

THE LAST DECADE AND WHAT TO EXPECT IN THE NEXT

STOCKS

The S&P 500 started the decade at 1469. Ten years later, it ended the year at 1115, which was a drop in price, not including dividends of 24%. This was clearly a lost and wasted decade for stock investors. This decade was the worst on record since 1830 and only one of two decades that was negative, the other being the 1930s, which was down but down less than this decade. We have had two very bad bear markets in this decade, the last of which was a 57% drop from peak to trough. That was the worst bear market since the Great Depression. By comparison, the average bear market peak to trough decline since WWII has been 28%.

Since the 1565 peak in the S&P in October 2007, the market hit a trough in March 2009 at 666. From that low, the market has rebounded to 1115, a 67% increase, the second strongest rally since 1932-33 over an equivalent period of time.

This rapid recovery resulted from the extreme over-sold position created by the bear market which was caused by extreme fear and panic. Additionally, historical low interest rates, unprecedented fiscal stimulus and corporate cost cutting which raises corporate earnings, have all contributed to this rapid bounce back. We still need a 45% plus increase from here to get back to the pre-bear market top.

Generally, low quality stocks, small cap stocks, and emerging market stocks suffered the most during the bear market but have also bounced back the most since the start of the bull market.

WHERE DO WE GO FROM HERE?

Although the worst is most likely behind us, that is not certain. Will we have a V-shaped recovery in which the economy bounces straight up from its low or will we suffer another down turn in forming a W shape before the economy recovers for a sustained period? In 1929 in the first two months of the bear market, the market collapsed by 45% only to rebound 47% in what proved to be a short lived recovery since the market then collapsed further until it hit bottom two years later with an 86% decline. Although not as extreme as that bear market, we had a similar fool's rally in the 2000-2002 bear market.

There are still major concerns on the horizon; the fragile banking system, huge fiscal deficits, and unprecedented unemployment reaching a high at 10.2% before dropping to 10% in December, (the second worst in the last 50 years, only better than the 10.8% in 1982). Additionally we have an overleveraged consumer with too much debt and too little savings, and a following dollar.

No one knows in certainty what will happen, but my opinion is that there is a lot of positive momentum that is hard to challenge. Every time the market tries to seriously correct, large amounts of sideline cash come into the market that props up prices. Interest rates are so low that fixed income alternatives do not offer reasonable competition to all other types of assets. This tends to push money into stocks and all other types of investments. The heavy stimulus, deficit spending and low interest rates are driving the dollar down and everything else, stocks, gold, oil and other commodities have been going up. This may create another bubble unless we are very careful. In the meantime, it is re-inflating most everything including stocks. We could certainly see a correction of 10 to 15% down to 950 for the S&P 500, near the 200 day moving average, but I think the sideline cash will most likely keep coming in after market drops to keep

the market moving in positive territory. In the long term, stocks should grow at a 5.5% to 7% real return (after inflation) which is much more attractive than current low interest rates.

Some experts believe we are entering a new period of much slower growth for the economy of around 3-4% annually compared to the 6-7% growth we have experienced over the last 20 or 30 years. Excessive financial leverage created excessive housing demand and speculation which brought home ownership to 69% of the population. Some experts believe de-leveraging will drop home ownership down to 62% of the population which can have a huge negative effect of lower spending for all the housing related areas. Additionally, the past financial leverage and growth in housing and stock values allowed consumers to spend without saving and the national savings rate fell to 0% and below. Going forward, with lower asset values and excessive debt, consumers are now saving at the 5% level and this savings rate continues to grow. This will lower consumer spending significantly which has been 70% of GDP. All of this could lead to lower growth rates going forward which may mean lower expectations for future stock growth, which could lead us into a second phase of the downturn, a W shaped second recession. I don't believe we will go back into a recession, but I do believe growth will be slower going forward for a long time which will mean stock returns going forward on a long term basis may be closer to 8% total return, (5.5% real return after inflation) from the historic 10-12% previously.

The S&P 500 earnings for 2008 were \$49.51 down 40% from 2007. Earnings for 2009 are expected to be \$56.22. Based on average profit margins on sales, the normalized Price Earnings ratio for the S&P 500 is 18 which is about average for the last 50 plus years (average since 1956 is 17). Assuming a 2.5% inflation rate, the real return on long term treasuries is 1.5%. The real return after inflation on stocks is 5.5% (1/18 P/E ratio) which is a 4% premium to the real return of the long term treasury which makes stocks look attractive relative to bonds.

Merrill Lynch is one of the firms that is more bullish than others about the market next year and believes the S&P will go to 1275 by year end, a 15% plus increase. They believe the steep yield curve is bullish and shows that the market expects the economy to pick up. The biggest risk they see is if our government pursues protectionism against China which they believe is the biggest risk to a market advance.

Currently, large high quality stocks look more attractive than smaller cap stocks. Small cap stocks have a higher price-earnings ratio currently even though they have more risk. Normally, small cap stocks trade at a discount, not a premium as is currently the case.

Even with lower expected returns for a long term investor, I would stay invested according to a reasonable asset allocation strategy based on a person's age, goals and risk tolerance. A rule of thumb is to keep a person's age in fixed income for protection and the rest in diversified stock funds.

INTEREST RATES

The Federal Reserve has expanded its balance sheet from \$920 billion at the end of 2007 to \$2.1 trillion currently, a huge increase. Additionally, the Fed lowered the federal funds rate and therefore other short term rates to unprecedented lows of almost 0%. With core inflation at 1.5% and unemployment very high, it is unlikely that short term rates will be raised before 2011 or late 2010. Fed Chairman Bernake is a student of the depression; and it is generally thought that the Fed raised rates too soon back then causing a much deeper and longer depression than necessary. Therefore, don't expect the Fed to raise rates for a while.

The concern regarding this strategy is that it may cause additional bubbles like we had in technology stocks early in the decade and like we had in housing recently. Further dropping of

the dollar (a dollar crash) could cause the Fed to consider raising rates to help protect the dollar from going into a free fall. Additionally, our 2009 government debt as a percentage of GDP is 85% and expected to grow to 108% of GDP by 2014. This is getting into dangerous territory and may affect our countries credit rating. For comparison purposes, "Advanced" countries like the United States have on average 118% of GDP in government debt and Emerging Countries only have 36%. Japan has one of the worst ratios with over 200% of GDP in government debt. The bottom line is to not expect the Fed to raise rates until well after the unemployment rate peaks which should not be until late 2010 or early 2011.

THE DOLLAR

In 1933, Franklin Roosevelt made it illegal for individuals to purchase gold. In 1971 Richard Nixon took our dollar off the gold standard which meant foreign countries could no longer redeem dollars for gold at \$35 per ounce. Because of the strength of the US economy and our gold reserves, since that time, the dollar has become the reserve currency for the rest of the world. This great privilege was beneficial to us and allowed us to use the foreign purchase of dollars to keep interest rates low and to finance trade deficits, caused by us purchasing more than we produced. However we abused this privilege with big federal spending deficits, consumption in excess of production and a non existent savings rate. Now with low interest on top of these factors, the dollar is under a great deal of pressure. Our government wants the dollar to gradually go lower to help offset our trade deficits and to make our goods less expensive which can help stimulate our economy. The concern is that this goes too far. Since its high in 2001, the dollar is down 38% and 15% just since March of 2009. As the dollar drops, commodities and other hard assets tend to trend higher. This decade alone oil has gone from \$17 per barrel to \$80 (high of \$145). Gold has increased from \$255 to nearly \$1100 per ounce. The dollar decreasing may have short term benefits but in the long run it makes everything more expensive by decreasing our purchasing power. Currently, hedge funds are borrowing dollars at nearly a zero per cent interest rate (dollar trade) and using these funds to bid up all types of real assets, stocks, currencies with higher interest rates and commodities which could create another bubble.

THE ECONOMY

With the economy growing at a 3.2% rate in the 3rd quarter, it appears that the recession is over. However, unemployment is at 10% and may ultimately still go some higher before it turns around for good. The low for unemployment over the last three decades was 3.8% in April of 2000. Including part time and discouraged workers, unemployment is over 17%. This recession was not typical but precipitated by more than 20 years of over consumption, financial leverage and debt. This rebalancing of the economy may slow growth for many years to come.

Pent up demand spending will probably be less than in past recessions because of the loss of wealth effect from housing and stock value decreases. Household wealth dropped \$12 trillion from peak to trough from \$62 trillion to \$50 trillion but has since bounced back \$5 trillion to \$55 trillion. The weak dollar and emerging market growth could create an increase in exports which can help strengthen the economy, as can business investment from previous depressed levels and the massive government stimulus.

Most experts expect the economy to grow between 2.6% and 3.1% on a real return basis in 2010. Merrill Lynch is again more bullish than many others thinking we will over shoot that with a 4.4% growth. The idea is that analysts tend to undershoot on both the downside and on the upside which they expect will happen again.

There still are credit risks in the economy. The Commercial Real Estate Index has dropped 43% from its peak in 2007. There is \$3.4 billion of Commercial Real Estate debt. Additionally, one third

of the \$900 million of credit card debt outstanding has been made to high risk, sub-prime borrowers. Finally, roughly 10.7 million homeowners or 23% of the total owe more money on their homes than they are worth.

The bottom line here is for a recovery, but modest by previous standards and slower long term growth than we have previously experienced. Finally, it will take a long time for job creation to get anywhere near what we consider full employment.

WHAT SHOULD AN INVESTOR DO?

The market is vulnerable to another correction so there are risks of being in stocks. However, fixed income yields are so low it is difficult and costly to stay in fixed income. Additionally, it is almost impossible to market time successfully. If a person can not afford a significant drop in stock prices, he may want to sell a portion of stocks on a further rally. For investors who can wait out a drop in prices, it makes sense to stay invested in equities based on an asset allocation percentage that meets a person's risk and age (again holding a person's age in fixed income). If stocks go up it may make sense to rebalance back to the level that a person plans to maintain. In other words let's say a 40 year old has 60% in stocks and 40 % in bonds and the market goes up to where his portfolio is 70%/30%. In that situation it could make sense to rebalance back to 60%/40%.

Within fixed income investments it makes sense to have a significant portion in totally safe investments like insured bank certificate of deposits, or treasury notes, bills, bonds or government guaranteed mortgage products, or possibly high quality municipal bonds or TIPS bonds which are government bonds that protect against inflation. In a crisis corporate bonds can have risks too, so I prefer fixed income investments that are free from credit risk. With a significant portion of fixed income in totally safe investments, an investor can feel more comfortable in a down turn as well as having some funds that can be available to invest to take advantage of opportunities. Expect that the markets will continue to experience volatility. Be patient, keep your nerve and stay focused on the long term.

Sources of information for this include Hammonds Associates Fall Research Report, The Pimco newsletter written by Bill Gross, Central Trust Bank's Market Outlook and The Markets Down Decade by Anthony Mirhaydari from MSN., Merrill Lynch RIC Report.

(Remember every investor's situation is unique and it is important to review your specific situation with a financial professional.)

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