



2010 Notes on the Quarter – Q1

Overview

- 1) Q4 2009 saw the markets up further: The S&P 500 was up 6.0% for Q4 and 26.5% for the year. The Dow was up 8.1% and 22.7% and the NASDAQ was up 7.2% and 45.4% respectively. Many foreign exchanges were up even more.
- 2) January 2010 was a disappointment: Every business news channel made a big to-do about the first week being up, but for the month all the indices were down: S&P 500: -3.6%, DJIA: -3.3% and NASDAQ: -5.3%. Many feel the markets have become over-extended (read that as expensive) given the economic climate around the world.
- 3) Interest rates have risen dramatically in 2009, except for the short end which is still yielding near zero percent. For example, the 10 year treasury has risen from 2.21% to 3.84%. However rates have been range-bound so far in 2010.
- 4) Commodities were up strongly in 2009, not so much in 2010: Oil: +42% in 2009, -9.5% in 2010; Gold: +22.8% in 2009, -2.1% in 2010; Copper: +131% in 2009, -9% in 2010.

Portfolio Specifics:

- 1) We have been expecting a pull back for several months now and in mid-January it started. By the end of January the markets were down just over 6% from their highs and down 3% for the month.
- 2) Gold started breaking down so we took profits with a number of our gold holdings, we will go back in when they bottom out, which we expect to be in the next few weeks and about 15% or so lower. We expect gold to drop to between 950 and 1050.
- 3) Commodities have broken down as well. Oil has dropped from about \$82/barrel to \$72/barrel. We think oil could go lower, but want to start to add some energy stocks as a hedge against inflation and political problems in the middle east.
- 4) Many stocks have broken down, losing 15% to 20% in the past couple of weeks and often breaking their 200 day moving averages. This is the opportunity we have been hoping for. We started buying Dynamic Materials (BOOM) which has backed off about 25% and have started adding John Wiley & Sons as well.
- 5) Our buy list include stocks in the gold, energy, publishing and internet infrastructure and industrial groups.



Looking Ahead:

Market Drivers: 1) Trading

The markets continue to be trading driven – this will not change soon as trading is the basis of much of Wall Street’s profits. While Volcker may push to remove proprietary trading from banks, a move we hardily support, it is not likely to happen as this is part of the financial industry’s bread and butter. They will throw lots of political dollars around to ensure they are not cut off from this pot of gold.

At the same time, leverage is still in use, making trading even more attractive. This week Schwab and Fidelity cut commission charges for investors who invest on-line. Fidelity has dropped the trading fees on certain Barclay iSHARE ETFs to zero! They want investors to trade, that is for sure.

The carry trade, and its U.S. dollar related trade continues to hold firm. As the dollar strengthened in the second half of January stock markets sank – everywhere.

Market Drivers: 2) Fundamentals

So why did the dollar get strong? First, because many traders thought it had been over-sold. More importantly, various global economic realities started to become more obvious. First, it became clear that the spending going on here in the U.S. by Congress and the current administration can not continue. Shake ups in an early elections in Virginia, New Jersey and Massachusetts have made it quite clear that citizens are not happy with the results of the past year, nor are they going to be very happy with the tax increases that will be required.

Second, investors are starting to question the reported economic growth in China. We have been arguing for some time now that China is not all it is cracked up to be. This is not to say that they are not a large and growing economy that is very important to the global economy’s health. But their growth is not sustainable as it is a combination of speculation and government spending, not private consumption. We are seeing more trading spats with China and the rest of the world and we expect this to increase as China continues to try and export its way out of its problems. The problem with this strategy is every other country is trying to do the same thing! More recently both China and India have started trying to slow their economic growth by clamping down on bank lending. This will help them but it means that commodity prices should drop and it is likely that their stock markets will too. In the past month both China and India are down over 15%.

Third, after many years of fiscal irresponsibility, Greece is finally facing a potential default of its sovereign debt. Part of the problem here is that many international funds have exposure, plus they are not the only country with such issues; Spain, Portugal, Italy and Ireland are next. And don’t



Looking Ahead:

forget that Iceland already defaulted. The U.K. has severe stress and we can't exclude the U.S. – our debt now accounts for over 17% of our GDP, the highest it has been since WW II.

Based on these broad big-pictures concepts, here are potential surprises that need to be addressed:

- 1) The dollar gets stronger, not weaker, as worldwide economies weaken.
- 2) Worldwide economies weakens including Asia
- 3) Oil will be under \$70/barrel unless there is trouble in the middle east – which is brewing.
- 4) Inflation is building, but deflation will also be a problem. A double-dip could lead to broad deflation as countries try and export their way out of economic issues.

The end of the world is not here, but the road certainly is filled with potholes.

So what do we do? First, we manage our expectations. In times like these, our goal should not be to get rich, but to make sure that we protect our wealth. The last decade is the example. Those who got greedy lost ten years worth of earnings between 2000 and 2002. The same happened again in the mid 2000s. Those who got greedy (especially in real estate) lost fortunes between 2008 and now. In some ways it was even worse this time as many more people were completely wiped out because the leverage was not limited to stocks where only 2:1 leverage is allowed (In real estate and esoteric securities, leverage was much higher).

Investors like us who have been more diligent got dinged, nothing more. Continuing this mindset will help ensure that when these issues are finally all addressed, the investment markets have squeezed out much of the excessive risk, the next true bull market will come and we will have plenty of capital with which to participate.

In the mean time, diversification will be critical as will a laser-like focus on cash flow. Whether invested in equities, fixed income, real estate or alternative assets – all of which offer some opportunities, cash flow will be king.

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