Opportunities & Risks in 2011

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State of the Markets

As always, I won't make any predictions for the coming year as the value in precise market predictions – such as what the S&P will end the year at, or what asset class will perform best – is fruitless. Like life, investing is a journey and there are typically many challenges along the way. It is practical though to know the state of the markets, risks facing the markets, a course to take, and plans for contingencies.

This year is opening up much like 2010 with Europe still sending global shock waves with its ongoing debt woes, unemployment in the United States still too high, the U.S. Government building a catastrophic amount of debt, and U.S. housing still under pressure. The new worries hanging over the market going into 2011 are the debt issues of the individual states in America, surging food prices around the world, and a trade/currency war.

Coming into 2011, the U.S. stock market (as gauged by the S&P 500) has gone up since this past September putting it well into overbought territory. There are plenty of readings that investors can use to gauge how long-in-the-tooth a market rally has become. Let's consider a few contrarian indicators:

- As of January 5th, the percent of bulls in the American Association of Individual Investors poll was 55.9% - higher than its' 2007 peak.
- On January 5th, the National Association of Active Investment Managers survey that measures the equity exposure of its members came in at 78.5%. This is near levels reached in April 2010, just before a 16% drop.
- The NYSE Bullish Percentage Index sits at approximately 80%. This indicator simply outlines the percent of NYSE stocks trading on a bullish signal. In 2010, when the 80% handle was reached for this index, 6% and 16% drops followed.
- The VIX (or fear index) measures how concerned options traders are that prices will drop. As with all sentiment indicators, the value of the VIX lies in its contrarian application. Over the last month, the VIX has been around 17. The last time the VIX spent time in the 17 area was the spring of 2010, just before a 16% drop.

It is safe to say that a pullback in the market is not far off, and that right now there is more downside risk than upside possibility. Any drop in the market in the short-term will likely present a buying opportunity. My outlook for the U.S. market through the summer of 2011 is positive (thanks to the Fed priming the money pump); however, beyond the summer things could get dicey again.

We can thank global central banks for both the opportunities and risks that we face in 2011. Let's make sure we are on the same page and understand that central banks are creating inflation, as they are the only entity that can control the money supply. Inflation by definition is the expansion of the money supply; the result of the expansion of the money supply is rising prices. Do we have inflation right now? Yes. The money supply has exploded in the last 10 years. The results of the flood of money are being felt heavily in the emerging markets as rising prices have already set in.

The single most important item that all investors must recognize at this point is that bond funds hold risk. As the global markets unwound in 2007-2008, scared investors ran to bond funds. Now, as stocks have become more attractive, and interest rates are beginning to rise from the ashes, bonds face serious head winds. If you think you can hop across the pond and pick up foreign bonds to tame the risk, think again. The currency tensions are wreaking havoc on global bond funds as well.

Concerns for 2011

It is nice to see the stock market moving up, but there are still very serious risks facing global economies. The six largest risks facing the markets are:

1. **Fed's Easy Money** – The Fed's plan of pumping money into the economy is giving many investors concern about inflation (rightfully so). Even though the easy money is supposed to drive down interest rates (to keep zombie banks alive), rates have actually been rising. Continued rising rates could put a real drag on the economy.
2. **Housing Weakness –** With the incentives gone, home prices are diving again. Home prices are important for investor psychology, as well as making the case for a robust recovery in the economy. Skittish investors are like hypochondriacs looking for the slightest thing to run for the hills, and housing weakness can seem like a deadly disease.
3. **Rising Prices** – Rising food and commodity prices could make real headaches for central banks. If central banks act against rising prices by raising interest rates, it could derail the economic recovery. If they do nothing, we would see seriously higher prices.
4. **European Debt** – Europe's debt problems are the world's problem. With Greece, Ireland, Spain, Portugal, United Kingdom and France all implementing austerity measures to control their debts, global spending will drop. Since Europe is struggling, it is in their best interest to keep the Euro currency low to make their exports attractive. That would be fine if every other country were not doing the same thing.
5. **Currency / Trade War** – Just about every nation is concerned with keeping their currency low to make their exports attractive. The most concerned is the U.S. seeing that we have the biggest hole to backfill. Even though the U.S. is a bankrupt nation, the dollar and treasuries are still considered safe havens. Should the stock market slide, the dollar will rise, putting downward pressure on U.S. exports.
6. **Emerging Market Inflation –** Countries from China to India to Brazil are having to make tough choices between dealing with inflation or letting prices rise. The emerging world has experienced high levels of growth, but it is entering a period of rising inflation. How emerging economies handle that inflation will be the decisive factor for the industrialized world. If emerging markets clamp down on growth and fight inflation, the industrialized world is in for "**IT**." If emerging economies tighten a little, the good times can roll on for a little while. But, just as raising the U.S. debt ceiling and bailouts prolong pain, so too does not taming inflation in the emerging markets. Not fighting inflation is just kicking the bear market can down the street.

Areas of Interest in 2011

Below are five areas, which under the current market conditions, look to prosper in 2011. Simply, we are looking for investments that mitigate developed markets' debt problems, inflation, and dollar volatility, while still leaving the opportunity for growth.

1. **Foreign Markets**

   The first thing to be clear about is that we are on borrowed time. The U.S. Government has dug itself quite a hole, but still has some digging power to buy some more time. History has shown that unless we take a different path right now, the only way to relieve our debts are to either inflate them away or default. As you can imagine, neither are particularly attractive routes to take. Many pundits and talking heads have pointed to increasing exports to help the economy. While this does help the issues, we need more than increased exports. We need decreased spending on all levels from national to state to local governments. As you can see from the news, we are not the only country wishing to make our exports attractive. One sure fire way to make exports attractive is to devalue currencies. We have already seen Japan, Switzerland, Chile and Brazil all fiddle with their currencies to make their exports more attractive. The U.S. dollar has been on a slide for years, and with the current economic plight, the last thing the U.S. needs is a rising dollar choking exports. Be sure that the dollar will stay down. With this in mind, a weak dollar makes foreign investments (and oil) that much more attractive. So, the first opportunity is in foreign markets of any kind. Even though they have had quite a run, many emerging markets are still attractive; those emerging markets are ones that have stable economies, sound currencies, and reserves. In the developed markets, the opportunities lie in the countries of Northern Europe that do not use the Euro currency, as well as in developed markets that are big commodity producers.

2. **Commodities**

   Commodities of all types, from metals to grains, are in high demand and short supply. The global pool of money that sloshes around the planet has stopped in developing economies. Many of those economies have rapidly increasing middle classes that want to eat more meat, eat more cereal, own homes and own cars. That means the world must supply more. Such a phenomenon is being billed as a commodity super-cycle. To add on top of this increased demand, we are seeing shortfalls in supply of soft commodities due to weather problems in Australia, Brazil, Russia, Indonesia and here in the U.S. On the metals side, precious metals are in high demand because fiat currencies are being devalued as mentioned above. Base (industrial) metals are in high demand because building homes and other infrastructure-related construction all need these metals. In addition, the parts of the world that are recovering need metals for increased consumer demand. The often overlooked rare metals have seen huge runs since China has placed restrictions on its exports of rare metals. China supplies 98% of the world's rare metals that are critical to modern technological devices, weapons, hybrid cars, and wind turbines. For metals, the one big way to keep prices down is bringing new mines on line to increase production. Unfortunately, few companies will spend the money in this economy, or cannot get the financing to start new mines. Even in good economic conditions, it takes years to get a mine on line.

3. **Food**

   In the end we must eat. Anything related to food, from seed makers to farm equipment to restaurants, will thrive. As prices rise, these types of companies can pass on the increased costs. Food inflation is already being seen around the world and will continue. Front line food companies like John Deere, Monsanto, Potash, Mosaic and the like will reap benefits as the world tries to provide the food for increased demand and disrupted supplies.

4. **Floating Rate Bonds**
   Interest rates at rock bottom levels have nowhere to go but up. Rates have been creeping up lately, which has put fear into bond investors as rising rates push down bond values. It could be that the Fed will not be able to control rates as they plan if commodity prices keep moving up, and if bond vigilantes take aim at U.S. debt. Floating rate funds invest in senior loans which are very short-term loans (typically less than 90 days). These loans are made to non-investment grade businesses to finance expansion or acquisitions, or to refinance debt. The interest rate on these bonds tends to be higher than most short-term debt instruments.
   To help ensure principal and interest payments are made on-time, senior loans have several important structural characteristics. First, they hold the highest rank as a creditor to a company, giving them priority over other creditors, bonds, and all preferred and common stock. Unlike bonds, which are unsecured (not backed by an asset), senior loans typically are secured by a first priority lien on the assets of the borrower. In the event of a borrower's bankruptcy or other liquidation scenario, senior loan obligations would be paid first. The rate of interest on a senior loan floats with changes in market interest rates, so these investments react positively to rising rates. In a floating-rate investment, when interest rates rise, the amount of income also rises, but the price should remain generally the same.
5. **Energy**
   Even though energy in most cases is likened to commodities, I enter energy as a separate opportunity from commodities. Energy companies have thrived in times when oil prices are rising. Price increases in energy are here, and energy exploration companies are digging deep in their pocket books to find more sources of oil and gas. Demand for oil, thanks to emerging markets' demand, is outstripping supply, which is always favorable to energy companies, whether they are drillers, refiners, or oil service companies. It also does not hurt that energy companies are defensive holdings, as well as inflation-friendly. A declining U.S. dollar will also help put a floor under a higher oil price.

Our Approach

It is not enough to just find good investments. Investors must have an investment strategy to identify entry and exit points. If the experience of managing money has taught us one thing about people, it is that people have very short memories when it comes to the markets. One of the many reasons clients hire an advisor is partly to be a subtle reminder to the less-than-desirable scenarios that may unfold. Here is a reminder of our approach to managing money. Let's start with our philosophy:

- Manage Risk – To manage risk is to look for the potential for bad outcomes and to strategize around those risks.
- Limit Losses – For an investor pursuing long-term goals, large losses have a much greater impact than large gains, both mathematically and emotionally.
- Go Global – The U.S. stock markets only make up 1/3 of the global stock market value; the rest of the world makes up the other 2/3. As well, we are living through a time where economic global power is shifting away from the U.S.
- Utilize ETFs – Exchange-Traded Funds (ETFs) provide the best, low cost way to build a diverse portfolio with trading flexibility.
- Follow Trends – The market moves in trends up, down and sideways. By watching the trends, we can limit exposure to the significant downtrends.

As an investor you can win by not losing. What should you expect under the winning by not losing approach to investing?

- You will not always "beat the market" in the short-term. The goal is long-term growth and protection of your portfolio with a weight on protection in uncertain times. The only way to protect growth is to have defensive (safety) measures. When it comes to investing, there is no such thing as a perfect strategy for getting in **and out** of the market, but you must have a strategy for in **and out**.
- The cost of protecting a portfolio is sometimes lagging the market in good periods. The lag is a result of the market not moving up linearly, but having spurts to the downside. With no crystal ball to indicate which move to the downside will lead to a larger drop, all breaches of security measures must be acted upon. We believe the trade-off of giving up some upside in good market periods to protect gains and capital is a fair trade and has produced historically superior results.
- There will be buying and selling. Some periods of time will have very little trading and others will have many trades. The market has gone through long stretches of growth with very few significant moves down. Likewise, the market can behave, as it is currently, with many moves toward the downside which increases trading in an effort to protect the portfolio.

Our strategy discipline is to:

- Sell any holding that falls below its 200-day exponential moving average (EMA).
- To analyze the fundamentals of any holding below its 50-day EMA.
- Analyze all holdings on a point and figure chart for buy signals and sell signals.
- Analyze all holdings on a relative strength point and figure chart to compare the holding to an appropriate benchmark for strength versus a broader market.

Opportunities

At the outset of 2011, so long as the equity markets remain in an uptrend, we have identified areas we will either maintain positions in, or will add to portfolios as opportunities present themselves. Those areas are:

- Materials
- Energy
- Technology
- Wood
- Agribusiness
- Commodities
- Metals
- Technically Sound U.S. Companies
- Sound Emerging Markets – Malaysia, Peru, South Africa, & South Korea
- Pacific Rim Nations – Singapore, Australia, & New Zealand

Disclosures

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