

By Christopher E. Grant

Question: Why did God create economists?

Answer: To make weathermen feel good about themselves.

For the fifth consecutive year, we have reserved our Winter Newsletter for “Pundit Prognostications” and a setting of the economic and investment stage for the coming year. Last year, we recapped in our *Three Strikes You’re Out* section the mostly dismal 2006-2008 track record of the crystal-ballers. Thus, it is only fair to report that the ’09 Barron’s Roundtable consensus forecast of +15-20% actually fell slightly below the final return of 26.5% posted by the benchmark S&P 500.

While the 12-month number worked out fairly well, it is more than safe to say that the road travelled along the way was anticipated by no one. Thus, **the key to successful market predictions is still frequency – do it often enough and at least one is sure to work out.**

A New Decade The Same Weathermen

Investors are certainly ready for a clean slate as we exit what has been labeled the **“Lost Decade” of the 00’s, which saw most stock portfolios shrink as the Dow dropped nearly 10%, from 11,497 to 10,428.** As always, both market optimists and pessimists are amply represented as we simultaneously enter a new year and a fresh decade.

On the positive front are those who argue that the recent economic calamities are behind us and that the 60% market rally from the March 2009 bottom will continue with a repeat of double-digit gains for 2010. Countering are the skeptics who forecast a double dip recession as soon as the government printing presses are

slowed and the multi-trillion dollar stimulus package is exhausted.

Clear and Sunny

Providing a voice for the optimists is Brian Wesbury, chief economist at First Trust Advisors, a Chicago asset manager. Affectionately nick-named “Mr. Sunshine,” Wesbury has set out his optimism in his new book, *“It’s Not As Bad As You Think.”* In a recent interview with CNNMoney.com, **Wesbury forecasts economic growth of 4.5% in 2010 coupled with unemployment falling from the current 10% to 8.5% in 2010 and 7% in ’11.**

Further, he says that housing is improving so fast that **by the third quarter of 2010, “there could be a seller’s market for new homes.”** Addressing the issue of tight credit for both consumers and small businesses, Wesbury likens the flow of easy money to a flood, “When the Fed prints this much money, it’s going to find its way into the system.” There is no question that Wesbury is an optimist on the economy. Admittedly, he also predicts that the Cubs will go to the World Series every year.

Storm Clouds on the Horizon

At the opposite end of the spectrum are Eric Sprott & David Franklin of Sprott Asset Management LP. In their December 2009 piece, “Is it all just a Ponzi scheme?” Sprott and Franklin challenge the sustainability of an economic recovery fueled by the Federal Reserve’s “quantitative easing” policy. Translated into English, “quantitative

easing” is a process of increasing the money supply, typically only seen when interest rates have already been reduced to zero and when the government is still trying to stop a credit crunch situation.

As calculated by the authors, the U.S. government needed to issue \$2.041 trillion in new debt – or almost three times the new debt that was issued in fiscal 2008 in order to balance the budget for fiscal '09. **Their study concludes that the Fed “is printing dollars to buy Treasuries as a means of faking the Treasury’s ability to attract outside capital.”** In fact, the Fed has been the purchaser of nearly 50% of the new Treasury issues in Q2 and almost 30% in Q3 on top of being virtually the only buyer of new mortgage securities. Traditional buyers are clearly not keeping pace with the U.S. government’s deficit spending.

The Federal Reserve’s announced policy has been very clear about the fact that they intend to stop the quantitative easing program at the end of March, i.e., stop buying mortgage securities and Treasuries. **With the federal budget calling for another \$1.4 trillion dollar deficit, Sprott and Franklin’s question is, “Who will buy the debt?”** Given the events of the past year, there is no need to describe the domino effect that ensues when a Ponzi scheme collapses under its own weight.

Just so you don’t conclude that this description is a conspiracy theory concocted by two unknown wannabe celebrities, consider the following three opinions expressed by highly recognized “experts” in Paul B. Farrell’s January 5, 2010 Market Watch article subtitled *“12 ‘Dr. Dooms’ warn Wall Street’s optimism misleads, will trigger new crash.”*

Financial Global Cooling

First, money manager Jeremy Grantham warns that our irrational nightmare will repeat. A year ago we came dangerously close to the “Great Depression 2.” **Unfortunately, we’ve learned nothing... condemning ourselves to another serious financial crisis in the not too-distant future.”** We had our bear-market rally. Next, historical cycles plus our irrational behavior guarantees another, bigger global meltdown. We “learned nothing.”

Next, Nobel economist Joseph Stiglitz recently warned: **Unless Wall Street’s incentive system is drastically reformed, “the financial sector will only try to circumvent whatever new regulations we put in place. We will simply have a short respite before the next crisis.”** Warning, nothing’s changed, it’s worse: Lobbyists run Obama, Congress and the Fed.

Finally, and virtually echoing Sprott and Franklin, is financial historian Niall Ferguson. “In the 400-year history of the stock market there has been a long succession of financial bubbles. **Who’s the culprit? The Fed. Without easy credit creation a true bubble cannot occur. That is why so many bubbles have their origins in the sins of omission and commission of central banks. Another bubble (and crash) is virtually certain,** thanks to Washington’s \$23.7 trillion explosion in debt, the Fed’s support for the \$670 trillion shadow banking system and Wall Street lobbyists getting superrich thanks to Wall Street’s insatiable greed.”

Financial Global Warming

Before you head to the pharmacy for a Costco size box of Prilosec OTC, rest assured that **the entire investment world is not out shopping for canned goods and water to stock their 1950s bomb shelters. Among the dozen Wall Street strategists and investment managers surveyed by Barron's, the consensus is for a 12% gain in the S&P 500** to roughly 1240 with James Paulsen of Wells Capital Management calling for a 22% rally to 1350. Also joining the 1350 crowd are the strategists at Prudential who see sustained GDP growth, corporate earnings surprises to the upside, low inflation due to excess capacity and high unemployment, and continuing "crisis low level" interest rates.

Bank of America Merrill Lynch, while not quite as positive with their 1275 S&P target, is highly optimistic about markets outside the U.S., calling for a 20% advance in the MSCI All-Country World Index. **They also predict continuing foreign demand driven rallies in gold and oil to price levels over \$1,500 and \$100, respectively.** And, citing their expectations for global growth led by emerging economies, a slow but steady U.S. recovery, and healthy S&P EPS growth, they present an interesting twist, calling for the "pessimism bubble" to burst in 2010.

Both U.S. Trust and JP Morgan are pointing to 1300 S&P peaks with identical calls for 3.5% GDP growth. The U.S. Trust's Chief Investment Officer, Christopher Hyzy thinks 2010 will bring "a pivotal transition from government-led repair to a private sector led recovery." As Americans pay down debt and trade down in their spending habits, Hyzy sees "both consumer demand and excessive leverage being repaired slowly."

A Man For All Seasons

If the past two years have turned you into a manic depressive investor, you will appreciate the all-weather market forecast by Deutsche Bank who offers a full range of four alternative scenarios, each with a projected return and an assigned probability.

Scenario 1 is the near perfection Goldilocks scenario, characterized by low interest rates and gradual reflation with money continuing to pour into high-risk assets. Total equity returns: 34%, Probability: 15%

Scenario 2 is characterized by a gradual easing in government stimulus and easy money with global policy makers successfully beginning to tighten money supply. Total equity returns: 20%, Probability: 50%

Scenario 3 depicts a failure of the quantitative easing programs to stimulate demand combined with a spike in interest rates and inflation. Total equity returns: -11%, Probability: 25%

Scenario 4 is the nightmare scenario of a double-dip recession coupled with deflation. New banking scares and sovereign debt defaults cause another flight to quality, 2008 redux. Total equity returns: -26%, Probability: 10% **Note that the weighted average return is 9.75%.**

Whatever your view of the market weather, be it partly sunny or partly cloudy, you will never have trouble finding an "expert" to back your opinion. As illustrated above, both optimists and pessimists abound, each with a cogent rationale to back his forecast. What is equally clear from our last four years of

prognosticator performance appraisals (as well as the past decade of market returns) is that Mr. Market has a mind of his own which, at least temporarily, can disconnect from economic fundamentals. Such was the making of the dot.com, housing and credit “bubbles.” In each case, the bubble eventually burst, once again disproving the theory that it was “different this time.”

Jobs, Housing and the Consumer Keys to a Fundamental Recovery

Eventually, fundamentals always matter. With this in mind, we turn to a brief analysis of three crucial drivers; jobs, housing and consumer spending which we believe will “reconnect” the market and the economy.

Employment – The Real Numbers

According to the Bureau of Labor Statistics, in December, the number of unemployed persons stood at 15.3 million and the unemployment rate held at 10%. The broader U6 measure, which includes “marginally attached workers who are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the recent past,” stands at 17.3%.

Additionally, in order to keep up with new entrants into the working force due to population growth, we need to add roughly 127,000 jobs per month. **Given the fact that approximately 8 million jobs have been lost since the recession began, in order to return to full employment in 5 years, we will need to create 18 million new jobs or 300,000/month.** Partly cloudy says tough slog ahead while partly sunny reminds us

that 20 million jobs were created during the 8 years of the Clinton presidency.

Housing – Double Dip or Recovery?

The impact of unemployment on housing has been catastrophic with one million American families losing their homes in the fourth quarter according to Realtytrac. **With five and a half million homeowners late on their mortgage payments and a second wave of Option-ARM loan rate resets on the horizon, Moody’s Economy.com anticipates another 2.4 million homes will go to foreclosure in 2010.** One quarter of homeowners with mortgages are under water (home value below the mortgage balance), 40% for those who took out mortgages in 2006.

The partly sunny news is that the first-time home buyer tax credit has been extended and expanded until April 30 (look for further extensions) and multiple governmental bodies are actively creating programs for mortgage restructuring to avoid foreclosures. According to the National Association of Realtors, expectations are also on the rise as existing home sales show a seven month uptrend while inventories continue to decline. In their most recent survey, 60% of respondents believe home prices will rise by as much as 5% in the next year.

Consumers – Deleverage or Spend?

One of the most often cited economic statistics is that roughly 70% of U.S. growth is driven by consumer activity. The evidence is highly persuasive as consumer debt (credit cards, auto loans, and bank loans) has exploded over the past 20 years, rising to \$2.6 trillion. Household debt, including mortgages,

rose from 47% of personal income in 1959 to **117%** by the end of 2007, from just 25% of GDP to 98% of GDP during this same timeframe. **A study by Haver Analytics showed that 3% of the annual GDP growth in the period from 2002-2007 was attributable to mortgage equity withdrawals alone.** And, prior to its July 2008 peak, consumer lending, including credit-card debt and auto loans (excluding mortgages) had been growing for more than a half-century.

But, with U.S. homeowners having seen their equity shrink by some \$8 trillion since the beginning of '08, the home equity ATM has virtually closed. Now that consumer lending has suffered eleven consecutive monthly declines, it would appear that the deleveraging process has begun. **Here, too, all is not gloom and doom. Economists have been predicting the demise of the American consumer for decades. Obviously, they have all been wrong.** And even if U.S. consumers really do

have to change their ways this time around, the world will not come to a halt. During the major recession of the '70's, a number of successful new businesses were started. Maybe you recognize the names Microsoft, Apple and Intel.

Spring Will Again Follow Winter But Not in January

As we enter this year's silly season of market forecasts, sound advice is offered by Chief Economist and Strategist David Rosenberg of Gluskin/Sheff, "the key for us is to refrain from hyperventilating over every piece of minutia and to maintain a realistic forecast of where the fundamental trends are with regard to inflation, savings rates, economic growth, profits and interest rates since the overwhelming tendency among so many economists, strategists, analysts and portfolio managers is to live in the moment." Patience and discipline will win out.

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