic statistic."

January 12, 2009

Well, that wasn't a bad way to start off last year, but here we are again with the same annual challenge of making forecasts for the new year.

So, let me get my expectations, note I didn't label them forecasts, off my chest right upfront, and then I'll try to support some of them with the facts as I see them.

But remember, markets rarely play fair; there is always the unanticipated that can render a reasonable set of predictions unrealistic. So, I'll also take a stab at some possible surprises, by definition low probability events, for 2010.

Expectations for 2010:

- The stock market is likely to get choppy and could finish the year modestly lower.
- The economy continues to improve at a rate that exceeds most predictions.
- Interest rates rise modestly.
- Inflation picks up but is still considered acceptable.
- The U.S. dollar continues a shallow decline but mostly against Asian, and those currencies tied to resource-rich economies.
- Gold moves higher as an alternative to paper currencies, but not substantially.

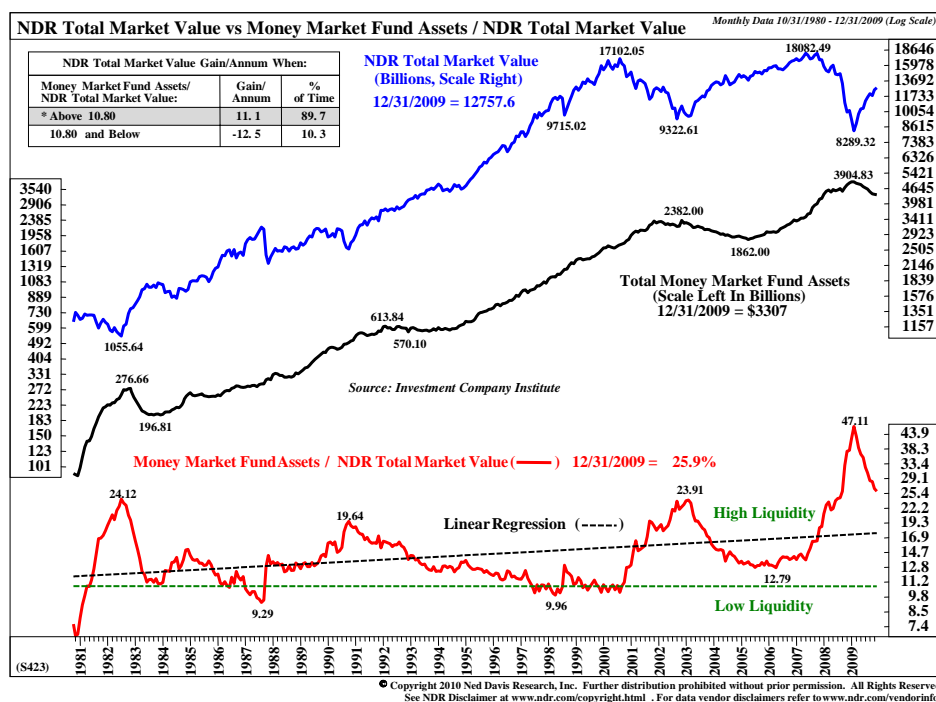
Now, let me elaborate on some of these expectations.

## The Market

Last year was a one decision market. You only had to decide whether you were in or not. If you were a buyer you did well, almost irrespective of what you bought. The disparities in performance were almost counterintuitive. The junk, debt laden and perceived broken companies, mostly small caps, did the best. While higher quality companies did well, they couldn't keep up with those who threw caution to the wind. But this year will be different.

As I said in 2009, liquidity trumped economic statistics. By last March, investors had liquidated billions of dollars of investments, consumers were paying down debt, corporations were paying off their bank loans and the government maintained a very stimulative monetary policy. At the same time, short-term investments yielded basically nothing, encouraging risk taking for better returns.

Liquidity was as good as it gets as the economy was in net liquidation as inventory levels were brought down and employees were being laid off.

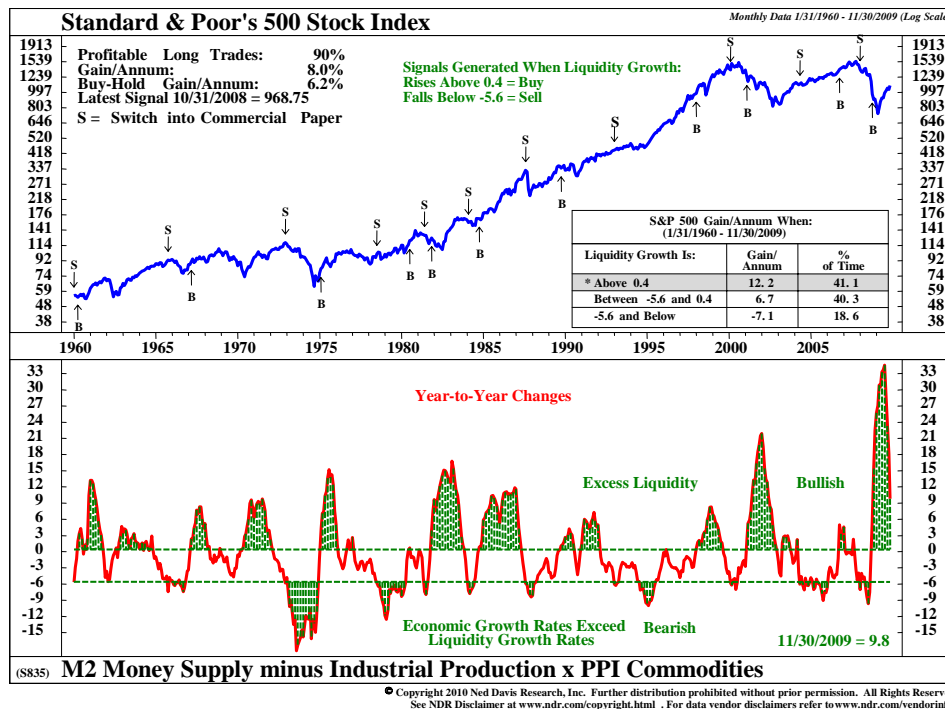


I used the above chart repeatedly last year. It shows money market funds peaking at \$3.9 trillion, and that doesn't include savings accounts, or directly held short-term investments, which probably pushed this number over \$10.0 trillion.

At the peak, cash in money market funds amounted to 47% of the value of the market.

Today, the statistics are still positive and in my estimation they probably provide a cushion against any significant decline in the market. But as one can see, money market funds are down by \$600 billion, a lot having gone into the bond market. Although money market funds now represent only 26% of the value of the market; that is still high by historical standards.

For this year, I think the chart that we need to watch is one at the top of page 3.



It measures the amount of liquidity being taken up by the economy, which will now compete with the stock market for the excess funds. You can see the same peak in liquidity back in March and also how much it has been drawn down by expanding industrial production adjusted for the price of commodities. If the economy grows at an above normal pace, which I think is possible, excess liquidity for the market could be a problem. Under these circumstances, one could expect the Fed to raise interest rates, also putting a damper on this market. As I have repeatedly said, liquidity will trump economic statistics in terms of its impact on the stock market. Thus, my cautious outlook!

This year, I think the market will get choppy. Last year, it was a recovery from desperation pricing and the primary driver of corporate earnings was improved profit margins as expenses were cut to the bone. 2010 will be all about revenue growth, and that is dependent on the economy transitioning from the one time impact of inventory rebuilding to something more sustainable.

My expectations are that the market won't trend higher as it did last year, but instead it will get tougher as it will be a "stock pickers" market, much like we saw in the 70's. Those of us who stick to solid, value style investing will do well.

### The Economy

Almost all of the statistics are pointing to an improving economy. This shouldn't be a surprise. It is important to understand that the severity of the market meltdown and recession was liquidity-driven, not solely a bunch of bad mortgage loans.

As lending and especially the securitization markets recover, which they are, they will breathe further life into the economy. Just think of someone who would like to buy a car but can't get financing. As leasing facilities return, he will be able to make that acquisition. In my opinion, there is still a base line of consumer and business demand that could be satisfied if financing was available.

Last quarter, I predicted higher than expected GDP growth, which after the third revision, didn't happen, but it was still a respectable 2.2%. The surprise was that inventories didn't build as I expected. Production was up significantly but consumption was even stronger, which was unexpected. As an example, in the auto industry, November sales improved to 10.9 million units annualized from 10.4 in October. That's weaker than September because of the lack of inventory. Yet, domestic production was only 6.8 million units in October while domestic sales were 7.9 million.

According to Ed Yardini, one of our favoured economists, if inventories are flat and final sales also stay flat, real GDP would be up 4.4% in the 4<sup>th</sup> Quarter. Any improvement in sales or inventories could push this number over 6%. Too optimistic? Well of the last 6 recovery cycles the average improvement in GDP for the 1st Quarter, when inventories turn, was 6%.

This latest inventory correction cycle started 5 quarters ago and is the longest on record. It should turn in the 4<sup>th</sup> Quarter of 2009 and usually continues for 2 to 4 Quarters. The key to a sustainable economy expansion is for increased consumption, which should occur with a longer work week and improved employment, something we started to see in the 4<sup>th</sup> Quarter.

If this economy is to really get cooking it will depend on small businesses being able to get financing from the banks, which right now isn't happening. If they do and can expand, employment should pick up further as 80% of non government workers are employed by companies that employ 500 or fewer workers.

In December, President Obama met with the banks to complain about this situation. Shortly after, the Bank of America said it would increase lending to small and mid-sized business by \$5 billion this year, compared to 2009. Wells Fargo said that it expected to increase lending to small business by as much as 25% to more than \$16 billion.

Yes, I know the arguments put forth by the "naysayers". America has too much debt and will have to save more, curtailing spending, that banks aren't out of the woods yet and will further constrain lending as the commercial real estate markets continue to deteriorate, and that government stimulus will be withdrawn as home-owners tax credits are withdrawn and the Federal Reserve backs off on its stimulative monetary policy, etc.

It's all true, but similar risks have been present during other recoveries only to be overcome by self sustaining economic growth.

In my opinion, if these concerns are for real, they will be a factor in 2011 rather than this year, which is another reason to be cautious on where this year's market ends as it starts to discount the economic prospects a year from now.

The balance of my expectations are pretty common to most forecasters; so they don't deserve to be elaborated on.

On balance, my greatest concern is that most of my expectations are consistent with consensus thinking, which means that they are probably priced into the market.

If the market outcome is to be different than what I expect, it will be due to the surprises, those low probability outcomes, that one has to be aware of, if possible.

## My 10 Surprises

1. A much stronger, "V" shaped economic recovery.

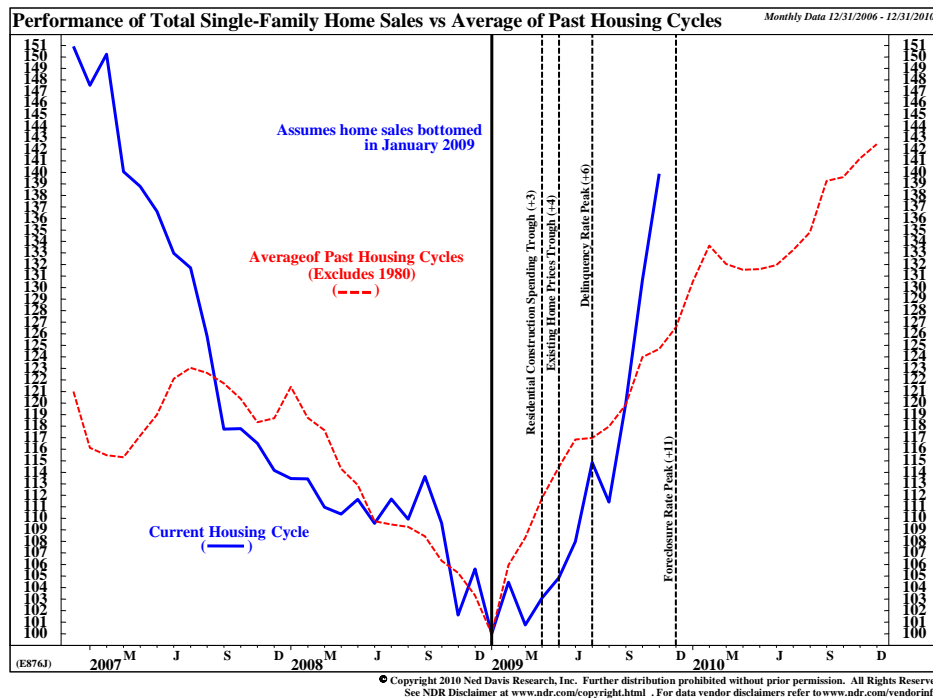
I've already mentioned the inventory replenishment cycle, which could be stronger and last longer than most think. Just as an example, auto production would have to increase 31% in the 4<sup>th</sup> Quarter to reach a normalized inventory to sales ratio assuming 11.4 million units are sold. However, the fastest vehicle inventory growth, going back to 1989, has only been 12.6%, so this recovery is likely to last for a few quarters, especially if consumer spending recovers.

Regardless, it's unlikely manufacturers will only bring production to the "sell through" level when inventories are low. They are likely to overproduce until inventories recover to a comfortable, more normalized, level.

Consumers could also surprise critics. The prevalent belief is that they are over-leveraged and unable to spend. However, John Aitkins, TD Newcrest's Chief Strategist, points out that "If the consumer lacks the willingness or the ability to borrow, then why are car sales and home sales up 23% and 40%, respectively, from recession lows given that these sales, despite benefits from fiscal stimulus, were surely financed with debt?"

Other things that could add to an economic surprise include:

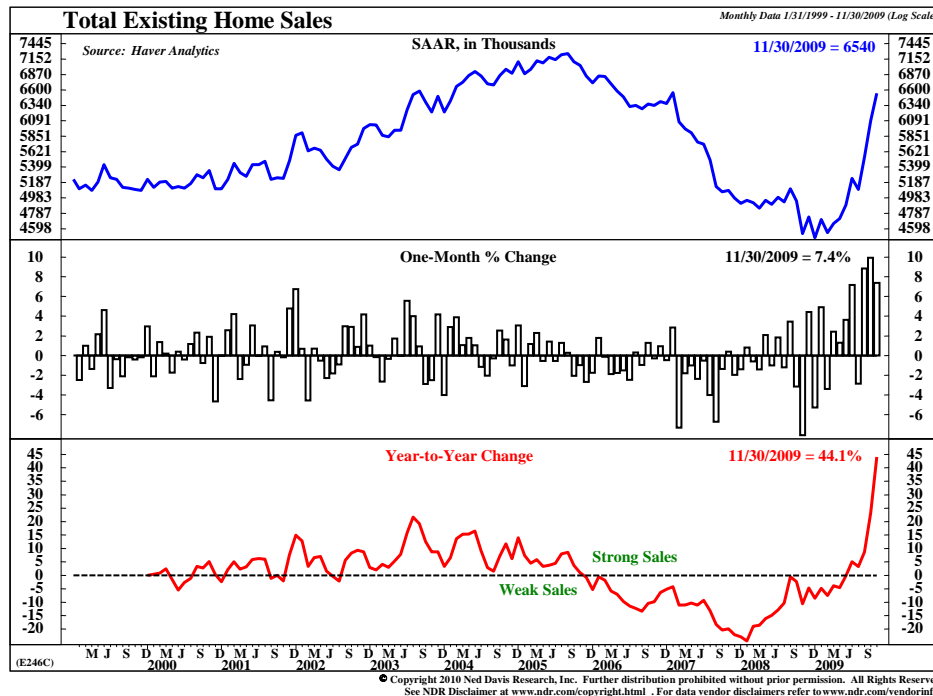
Housing, believe it or not.



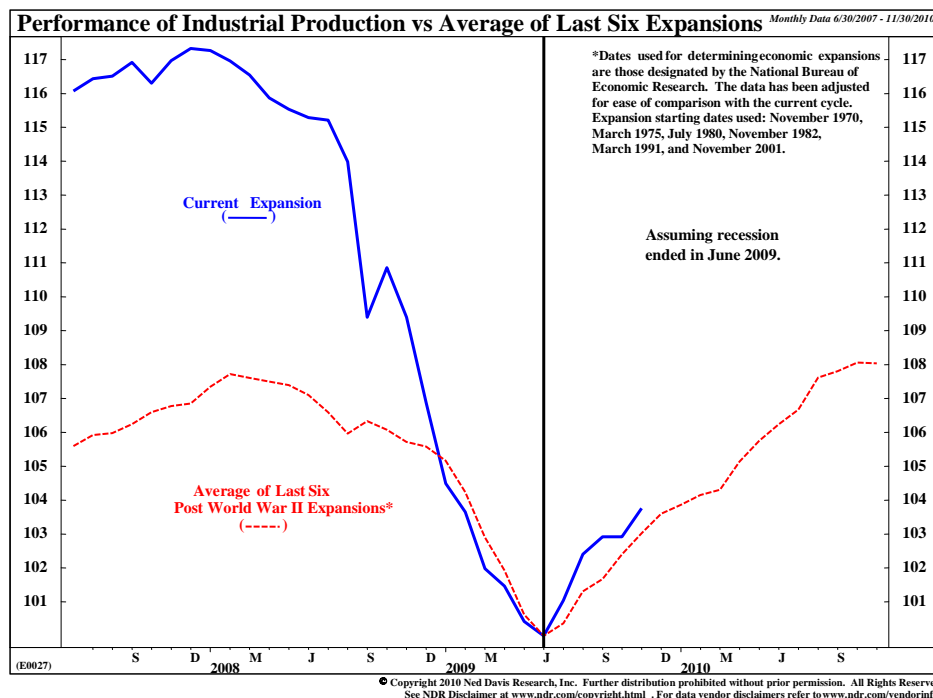
As this chart would indicate, the sales of single, family homes is running well ahead of what we have experienced in past cycles.

The supply of existing single family homes was down to 3.0 million units in October, from a peak of 3.9 million in June 2008. That's a decline of 23% and the lowest since the end of 2006.

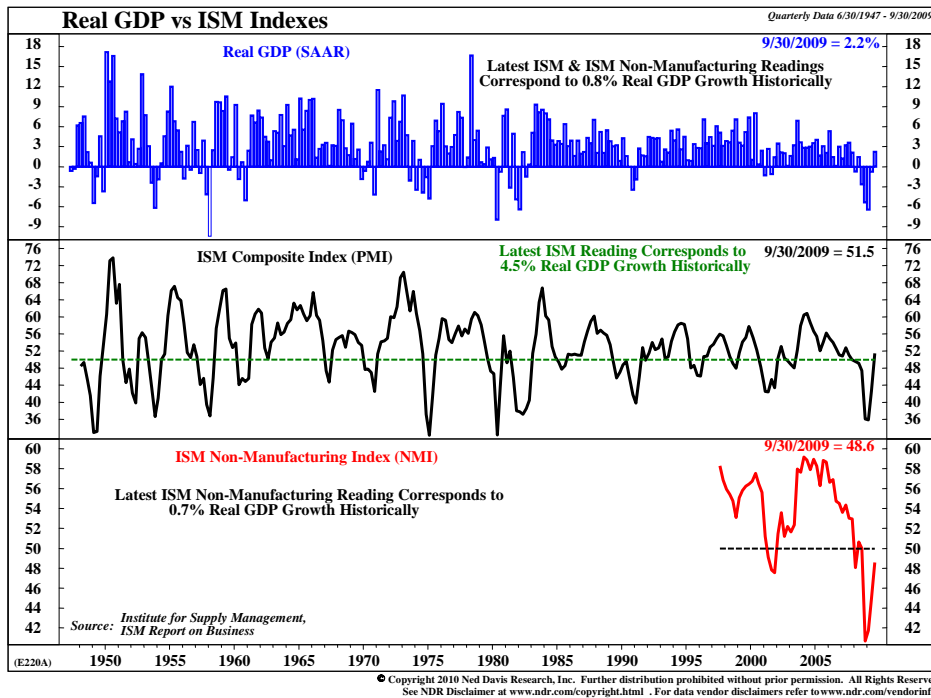
Sales are up 31.6% over the last nine months. In November, sales surged a further 7.4% to a 6.5 million annual rate and are up 44.1% from a year ago, while total inventories including condos have declined to 3.6 million, the lowest since April 2006, as seen in this chart.



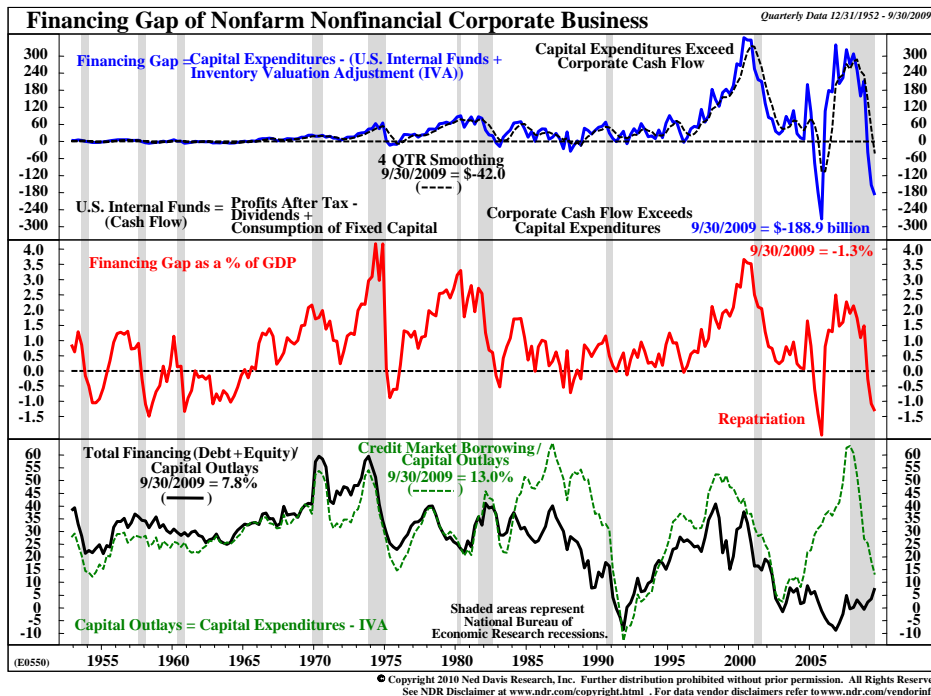
Industrial Production is also ahead of the typical cycle.



The PMI index is now at its highest since April 2006.



As seen in the middle clip of the above chart, the latest PMI index corresponds to a 4.5% GDP growth rate.



Further, capital expenditures in the U.S. were extraordinarily weak in 2009 and cash flows actually exceeded cap/ex. As shown in the middle clip of the above chart, it was the biggest spending gap since the 4<sup>th</sup> Quarter of 1960, excluding the government-induced funds repatriation in 2005.

Given the level of corporate profits, capital spending is going to recover in 2010.

Productivity growth will also help. It usually remains strong for the first two years of an expansion. Typically, productivity growth averages about 8% in the first quarter of recovery while in the 3<sup>rd</sup> Quarter of 2009, productivity grew at a 9.5% annual rate.

As for the end of Government stimulation for housing and autos hurting the economy, in the 2<sup>nd</sup> half of the year there is an offset. In February, the U.S. Congress authorized \$787 billion in stimulus spending. By the end of October, only 26.3% of this had been spent, so there is more to come.

The final bit of stimulation that could push the economy higher than expected is counter-intuitive. It could come from what most forecasters consider a negative, and that's an increase in interest rates by the Federal Reserve.

Right now, the banks are sitting on about \$1.0 trillion of excess reserves which the Obama administration would like to see lent out. If they were, it could be meaningful to small businesses and the job market especially.

What's holding the banks back is the ability to borrow at virtually zero and deposit that money at the Federal Reserve to make a small, but virtually risk-free, rate of return.

The perversity of a Fed rate hike is that it might force the banks to seek better rates of return on their loans to continue making a spread. This would benefit the economy.

Of course, there are consequences to this. Faster lending of these excess reserves could be very inflationary, and this could also cause longer interest rates to rise as these banks no longer buy government debt. However, stronger growth might also improve government revenues and lower the deficit.

Bottom line, there are a lot of things that could result in higher than expected economic growth.

As for those who continue to focus on an overleveraged economy, a little history might be appropriate.

According to Grant's Interest Rate Observer from 1933 to the early 1950's, the debt-to-GDP ratio fell from around 260% to 130% while over the same period, real GDP grew at an average compounded annual rate of 6.1%.

## 2. Federal Budget deficit starts to narrow.

If the economy turns out to be stronger than expected, it's possible that it could have a positive impact on the government's budget deficit. Revenues would be higher, and there would be less need for further government stimulus programs.

## 3. Lower than expected unemployment.

After the last two recessions, in 1991 and 2001, unemployment didn't peak until 15 and 19 months after the contraction ended. However, in earlier cycles, the economic trough to unemployment peak was a much shorter 2.5 months. So how does this cycle compare, one might ask?

Jobless claims peaked at 658,750 in April, 2009 and have dropped to 473,750 in December, very comparable to the decline seen in 1982, which was also a severe recession and the last time unemployment topped 10%.

The 27% drop in jobless claims that we have seen over the last 34 weeks compares to a 24% average decline in the past 5 recessions.

Back in 1982, the Fed's Beige Book on the economy predicted that employment would "range from a slight upturn during the next six months to little pick-up until late 1983." A total miss as employment was much stronger than expected. The same thing could happen this cycle, especially if lending to small businesses improves.

The fact that the census Bureau plans to hire 1.2 million census takers by May of this year won't hurt either.

4. Strong Housing Market.

This would be consistent with a stronger than expected economy.

5. Sovereign Debt comes under attack.

A European Commission warned that public finances in half of the 16 Euro-Zone nations are at a high risk of becoming unsustainable. Greece and Spain have already seen their credit ratings downgraded. Ireland and Portugal have been warned that they could be next.

The London Telegraph notes that Britain's debt is riskier than Italy's. Britain's 10 year gels trade at a higher yield than similar Italian government bonds and the U.K's cost of debt has risen by more than a full percentage point since March despite the Bank of England spending 200 billion pounds through quantitative easing.

Standard & Poors said Japan's AA credit rating could be threatened if policies fail to stabilize and gradually reduce the nation's debt.

India's Finance Minister said the nation's budget deficit, forecast at 6.8% of GDP, cannot be sustained.

It's possible that the debt crisis moves from the housing market and banking to Sovereign Governments.

Obviously, this would be a positive for Gold but also possibly the U.S. dollar.

6. Strong U.S. dollar.

Sure, the U.S. and the dollar have problems, but relative to other currencies things don't look that bad.

Also, don't discount a stronger U.S. economy requiring higher interest rates, which would push the interest rate yield spread up and in favour of the dollar.

But probably the biggest factor influencing the dollar would be the Sovereign Debt risk that I mentioned earlier. According to Purchasing Power Parity models, the dollar is already cheap relative to most other currencies. Throw in a little flight to the "safe haven" of the U.S. dollar, and there's a case to be made that the popular bet against the currency will have to be unwound and the complementary positive outlook for gold would be reversed.

7. Deflation.

Fear of inflation gives way to deflation as global economies actually plummet due to a renewed banking crisis or Sovereign debt risk, and interest rates actually decline. This would happen if the economy shuts-down, and there is a flight to safety causing a strong U.S. dollar. China and others would be forced to buy more U.S. government debt to stabilize their currencies as the U.S. government practices "quantitative easing" to stimulate the economy. This could be a repeat of 2008, and the recession's second coming.

Although I see a greater likelihood of a surprisingly strong economy in 2010, the possibility of a much weaker one is a reality and rises in probability as we approach the end of 2010.

8. China's growth slows dramatically.

Right now, China seems to be the engine of growth for the world. But how sustainable is it?

Consider this. Through the first nine months of the year, total renminbi denominated loans rose by 8.7 trillion, roughly equivalent to 30% of GDP. Year over year,  $M_2$  growth was 29.3%.

Growth based on capital spending, has driven the investment to GDP ratio to unprecedented levels. Grant's Interest Rate Observer estimates that fixed capital formation accounted for 70% of China's growth in 2008, and closer to 90% in the first half of 2009.

There is a diminishing return on each incremental dollar of investment (i.e. returns eventually collapse, and it is this return that supports the debt.

Could this happen in 2010? I don't know, that's why it would be a surprise.

However, we are starting to see diminishing rates of return on this debt stimulation. According to the International Monetary Fund, in 2000, it took about \$1.50 of credit to create \$1.00 of GDP growth. That compares favourably with the peak of \$4.00 of credit to create \$1.00 of GDP in the USA in 2008.

However, in the first half of 2009, it took around \$7.00 of credit for each \$1.00 of GDP growth in China.

This could result in inflation as they print more money to sustain demand and growth. To control this inflation, they may have to let the renminbi appreciate to cheapen import prices.

This situation, however, could also cause a lot of bad debt which would cause growth to falter, the economy to slump, and the renminbi to decline.

9. Commodity prices decline.

Price of Oil drops below \$60.00 and Gold below \$900.

Right now everyone is betting on commodities as a hedge against strong emerging market economies, a weak U.S. dollar and higher inflation.

But, if some of my other surprises come to pass, commodities could suffer.

China is also talking about raising interest rates to control economic growth, which would reduce commodity demand.

10. The U.S. stock market outperforms other stock markets around the world.

This would potentially be due to the inverse relationship between the U.S. dollar and emerging market performance, which could be triggered by either a stronger U.S. economy or a flight to safety as Sovereign risk becomes an issue.

### Summary

So my base case expectation, reasonably strong economy, rising inventories, slightly higher inflation, etc, all soak up excess liquidity which is bad for the market.

Valuations are not out of line for the market if my scenario plays out, and suggest that the market doesn't have a lot of downside. However, because the valuations are high based on current earnings the market is already discounting a reasonably rosy outlook, so the positives seem to be priced in.

As the year progresses, and the possibilities for 2011 become clearer, the market will respond. If the economy can overcome the withdrawal of Government stimulus and become a self-sustaining expansion, then the market will start to discount even higher earnings next year. But that's a ways off.

In the meantime, I expect a choppy market where money is made by good stock selection, not riding the trend as we saw last year.

But beware of the surprises. Unlike a prediction, our opinions are always being tested and challenged by the release of new information which can cause a change in that opinion and that's what we do as investors. We develop a plausible set of beliefs that get tested throughout the year, and this year won't be any different.

Yet, it's the surprises, the outcomes that are unexpected or different than the consensus opinion that cause changes in the market's value.

So, going along with the crowd may be comfortable but it is not likely to make you any money in the market.

January 12, 2010

CREDITS: Ned Davis Research  
Ed Yardini