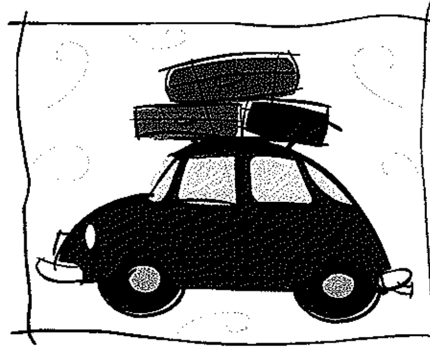
Colley Asset Management, Inc.

REGISTERED INVESTMENT ADVISOR

What a Long, Strange Trip It's Been!



There are many tidbits of Wall Street wisdom out there and perhaps none more timely and apropos than a quote from John Templeton. Over my career, I have always been mindful of insights from Templeton, the founding father of mutual funds, who recently passed away at the wise old age of 95. In my opinion, **Templeton's observation that "bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria" is right on target**. The old adage of "climbing a wall of worry" is also a spot-on point that deserves to be addressed, as we are actually "living it" here as we enter a new year.

In short, since the economic bottom was established in March 2009, the global financial markets have begun a staircase recovery with stutter-step rallies and pullbacks. **The upward and net-positive slope, although not altogether convincing, has been accomplished amid a great deal of doubt and pessimism.** Problems like terrorism threats, Dubai, Greece, Iceland, GM, Citi, AIG, stress tests for banks, Fannie and Freddie all nipped at the bull market but did not kill it. In fact, if you try to frame the past decade you could easily characterize it as one of extreme sentiments capped in '08 and early '09 by crazy volatility and unbridled panic not experienced for almost two generations. **It has been a bittersweet privilege to survive this place in time and to now move on.**

The numbers tell a story when you survey the S&P 500 results for the last decade (1999-2009). Sadly, the total return on the S&P 500 from the end of 1999 to year-end 2009 (including dividends) was -10%. The US economy (GDP) is on track to have grown by less than 2% a year over that decade. **Historically speaking, the S&P 500 has lost more value in the 00's than it did in the 1930's.** Fixed income and bonds (of all maturities) turned in very mediocre returns, suffered rating downgrades and reduced rates of return, "net negative" after inflation. In addition, **never before have we witnessed US T-bills provide a "zero" coupon or 0.00% return at Federal auctions.**

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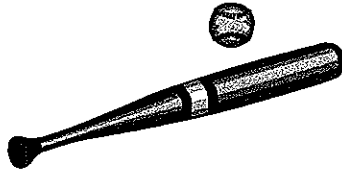
Every January when I write this particular Newsletter, I like to reflect on the past but really concentrate on the future. So, as I begin, I'm **humorously reminded** of a cute quote from one of baseball's greats, Casey Stengel:

"I try never to make predictions, especially about the future."



With that said, let me start out with a few reflections. The balance of 2009 embraced some optimism and improvement, which can be built upon in 2010. The hangover and hardships of the recession are not over, but the headaches are much less worse and the fundamentals are improving. **So it goes into 2010...most analysts are offering upbeat forecasts for stocks, though tempered with an ample dose of "what-ifs":** Do we experience a double-dip recession? Will housing ever get back on track? Will the Fed raise rates too soon and choke off the recovery? Will inflation come roaring back too fast? Will government spending catch up with the recovery and stall it? Is the stimulus plan really working to create jobs? Will tax increases come at the wrong time? And, most ominously of all, will unemployment continue to prevent the consumer from recovering? I could go on and on, but I'll stop there because you get the picture. Next up:

Winning Strategies and 10 Factors to Watch for in 2010. As we turn the calendar to 2010, the worst-case scenario – a depression – appears to be off the table. However, **some of the underlying forces that caused the credit crisis remain,** and **the extraordinary steps taken to avoid an "Armageddon"-like meltdown have caused other imbalances and triggered additional problems and opportunities.**

I. Global vs. Domestic Picture

We must remember that the US financial markets are part of the global scene and more driven and responsive to the world markets than ever before. If you look at only US supply and demand statistics, the analysis really misses the mark and gives us only part of the story. Import-export business, currency variables, trends in world trade, tariffs and protectionism, emerging markets and geopolitical developments are keenly integral and relevant now. This is not to say that domestic policies, federal and state budgets and unemployment woes aren't important, but the global meltdown proved that the world is more interconnected, interdependent and more integrated than ever before. Large cap companies like Caterpillar, Deere, GE, Merck, US Steel, Johnson and Johnson and IBM

now derive more than 50% of their revenue stream from business done abroad. This trend is continuing to unfold. In fact, it is the basis for one of CAM's "theme" investment strategies; namely, invest in well-managed, financially sound large cap companies that are well positioned internationally. Remember, too, that developing nations are home to about 82% of the world's population and, in 2010 and 2011, these nations will be responsible for 66% of the world's GDP growth.

II. Alphabet Soup

If you have watched CNBC at all lately, you may have wondered if the producers of 'Sesame Street' had taken over the network and programming. Guests kept talking about the letters L, V and W or even B for "bathtub" type recovery. The unprecedented stimulus and "zero" interest rates took L off the table. The exact end date of the recession will not be known for months, but the best guess is that the expansion in GDP started around June 2009 with some V-like rallies, only to be "submarined" by W, indicating a double-dip in case the rally dies and we again retreat into a recession. The consensus opinion of economic experts is that we will avoid the "double dip" but that the recovery moderates and endures more slowly (with a few exceptions). The exceptions are important because some point to the tremendous opportunity while others contain the caution and risk themes for sectors in insurance, banks, airlines, retailers and consumer discretionary areas that you avoid. More on this later in the Newsletter, but the **"moderation" case** should be further explained in III and IV below.

III. The Consumer is Cautiously Moving Forward

The rebound and return to financial health for the consumer is just going to take more time and more work. A deep recession takes a deep toll and although we all know that unemployment is a lagging indicator, look for sluggish consumer spending to continue beyond the recession.

Our economy does not reward saving and conserving as much as it has rewarded and tracked spending. This new emphasis on saving and conserving lends itself to the theme that momentum growth and spending patterns will moderate and not be as robust as in past recoveries. One variable that may give us false reads on this "less is more" theme is the inventory restocking data. During a recession mind-set, businesses and companies let their inventories draw down, they fire workers to cut labor costs due to lower demand and resist restocking their shrunken inventory...so in a typical expansion we will begin to see the pent-up demand and restocking numbers give us some false positives. This scenario is further affected by rate-sensitive sectors like borrowing and credit card debt. So, strapped with too much debt, the consumer retracts again, adding to our theory that consumer spending is kept in check. One of the most rate-sensitive sectors is housing

and the housing market is coming off its steepest decline on record, with average prices falling about 36% from their April 2006 peak, based on the S&P Case-Schiller Index. The worst of the real home price decline may be behind us, but the prospect of housing being the engine for growth is not promising, which also supports the rationale for slower consumer spending. **As it is now, we may see housing prices flatten for 2 to 5 years, before moving higher.**

IV. The Consequences of Debt

For the past 50 years or so, US consumer spending has been the engine of capitalism and the propeller of economic growth both domestically and internationally. The future drivers of consumer growth will come from emerging countries of the world as exemplified by what is going on right now in Brazil, India, China, Central America and developing countries in Africa and Asia. Although consumer spending accounts for about 69% of the US's GDP, this number used to be 75% five years ago. US consumer credit is down 5.2% (in the past year), which is the steepest decline since record keeping began in 1965. The defaults and foreclosures are beginning to ease some, but the side effects will stay with the US consumer for some time. In brief summary, the US consumer (strapped by debt) will not significantly add or subtract to growth in 2010, supporting the square root-shaped outlook. It is believed that **unemployment problems will begin to improve in the second half of 2010**, but the labor improvements will be slow and gradual on this front. Unemployment and its side effects are a major concern to stodgy consumer spending and saving patterns.

V. Stock Market Indications

As I've said many times before, investor sentiment is an underestimated force in determining the stock market's direction. In short, the opportunity for further strong appreciation in the stock market does exist. In fact, it is possible over the next 2-3 years to see a powerful explosion to the upside, with 5-7 corrections of 5-10% along the way. As already pointed out, this year's story is as challenging as ever as investors must confront many unanswered questions and worries. Low interest rates (even if monetary policy finds cause to raise them slightly to strengthen the US dollar and keep inflationary pressures contained) are bullish for stocks. The world recovery will probably unfold much faster than the rebound in the US...the GDP growth rates are pegged at 6-8% for China, India and Brazil with more modest 2-4% rates of growth for the US. The US rebound may be peppered with a slow or fast quarter adding intermittent confusion to stock price movements. **Additionally, the political tenor and partisan antics add another dimension to the frustration factor of investors/consumers.**

VI. Outlook for Earnings and Valuation

The 500 companies in the S&P 500 Index lost $23 per share in the fourth quarter of 2008, the worst quarterly decline on record dating all the way back to 1926. Operating earnings, which exclude one-time write-offs, were also the most negative on record (even worse than suffered in the Great Depression). So what did corporate America do? They went on the defensive big time, which meant cutting production, slicing general operating expenses and implementing huge layoffs as well. The carnage of late '08 and early '09 means the comparisons here in '10 could be artificially higher and easier to hit. The median P/E ratio for the S&P 500 over the last 25 and 50 years is remarkably similar (20.2 and 20.3 respectively), so the current 14.4 ratio still cries out 'undervaluation'. The 10.9 P/E low was achieved in the first quarter '09 and it has never been that low before. Even the PEG gauges are attractively low, and CAM points out that certain industry sectors are more attractive if you believe in the rebound scenario in the worldwide industrial and manufacturing sectors. **Some of the favorites on our buy list include both blue chips and turnaround situations:**

General Electric (GE)	**CSX Railroad (CSX)**	**Mosaic (MOS)**
Precision CastParts (PCP)	**Deere (DE)**	**Potash (POT)**
Textron (TXT)	**Southern Copper (PCU)**	**Terra Nitrogen (TNH)**
Manitowoc (MTW)	**US Steel (X)**	**Ford (F) and Honda (HMC)**
Caterpillar (CAT)	**Frontline (FRO)**	**Monsanto (MON)**
Energy favorites include:		
Duke Power (DUK)	**BP Royalty Trust (BPT)**	**Enbridge Energy (EEP)**
Enterprise Group (EPE)	**Trina Solar (TSL)**	**Conoco Phillips (COP)**
Apple (AAPL) and Google (GOOG) represent the best in breed tech stocks, with Microsoft (MSFT) and IBM close behind.		

VII. Interest Rates, Inflation and the Central Bank

Many of you have asked me if the Fed's monetary policies will lead to higher interest rates and inflationary pressures. The short answer to this is 'yes', but not right away.

With unemployment at a 26-year high and capacity utilization and the manufacturing index in slow motion, there is plenty of slack in the domestic economy. Eventually, foreign demands will put upward pressure on commodities, metals, food and natural

resources, but for now it is not a domestic recipe for inflation. The Fed has signaled that it plans to keep its target interest rates very low and Fed fund rates near zero. Crude oil prices could fluctuate between a $30 range...$68 to $98 per barrel. A stronger recovery could create more demand and further upward pricing pressure on oil/gas/coal/solar.

The brilliant Ben Bernanke studied the Great Depression at length (for his doctoral thesis and even post-doc work) before becoming Fed Chairman and the lesson he learned from the 1930's is that monetary policy can be tightened too quickly, so he may delay in raising rates until the recovery is solidly entrenched. Unfortunately, some investors and economists have already begun to worry that the Fed will be too loose and may err on the side of maintaining the "low rate" stimulus for too long. As in chess, please expect this checkmate to play out in 2010 as the "wall of worry" syndrome always invites worry-worts, second-guessers and know-it-alls to the game.

However, in 14 of the last 15 post-recession recoveries, inflation and interest rates did both rise by 300 to 600 basis points (or about 4.5%) on average, so it is strongly contended that long and intermediate term rates will rise first and short-term rates will lag. There are a multitude of factors here and several undertones as well, but suffice it to say, rates and inflation will be rising in the second half of 2010 and into 2011 as the recovery and faster velocity of money supply and spending both trigger it. The magnitude of the increase could be large if the legs of the economic recovery are long. In the late '80's (post '87 crash) rates rose to 9 and 10% and CPI inflation peaked around 6%. Consequently, CAM can develop many prudent fixed income strategies that are designed to protect principal and maximize the sweet spot of the yield curve. This strategy becomes especially desirable and prudent when bond yields rival equity returns. The ACG Income Fund and others offer monthly income and sound intrinsic quality. Also, defensive telephone utility stocks like AT&T (T), Verizon (VZ) and Century Telephone (CTL) can serve as bond equivalents with 6% dividend yields.

VIII. The US Dollar's Future

One of the obvious effects of the Fed's zero interest rate policy is that it makes the US dollar less attractive against foreign currencies. This phenomenon has also helped gold, silver, copper and platinum hit new highs as well. Globalization and deregulation mean that both US and foreign investors can take advantage of low US rates by using the "greenback" to fund carry trades (i.e. investors borrow cheaply in dollars and invest the funds in higher yielding assets). The trend has been accentuated by the investor's recent willingness to invest in equities and not in bonds (as the risk appetite gradually improves). Add to this the twin trade and budget deficits and you can see why the dollar's status as the world reserve currency has been questioned. In the long run, further devaluations are plausible, however a collapse in the US dollar index is highly unlikely.

The Fed's "magic bag" of monetary policies will be key levers to creating a more stable dollar. I can elaborate on this if you want, but I didn't want to put anyone to sleep.

The US Dollar Index fell 14% between Feb. and Oct. '09, representing the biggest 8-month decline since 1985. Bottoming at around 74/100, the dollar has rebounded slightly to 77/78 and should remain in the 76-80 range for the first half of 2010. CAM can explain the ramifications to you.

IX. Emerging Markets – Where the Action Is

Emerging markets have led the global recovery, with the economies in China, Russia, Brazil and India all hitting a bottom before the US did. The sheer population difference is <u>one reason future GDP expansion in these BRIC countries can pierce 10% again</u>, as more and more people spend money and buy food, consumer products and other services. In relative terms, the emerging markets are still the "cheapest" place to invest and the weaker US dollar also encourages the dollar carry trading. This long term uptrend, despite a few hiccups here and there, is decidedly intact. You will see CAM using ETFs like <u>BIK</u> to get into the action. The ETFs often hold 50-80 companies and provide smart diversification as a broad basket of picks. <u>Other ETFs for the higher risk financial (XLF) and homebuilder (XHB) sectors could be appropriate for some.</u>

X. Risk/Reward – A Fiduciary Orientation is Needed

CAM evaluates risk/reward parameters as part of a fiduciary overview process, using certain technical analysis to highlight outperformance opportunities that stick out like sore thumbs. The charts reveal severely oversold stocks, some of which are down for a reason and will not come back. One question I have been fielding lately relates to the "fallen" sectors like financials. Will financials and real estate/housing and other early cycle leaders begin to outperform in this rebound? Remember, the early stages of an established bull market are driven by **mean reversion**...a.k.a., **the most beaten up can bounce back a lot, even if their fundamentals don't justify it. They won't hold up, though, if the earnings don't show up.** <u>The 65% decline in the S&P 500 had left plenty of room for mean reversion.</u> The dividend cuts were also severe and soon a gradual rebuilding of dividend yields will be rewarding again, coincident with improving EPS and balance sheets. <u>Frontline</u> and <u>PCU</u>, both known for above average yields in the past, will once again (in due time) reward shareholders with double-digit yields. Even severely oversold stocks like <u>MTW</u> (once $50-55 and now $10/13) will be a rising star again.

So, with more than $3.5 trillion sitting in US money market funds, there is a treasure trove of cash sitting and waiting on the sidelines. With money market yields so low,

stocks and bonds do indeed offer more reward potential, but also more volatility and risk. This doesn't include the low rate CDs and bonds that will soon be maturing for investors or the "cash" deposited abroad in foreign banks. The "mom and pop" and institutional investors alike will soon be deciding whether or not to invest that cash in those vehicles again. **My educated hunch is that the risk/reward advantages could definitely be worth it.** CAM is already there, looking for the sun to rise higher in the horizon. So, here's to 2010 being a very good year – onward and upward! Exercise patience as the slow bull market gradually unfolds and with CAM's assistance find an asset balance and income formula that is suitable and comfortable for you. I'll be talking and/or meeting with you shortly.

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