

A Look Back, A Look Forward

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One year ago, we sat down with our clients and reviewed a spreadsheet of credit data from the Federal Reserve. From this and other sources, we recommended overweighting stocks and underweighting bonds for 2010. Here we will grade ourselves in hindsight. The **blue lettering** is from our January 15th newsletter, the black print is our grading comments.

- **Bonds.** **In general, we are slightly underweight fixed income, and overweight equities.**
 - **Comment.** Yields on 10-Year Treasuries started the year at 3.8%, dropped as low as 2.4% in the fall, and have now climbed back around 3.6%. This underperforming asset class has not had a substantial impact on our clients' performance due to our underweighting.
- **Gold.** **We do not recommend buying gold at this time, although we understand some of our clients feel comfortable holding some gold in their portfolio.**
 - **Comment.** As measured by the performance of the largest gold ETF, SPDR Gold Shares (symbol: GLD), gold has risen about 23% this year. Our clients have not participated in these gains.
- **Oil.** **We are neutral. \$80 per barrel could move up or down depending on what happens with the U.S. dollar, and depending on how quickly or slowly the economy rebounds.**
 - **Comment.** A barrel of oil today trades around \$88.
- **International Equities.** **We are neutral to slightly underweight here, depending on risk tolerance. We prefer Asia, excluding China, over Europe.**
 - **Comment.** The benchmark European index, the MSCI EAFE, is essentially flat for the year. The Asia-Pacific region, as measured by the iShares MSCI Pacific ex-Japan ETF (symbol: EPP) has risen about 9% for the year. Emerging markets are up about 7%, as measured by the iShares MSCI Emerging Markets Index ETF (symbol: EEM).
- **Small companies.** **This is our favorite area. We recommend overweighting small- and medium-sized companies.**
 - **Comment.** The Russell 2000 index, the standard benchmark for small companies, is up about 21% for the year. The S&P 400 MidCap Index is up almost 22%. Our clients, overweight in these areas, have participated.
- **Large companies.** **We are neutral here.**
 - **Comment.** The S&P 500 index is up about 9% for the year. The NASDAQ, the index of large technology-focused companies, is up about 14%. Our clients have participated in both.



As each client's portfolio is tailored to their unique goals and situation, individual performance varies. However, in general, we are always pleased to see our clients making money, and 2010 was a pleasing year. Our advice to avoid bonds and maintain discipline in buying stocks, especially small and medium sized companies, has resulted in solid gains for our clients over the past 12 months.

In looking ahead, we will again review credit data from the Federal Reserve, updated with available 2010 numbers.

F.1 Total Credit Market Borrowing and Lending (1)

Billions of dollars; quarterly figures are seasonally adjusted annual rates

	2006	2007	2008	2009	2009				2010			
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	
1 Credit market borrowing	4043.4	4483.1	2585.4	-643.9	-155.7	-625.9	-814.4	-979.5	354.8	549.3	1062.2	1
2 Domestic nonfinancial sectors	2413.6	2523.1	1906.2	1023.2	1572.5	1497.7	719.0	303.5	1489.4	1663.3	1473.1	2
3 Household sector	1186.6	873.4	35.9	-240.0	-115.0	-264.7	-304.0	-276.4	-292.4	-293.4	-232.0	3
4 Nonfinancial corporate business	467.1	752.3	364.2	0.7	183.0	4.0	-117.9	-66.4	374.4	266.8	328.5	4
5 Nonfarm noncorporate business	408.6	454.8	211.4	-290.7	-173.6	-286.8	-360.8	-341.5	-320.6	-270.1	-162.7	5
6 Farm business	14.2	14.6	4.0	-2.0	2.4	-3.4	-3.8	-3.2	-6.5	-6.0	19.3	6
7 State and local governments	153.7	191.0	51.5	111.3	125.6	97.1	134.0	88.4	132.7	-36.9	124.1	7
8 Federal government	183.4	237.1	1239.2	1443.9	1550.0	1951.5	1371.5	902.6	1601.9	2003.0	1395.9	8

The red circles are the numbers we looked at in January 2010. We continue to focus on household and government spending in drawing macro and micro conclusions. Although overall credit (line 1) has started to expand again after shrinking in 2009, you can see our nascent recovery looks nothing like the heady bubble days of the mid-2000's. Further, the household sector continues to borrow, and spend, relatively much less. Government stimulus is propping up our balance sheet, but with no money to spend, consumers will probably not be driving up prices anytime soon.

There is some similarity to Japan of the 1990's where a stock and real estate bubble collapse led to deflationary consumer activity, despite years of extremely low official interest rates.

The problem is studied at a high level, but ultimately our guys and gals on Main Street know what the problem is. The problem is that real interest rates for consumers are very high. Banks are stuck with large, ill-advised

mortgage loans and have little to lend small businesses. Small businesses must turn to non-traditional financing sources, or credit cards.

Consumers who want to improve their house or send a child to school once had the option to cheaply borrow with tax subsidies against the value of their house. Today, borrowing must go on a credit card, or not happen at all.

So Federal Reserve rates of 0% are much like food supply in a broken socialist system. The good news is that everything is very cheap and affordable. The bad news is we're sold out.



On a macro level, this environment is relatively easy to explain. Unemployment should stay stubbornly high, official interest rates will stay low, real interest rates will be high and move higher. Some equities could be quite good, while bonds as an asset class do not look good.

On the micro level, analysis is more difficult. Good companies will be good investments, bad companies will not, but how do you tell the difference between the two? As an example of what to avoid, here is testimony from the CEO of the Great Atlantic & Pacific Tea Company, better known as the A&P Grocery conglomerate, which declared bankruptcy this week.

"The company couldn't compensate for the combination of high debt and the suddenly fading purchasing power of the customers," Karl-Erivan Haub, chief executive officer of Tengelmann Group, A&P's biggest shareholder, said today in an e-mailed statement. The insolvency will help A&P to get a "solid financial basis, to advance necessary restructuring," he said.

The lesson from A&P is striking. Consider that consumers who cannot afford food can get federal dollars to continue spending money at a grocery store. A&P therefore is a government-subsidized business, more recession-proof than many other industries (computer chips perhaps) and yet still has taken bankruptcy. Mr. Haub explained that the company had too much debt, which is a result of multiple management decisions taken over a long period of time. Looking forward, we want to invest in companies where multiple decisions taken over a long period of time add value to a company, rather than debt.

Here are our comments for 2011.

Bonds. More of the same. We favor cash and CDs for safety. As a stretch, we also favor utility stocks and high-dividend paying stocks. A potentially rising interest-rate environment continues to make bonds riskier than stocks, in my opinion. We are underweight bonds.

Gold. Perhaps 2011 will be the year that the "gold bubble" pops, and perhaps not. We would recommend reading about it from a safe distance. We do not recommend buying gold at this time, although we understand some of our clients feel comfortable holding some gold in their portfolio.

Oil. A slowdown in China could cause oil prices to plummet. Continued global recovery and dollar weakness should otherwise cause continued slow growth in oil prices.

International equities. Although stocks in Europe are priced attractively, the continued currency problems stemming from sovereign-debt questions are causing investors headaches. We will continue to underweight Europe as of December 2010, but this could change in the near future. China's insatiable demand for raw materials, coupled with Federal Reserve monetary easing in the U.S., is driving a flood of cash into emerging markets. We recommend overweighting emerging markets in Asia, Latin America and the Middle East. Political, social or economic problems in China pose a significant risk to global recovery, so we continue to favor investing in exporting American companies, rather than directly in foreign companies. Emerging country stock markets offer high risk and high reward.

Small companies. We are overweight here.

Large companies. We are overweight here.

Individual equities. Looking ahead to 2011, we favor active investing over passive investing. Active investors believe that they can do better than the market, using research and analysis. Passive investors believe that investing in an index is the best way to go. Although we believe equity indexes will continue to climb in 2011, we want to avoid more of the A&P companies, and instead invest in companies with low debt loads, strong profit margins, and decent growth prospects. We like companies like Medtronic, which pays a good dividend yield, has low debt, and solid brand recognition in a growing market of aging baby boomers. As credit becomes more and more scarce, companies like Capitol One will continue to borrow at government-subsidized rates and lend at punitive rates to consumers. Companies like 3M and Intel are also attractively priced, and do nearly 75% of their business outside the U.S., which makes their profit forecasts in a weakening dollar environment very favorable indeed.

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