Prepared Comments from 1/20/2011 Conference Call

My last conference call was on October 15th. US stocks have since recovered 8.7%. The 4th quarter brought gains of over 10% for US stocks, foreign stocks rose about 6%, but bonds fell about 3%. These results followed signs of a continuing economic recovery, coupled by significant steps by both Congress and by the Fed, to shepherd this recovery through stimulus steps.

The Fed announced QE2, Qualitative Easing version II, in which it uses hundreds of billions of dollars to purchase government (and perhaps mortgage) bonds. This is designed to artificially lengthen the time that these bonds retain historically low interest rates. This enables consumers and businesses to save money, by keeping borrowing rates low. Yes, the Fed makes these purchases with newly printed dollars, however in the future, when the Fed feels that the economy can handle it, the Fed will essentially burn the dollars that the Fed is repaid as these bonds gradually mature.

Congress passed a dramatic tax law change in December, the impact of which I covered in my recent newsletter article. There are many stimulative areas of the new law, including cutting the employees' share of Social Security taxes, extending unemployment benefits by just over a year, and by delaying by two years the expiration of the 'Bush-era tax cuts.'

While the country's unemployment rate remained close to 10% for most of the year, it fell 0.4% in December, and we are beginning to see monthly job creation rather than job losses. If the US economy indeed benefits from the late 2010 stimulus, job creation in 2011 should be better than in 2010.

For most of 2010 I described US corporations as well positioned for growth and profits. This remains the case. Companies continue to sit on a large amount of cash. This morning the Conference Board announced that their Leading Economic Index rose another 1% in December, after a 1.1% increase in November. With the two stimulus steps mentioned previously, many market analysts have been revising their 2011 projections upward.

It is likely that the earnings for the S&P 500 companies in 2011 will exceed their highwater mark from early 2007. Yet the S&P 500 stands 18% below its 2007 peak level.

Here at the start of 2011 we find the US consumers are becoming better positioned for growth, even if many don't realize it. Late last month the University of Michigan's Index of Consumer Sentiment rose 4.1% versus a month earlier, and 2.8% higher than a year ago. This index remains well below their levels from most of the last decade, but at least they are well above their 2008-2009 lows.

Delinquencies on consumer loans have been falling for the past six months, and on mortgages have been falling for the past few months.

Investors enjoyed a good year in 2010, with bonds doing fine (corporate bonds faring much better than municipals), but stocks excelling. So what do we do in 2011?

On the 10th I prepared my 2011 Market Review and Outlook, including my predictions for 2011.

Let's begin with bonds. Yes, a bond bubble has been building. I regularly remind people that the damage from a burst bond bubble is far less than from a burst stock bubble. Furthermore, I don't see the bond bubble bursting for many quarters. As long as the Fed and the federal government are stimulating the US economy, the burst date is being artificially delayed.

While I typically like to have 80% of bond money invested in high quality bonds, in this environment I prefer only 65% in higher quality bonds, and 35% in 'opportunity bonds.' This 35% is spread amongst high yield (aka junk) bonds, bank loan/floating rate bonds, multisector bonds, and foreign bonds. Think of this as placing eggs into six baskets. If the economy strengthens more than we currently expect, and the Fed and Congress stop stimulating the economy and rates rise, high yield and bank loan bond funds should fare just fine, and foreign bonds may be unaffected. If the economy merely limps along, then the 65% high quality bonds should provide steady income.

There is a lot of concern over municipal bonds, as state and municipality finances have been quite shaky, especially in some areas such as California, Nevada, Illinois, and Florida. I expect that this has been fully incorporated in current muni bond prices and yields. Municipal bonds yield over 110% of treasury bonds after-tax, while historically they yield less than 90% of treasury bonds after-tax. The concern is real, and the fear is real, however at some point, the price fully reflects this.

All else being equal, however, I prefer corporate bonds over municipal bonds. However, investors have taxable money, and interest from corporate bonds are fully taxed while interest from municipal bonds are at a minimum tax-free at the federal level.

While I expect that in the coming five to ten years bonds will underperform both their 20-year average returns and stocks' returns, I still favor maintaining close to 'normal' levels of bonds. Why? Because investors benefit from having part of their portfolio more secure, less exposed to the sharp ups and downs that stocks bring. Furthermore, with the 'opportunity bonds,' I am hopeful that Mallard's clients earn better than average returns from their overall bond positions.

This brings us to stocks. I like them. I like them because investors don't. Investors pulled money from US stock funds for the past four years, while adding money to bond funds for the past ten straight years. I wish it weren't the case, but the typical investor runs from stocks when it's too late, and returns to stocks when it is also too late, when they consider stocks to be 'safe.'

Stocks are never safe. Never have been and never will be. You can't get a 100% chance of making a bundle in stocks. You can, however, improve your odds.

You can consider how expensive stocks are. The S&P 500, when looking at forward P/E ratios, price/book ratios, and price/cash flow, is cheaper than its 5, 10, and 15-year averages.

The S&P's 'earnings yield' (earnings divided by stock price) is 1.5% higher than the average Baa rated bond. Other than the past three years, the difference has not been that high in the past 27 years.

One reason that I like stocks is that the alternatives stink. Money markets yield near zero, and CD and bond yields are historically low. This makes stocks more attractive, by comparison.

I like large US stocks. Why? Someone has to. Large-cap US stocks get no respect. Small-cap stocks almost doubled large-cap US stocks' returns in 2010 (+25.2% versus +12.9%). At some point investors will realize that large US companies are very stable, are well capitalized, and are well positioned to sell both into the US and outside the US. Large US stocks trade at PEs about 80% their 20-year average, while small US stocks trade at about 94% of their 20-year average. I like small US stocks, but I think that large US stocks represent a bargain at this time. How long it takes others to recognize this is anyone's guess.

Foreign stocks had a very tough 2010. Most of this had to do with PIIGS, Portugal, Ireland, Italy, Greece, and Spain. Investors worry about the government bonds from each of these countries. Greek government bonds yield over 12%. As 72% of Greek government bonds are held by non-Greeks, the government is not in control of its destiny.

This led to runs on the bonds from these countries, and the European Union and other international entities came together to 'backstop' these bonds, to alleviate some of the growing panic. While this helped a bit, many investors decided that it wasn't worth the trouble, and kept their dollars in the US, far from headlines of Europe's 'border countries.'

The risks in the future are many. A slowing instead of improving economy could reverse the recent reduction in the unemployment rate, which is critical to strengthening the US consumer, and state and local finances. Rising oil prices can do as much damage as rising unemployment, and with the growth of countries such as India and China, oil prices can rise even while the US economy continues to merely limp along. A run on the US dollar, and/or a sharp rise on interest rates in the US can harm investors, consumers, and companies.

However, I recently read an article noting that it is worth being on the lookout not only for Black Swans (unlikely events that cause significant pain), but also Ugly Ducklings (bargains that can bring significant gains).