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• One Man's Opinions – 1/11/11 - Winter 2010-2011

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In December, advisor confidence in the U.S. economy and stock market reached its highest mark since February 2007, according to the Advisor Confidence Index, a benchmark that gauges advisor views. The index jumped to 116.13 in December, an increase of 4% for the month. In fact, all four measures of the ACI increased in December, with the 12-month economic outlook soaring 7.2%., the current economic outlook 4.5%, the six-month outlook 2.12%, and the stock market outlook 1.97%.

On the other hand the Conference Board Consumer Confidence Index also increased in both October and November. The index stood at 54.1 in December, up from 50.2 in November. In a normal economic recovery, in order to make a significant impact on unemployment, this number needs to be in excess of 90! The public thus continues very skeptical regarding the economic outlook, while professional investment advisors remain quite optimistic as a group. Generally I am inclined to go with the latter.

What is clear is that there is still great public uncertainty. The dichotomy of good and bad economic news continues to impact the public daily and the mainstream media focuses on the bad news of course. Unemployment is historically very high for this point in a recovery, and there is a lack of spending and investment from businesses. The Fed's recent announcements regarding the purchase of $600 Billion in U. S. government debt should be seen as a sign that the Fed fears deflation and high unemployment more than any inflationary signs in the economy. On this I disagree heartily, as I think we are headed for an inflationary spiral in the next 18 to 24 months.

I will argue that many investors have gone through a full dose of emotions in the past couple of years. We had a sudden shock to the economic and financial markets in 2008, which caused an immediate sense of understandable fear. How badly am I hurt? What is going to happen next? What will happen to me? The ensuing recovery has regained 80% of the lost ground. But this assumes the investor did not panic and sell out. After the initial shock, the next step was to assess the extent of the damage and make sure sufficient cash was on hand to meet anticipated expenditures. The next step was to make sure one's financial plan was still appropriate to meet our goals. Finally, recovery began and has continued for the past year and a half.

The reality is that, although both advisors and consumers are now becoming more optimistic, there is still a long way to go before we can say we have a completely healthy economic recovery. The current recovery, keep in mind, is already 18 months old, no longer in its early phase. Past recoveries have been more dynamic.

My expectation for 2011 is more slow economic growth, on the order of 2.5-3.5% in Gross Domestic Product, with the stronger numbers coming in the second half of the year. Unemployment will remain stubbornly high, probably above 9%, as tougher regulations are placed on an already anemic private business sector. The extension of the Bush tax cuts is a very positive note, and will allow some loosening of the purse strings in this sector, as well as in the larger publicly owned blue chips. Progress, however, will likely be slow.

Stock market performance bears out the slowness of the recovery as well as its strength. Prices remain reasonable, given good corporate earnings and expectations. Most advisors, including myself, see buying opportunities

aplenty, with little chance of a major economic downturn. These relative bargains will continue to attract at least the professional investment managers. I expect another modest increase in stocks similar to the 12% gain in 2010, perhaps modestly lower. Interest rates are, in my opinion, almost certain to continue to go higher.

The national press is making a big deal about the President's dramatic "recovery" of popularity as represented by the achievements (??) of the lame duck Congress (which included cooperative Republicans). While I believe this cooperative attitude was a step in the right direction, the $800 billion in deficit spending on new stimuli is being largely ignored. Readers may recall I supported the February 2009 stimulus bill as psychologically necessary, while also predicting it would not work. This one won't either! Such programs never do. We are looking at a huge addition to our gigantic and rapidly growing $14 TRILLION U.S. debt, while Congress and the President banter about minor programs to save tens or hundreds of $billions. We have a long way to go in the new Congress. On a more positive note, it surely cannot be as poorly run as the last one was.

Readers of these quarterly newsletters, all but 12 of you, also receive my weekly blogs. We just completed 2.5 years of blogging, which have been well-received. Our timing was also appropriate in view of the near collapse of the world economy in the latter months of 2008. I am very proud of most of my 120 or so blogs. (Several were, I think, outstanding, most good, with a few less than satisfactory when read in hindsight. Not bad for a beginner, I think.) If you get this newsletter by U.S. mail and now have internet access, please mail me your EMAIL ADDRESS and I will add you to the blog list.

However, I want to caution my readers that it would be unrealistic to rely on my blog posts (or anybody else's) as a way of predicting how the economy will behave. I will continue to wave yellow flags where I believe them necessary, yet I have no way of knowing when the economy might be preparing to drop like a rock or to soar.

What is important is to remember that we cannot predict when the next painful market experience is going to take place. If you try to sit out the market until it "heals" you may well end up "sitting out" until the market is at new highs. Even worse would be to miss out on the periodic "fat tails" when returns skyrocket over a very short period of time. We need to remember that many years worth of returns often occur in just a few months in the markets. There is no way to make them up if you are on the sidelines.

A few months ago, several of my "blue chip" CFP peers, led by Harold Evensky, who is one of my most admired colleagues as is my friend Elaine Bedel here in Indianapolis, did an exploration of what, if anything, might signal the next downturn in the economy. Among other things they looked at the VIX (market volatility) index, and found that, rather than being a good sell indicator, it actually provided good BUY signals.

After an exhaustive search, the group found nothing that could be relied on to ring the alarm. They also found that, even were they able to find such a miracle, there was no clear way to get clients quickly out of harm's way. There is much talk of using hedging techniques and highly expensive hedge funds, but the group found that hedging would be insufficient protection. At the first sign of panic, the cost of hedging would go through the roof, as it did in 2008. They also point out that if you sell, you risk selling into a competing blizzard of sell orders in a market stampede, and triggering tax consequences that might make the problem even worse. So, much as I regret the admission, there is NO magic sell indicator for the markets. The Great Recession may have ended months ago, but we will always face uncertainty in the world. The best way to deal with it is to follow a specific plan and revise it as necessary.

I will continue to wave red flags from time to time. An example is the advice I've been repeating for the past few months to avoid bonds and bond funds, which have been priced at historic highs. Unfortunately, many public investors continue to liquidate equities and invest the proceeds in longer term bonds for "safety" reasons. In my opinion, this is at very high risk of losses in their fixed income holdings.

As we enter 2011 and my 49th year in the investment world, I'll continue to study the economic news and the markets, waving red, yellow, and green flags as I judge one is warranted. Hang on and stay tuned.

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