OVERVIEW

Economic Analysis and Market Review Q4 — 2010

The Year in Review

IT'S THE END OF ANOTHER YEAR and a good time to look back and assess the economic environment we find ourselves in and how the markets are responding. Actually, the markets performed remarkably well, all things considered: 2.87 million homes received a foreclosure filing, a record. One million homes were actually repossessed, a record. Sales of new homes declined to the lowest level ever recorded. The price of gold reached $1400, a record. Over 1.5 million consumer bankruptcy petitions were filed in 2010, the highest since Congress tightened the bankruptcy laws several years ago. The number of Americans working part-time jobs "for economic reasons" was the highest it has been in at least five decades. The number of Americans on food stamps surpassed 43 million in 2010, a record. Over 43 million Americans are living in poverty, the highest number in 51 years of record-keeping. Government spending continues to set new all-time records. It has surpassed $14 trillion and is projected to exceed $15 trillion in this year.

Burgeoning debt is the sword of Damocles that hangs over the global markets. It's not just the United States that is in trouble. Nightmarish debt problems in Greece and Ireland have already led to bailouts from the European Central Bank and the International Monetary Fund. Spiraling debt in Spain, Portugal, Italy, Belgium and several other European nations threaten to crash the euro at any time. In fact, many economists are now openly debating which will collapse first under the weight of excessive debt — the euro or the U.S. dollar. With the danger of European debt contagion, sabre rattling in N. Korea, concerns of inflation in China, new investigations into insider trading violations and more regulatory pressure on financial services it is amazing that the stock market set a new two-year high. Not only have stocks risen in this environment, but bonds and gold – virtually all assets in the world locked arms. It appeared that we had entered into a period in which all correlations went to 1.0. The concept of diversification in this circumstance has been seriously questioned. A South African gold mining stock, a Canadian oil driller, a California retailer and an Illinois machine parts maker all are finding their fates linked.

Perhaps one answer to this is that politics has intruded into the economy to a far greater extent than we have been used to. Quantitative Easing is the name of the game now. QE1 didn't have the desired effect on the economy so the Fed initiated QE2 in the fourth quarter — a $600 billion surge into the market. The Fed wants U.S. investment confidence and equities to go up. The housing crisis caused peoples' sense of personal wealth if not their actual personal wealth to decline dramatically and brought spending down with it. Our economy is driven by consumer spending and so this had to be reversed. If the Fed's actions cause the markets to rise, this should help elevate the consumer's wealth factor and raise retail sales and the economy with it.

On a year-over-year basis, retail sales are now up 6.3%. Much of the upside has come from vehicles, which are up 10.3%. Outside of vehicles, sales are up 5.8%, the fastest pace since June 2006 according to Ned Davis Research. Building materials and garden equipment and supplies store sales have risen 9.0%, the most since April 2006. Something seems to be working.

In the markets, this sense that things seem to be improving is carrying the day. The US stock market as measured by the S&P 500 gained 15% for the year and 23% in just the last six months. Some might also attribute this stellar performance to the 4-year cycle or "Presidential Cycle". According to the "Presidential Cycle" we are now in a very favorable period. It is after the mid-term elections that the cycle turns up. If this road map holds this time, we should have a run up through next year, topping out in early 2012. The next bear phase would begin in 2013.

If only we could count on history repeating.

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