

## Prepared Comments from 1/15/2010 Conference Call

My last conference call was on October 15<sup>th</sup>. US stocks have since risen 4%. The 4<sup>th</sup> quarter brought a continued stock market recovery. Unemployment seems to have stopped increasing, and corporate profit growth is expected to be strong in 2010. Investors have begun to warm to returning to stocks.

An economic recovery seemed unthinkable ten months ago, seemed like a remote dream last Spring, but has come into focus in the second half of 2009. There remain many dangers and threats to the current recovery. That is the nature of the beast. Be aware of these dangers, but do not be paralyzed by them.

Earlier this week I prepared the quarterly Market Review and Outlook, which is posted on our website [www.mallardadvisors.com](http://www.mallardadvisors.com), under **Client Resources** and then under **Newsletters and Articles**. It includes my investment outlook for 2010.

### The Economy

There are factors to worry about, and others to celebrate:

#### Economic Highlights

- Majority (72%) of stimulus remains unspent—BIG positive impact to economy in 2010
- Inventories are still low (drawn down during most of 2009)
- Fed is expected by many to hold Fed rates at current low for first half of 2010
- GDP growth is improving, leading indicators are improving (8 straight months, per the Conference Board), earnings growth is improving (expected to rise over 20% in 2010)
- Inflation pressures low due to excess capacity (low demand) and high unemployment (which could last several years), +1.8% in 2009 (ex-food, energy, +2.7% all-in), per [www.bls.gov](http://www.bls.gov)
- Residential real estate appears to have bottomed (year-on-year growth expected in quarterly figures from here onward, per Nat'l Assoc. of Realtors)
- Housing could surprise on upside—housing is 24% more affordable than a year ago ([www.realtor.org](http://www.realtor.org)), due to combination, price decline and historically low mortgage rates

## Economic Dangers

- Banks still aren't lending much, requirements are high
- Mortgage delinquencies at 10%, and foreclosures are 3.2% (Lender Processing Services), and appear to be rising—mortgage resets in 2010 could aggravate this
- Many states are in the red (California at the top of the list)
- Future economic growth is likely to be restrained, due to high unemployment, and a much more careful consumer and lending environment (PIMCO's New Normal)
- Still no evidence of fiscal responsibility at the federal level (bipartisan commission, ala BRAC may be necessary)
- Commodity prices recovered strongly in 2009 despite the global recession, emerging markets could help continue this trend (Asia ex Japan has 20% of global demand, and 4% annual growth—US at 23% has growth under 1%)

## Bonds and Stocks

### INVESTMENTS

#### Flow of funds

- No net money added to stock funds in 2009, despite 30% gain, after \$230 billion withdrawal from stocks in 2008
- \$350 billion added to bonds in 2009—as way-station for destination in stocks?

#### Bonds

- Government—supply expected to steadily increase, demand likely to fall as investors seek higher yielding alternatives—AVOID (both TIPS and normal)
- Mortgage backed bonds (FNMA, GNMA)—imminent sales by Fed will hurt returns
- Corporate—better than government (higher yielding, smaller risk of loss right now), avoid long-term, keep short and short-intermediate
- Muni bonds—fiscal stability is falling, supply could increase (both negatives), income tax rates likely to rise (positive)
- High Yield bonds, up 31% in '09, cut these back!
- Global—good for some, for diversification, for dollar weakness in 2010

## Stocks

- P/E levels are misleading—at trough levels—10% revenue gain can be 100% profit gain
- Earnings recovery—to return to 10/07 peak, in three years will mean 14.5% annual return during those three years
- Cash on Sidelines—Still about \$3.3 trillion, from peak near \$4 trillion
- 10-year Treasury yields 3.8%, S&P 500 earnings yield is 3.6%
- Best stock performance in 2009 was the junkiest—2010 brings return to quality? (value, dividends)
- Sectors—
  - Technology—keep at ‘normal’ levels
  - Real Estate—storm clouds still swirl, but maintain a modest level (2-4% of stocks?)
  - Health Care—impact of health care reform legislation is likely priced in—up only 22.5% in ‘09—appear reasonable now
- Valuations—overall they seem reasonable, good growth expected in Asia, US seems reasonable, Europe is OK, periodic wide swings in China, India, Latin America
- Names—top three stocks, all currently held by clients—Bank of Nova Scotia (limited bad loans), 4% yield, Hewlett Packard (computers, printers, service (EDS)), earnings growth in high teens, Teva Pharmaceuticals (Israeli company, leading provider of generic pharmaceuticals), earning growth expected of 20% or more. Three different industries (two foreign)

## Closing Thoughts

Right now the positives outweigh the negatives. Substantial economic growth is occurring and is likely to continue. Corporate profits (outside banks, autos, and housing) held up through the recession, and are poised to jump in 2010 and 2011. Inflation is not a concern for a few years, and interest rates are very low, although they will move up in time.

Stocks appear very reasonable at this time. Rebuild to your long-term target levels. Aim for 40% or so of your stocks to be overseas (in both developed and emerging markets). Exercise caution for your bonds, avoiding treasuries and long-term bonds. Cut back your high yield bonds, and consider foreign bonds.

It appears pretty clear that we have survived the Great Recession, scarred but standing. Congratulations!