

Thought for the Week: Monday, January 3rd, 2011

"Stocks have reached what looks like a permanently high plateau"

No, this isn't the Global Investment Team's prognosis for 2011 U.S. equity indices, it's a **1929 quote from Irving Fisher, the then Professor of Economics at Yale University**. So why start out with this line? Do we think markets will be flat or are we just trying to be controversial?

At a time when most investors are looking to the so-called 'experts' to predict what will happen over the next twelve months, the purpose of the quote is to highlight the fact that **all forecasts are subject to error**. More worryingly, **investment forecasts tend to beget managers to stick to strongly held views** and close their minds to adapting to ever-changing market conditions.

The best managers of 2011 will not be those who correctly foretell what happens over the next twelve months and stick to their guesses, they will be the **managers who question their assumptions on a daily basis, exercise vigilance with regard to shifting global economic information and modify their portfolios accordingly**.

So, if Global isn't going to stick their necks out with predictions, what can they offer with respect to 2011?

Equity Markets

Currently we feel the S&P 500 will probably gain somewhere in the **3% - 10% range during 2011 depending on:**

- **The Government's ability to stimulate both the economy and its popularity during its third year;** a favorite year for presidential incumbents to inflate ratings and financial markets. What happens when QE2 runs out early in the summer will be an important factor in the steady improvement in equity markets. **2011 should be an interesting year politically** with the obvious need to cut spending being offset by the need to avoid being blamed for high unemployment.
- **How long company earnings and revenues can continue to improve.** One of the major headwinds for 2010 equities was the parlous state of employment, housing and consumer spending (although spending improved towards the end of the year). Many companies reported excellent profit growth despite these headwinds. **Should these quarterly reports falter, the naysayers will probably blanket the media with "told you so's" and confidence will take a hit.**
- **Whether China and its neighbors can continue its Goldilocks-like growth.** Chinese Interest rates and Inflation are rising while spending and credit curbs are in place, all with the intention of slowing growth to "sustainable" levels. **Will these controls cool the porridge too much though?** One thing to remember, DIAS portfolios have little exposure to Far East stock market prices; they have more exposure to developed-economy companies who benefit from the emerging-market growth in infrastructure, energy, technology and commodities. That said, **China is driving a great deal of current Global growth and growth expectations.**

Beware 'Experts' bearing predictions:

"Everything that can be invented has been invented." -- Charles H. Duell, U.S. Office of Patents, 1899.

"I think there is a world market for maybe five computers." -- Thomas Watson, IBM chairman in 1943

"It doesn't matter what he does, he will never amount to anything."
-- Albert Einstein's teacher to his father, 1895

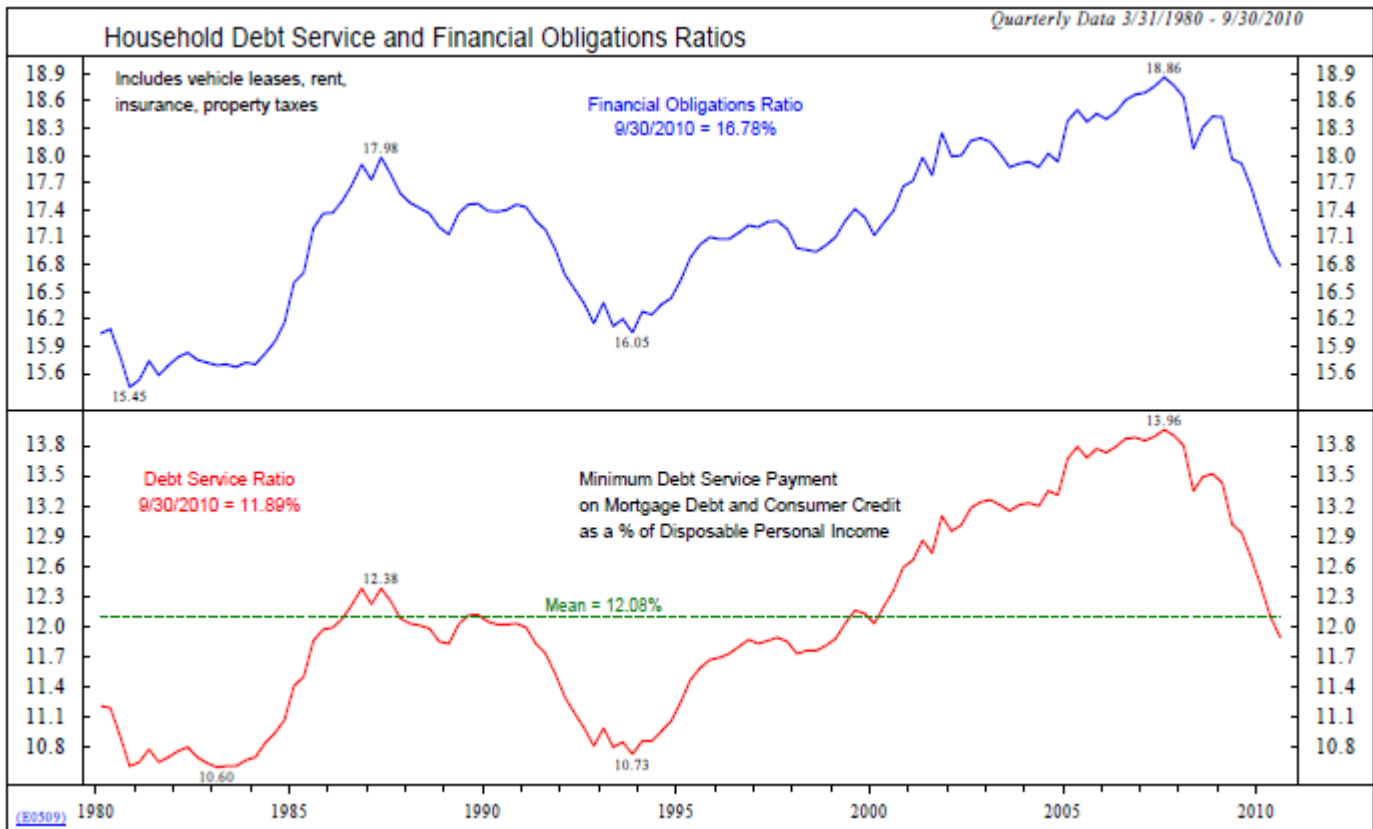


GLOBAL FINANCIAL

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COMPREHENSIVE WEALTH MANAGEMENT

- **Consumer spending coming back for good.** The Consumer is 70% of the economy, as the old adage goes. The charts below show that the consumer has deleveraged its debt much faster than the government. **If consumer confidence doesn't take a hit, there may be enough dry powder to sustain further improvements in consumer spending.**



Treasuries and Muni Bonds

If the global economy continues its recovery from recession, as many commentators and data predict, expect Treasuries to fall further in price. This is not contingent on interest rate rises; this is because demand for 'safer' assets will fall as investors relax their fear of impending global doom. Government support of safer asset classes via QE2 will peter out; **in the absence of QE3, or similar, investors may look ahead and sell on the expectation of waning future demand.**

Municipal Bonds fell towards the end of 2010 and we expect further pressure in 2011 unless the Government steps up and supports the issuers. Holders of Muni bonds with attractive tax-adjusted yields may be justified in keeping them until maturity, but **those invested in Muni bond funds may want to review their 2011 prospects.**

If, and when, these prices have fallen, **opportunities to buy attractive yields may appear.**

High Yield & Corporate Bonds

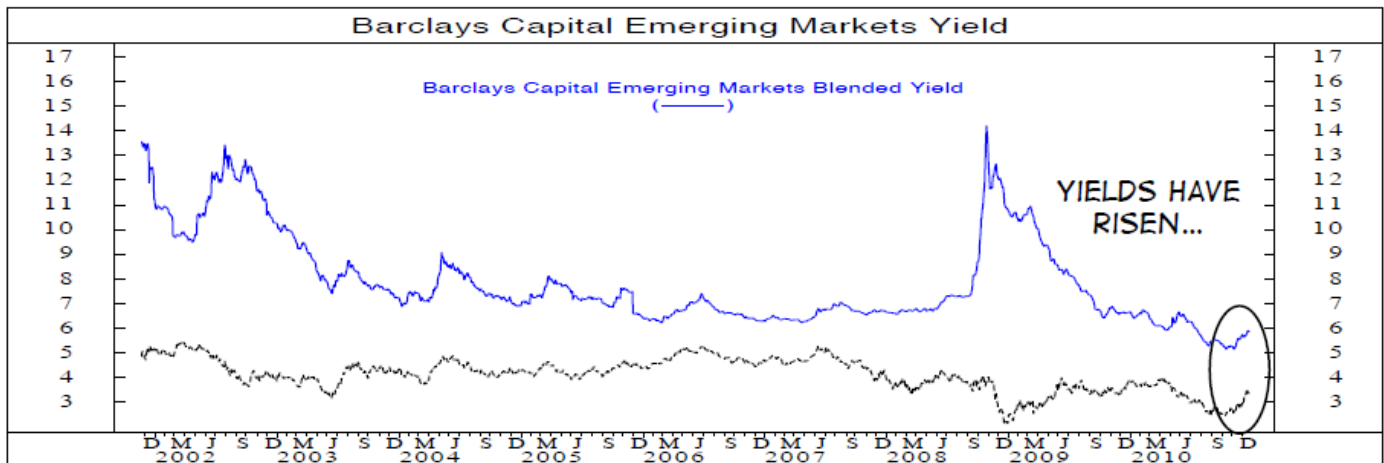
If investors continue to further discount the probability of corporate defaults and the global economy continues its recovery, **higher yielding, corporate bonds should continue to perform better than traditionally 'safer' areas of fixed income.**

Corporate yields are generally high enough to cushion some of the effect of rising interest rates.

For example, if interest rates rise by 0.5%, it should make a 3.5% yield bond much less attractive than a 6.5% yielder as the difference between 6.5% and 6.0% is much easier for an investor to stomach than dropping from 3.5% to 3.0%. However, **holding bonds with short durations is still our preferred method of reducing interest rate risk.**

Emerging Market Debt

Rising Interest Rates, Rising Inflation and the need to cool economic growth has taken the shine off the demand for Emerging Market debt. **This asset class looks a little over valued** at this time but we will watch the emerging regions closely during 2011. This is a more volatile, but potentially more lucrative, investment market.



Eurozone Worries

Although the Euro added a new member in the last few days, few would suggest their worries are over. Of the 2010 PIIGS of Europe, Spain, Portugal and Italy have yet to see an attack on their debt. There are many technical methods for tracking the potential for another European crisis, including Credit Default Swaps (the cost of insuring against default).

The chart below shows two of the many indicators we use to monitor the risk of a European crisis:

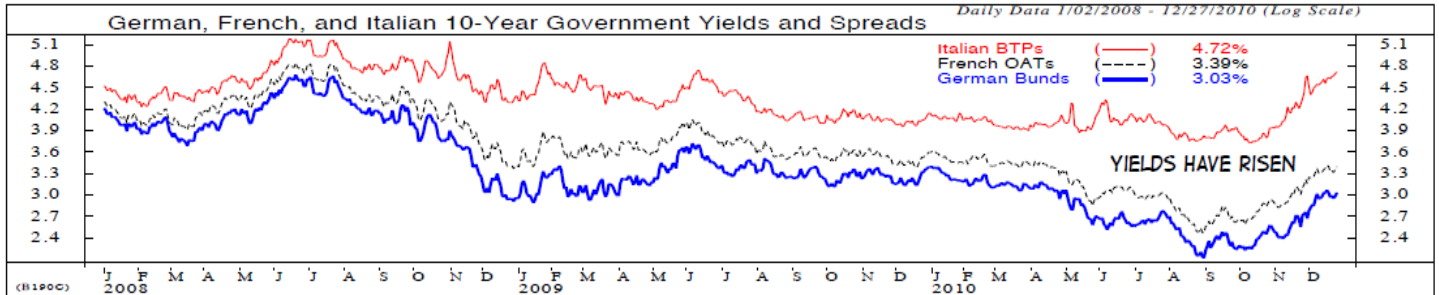
- The yield an investor is willing to accept to own a specified bond. **Yields are rising in a similar manner to our own Treasuries** signaling the a reduction in economic fear
- The additional yield (Spread) investors demand in order for them to own non-German bonds over German bonds (the safest of the European debt issuers. **This spread is still large signaling continued concern regarding the future viability of the Euro** as a single economic region.



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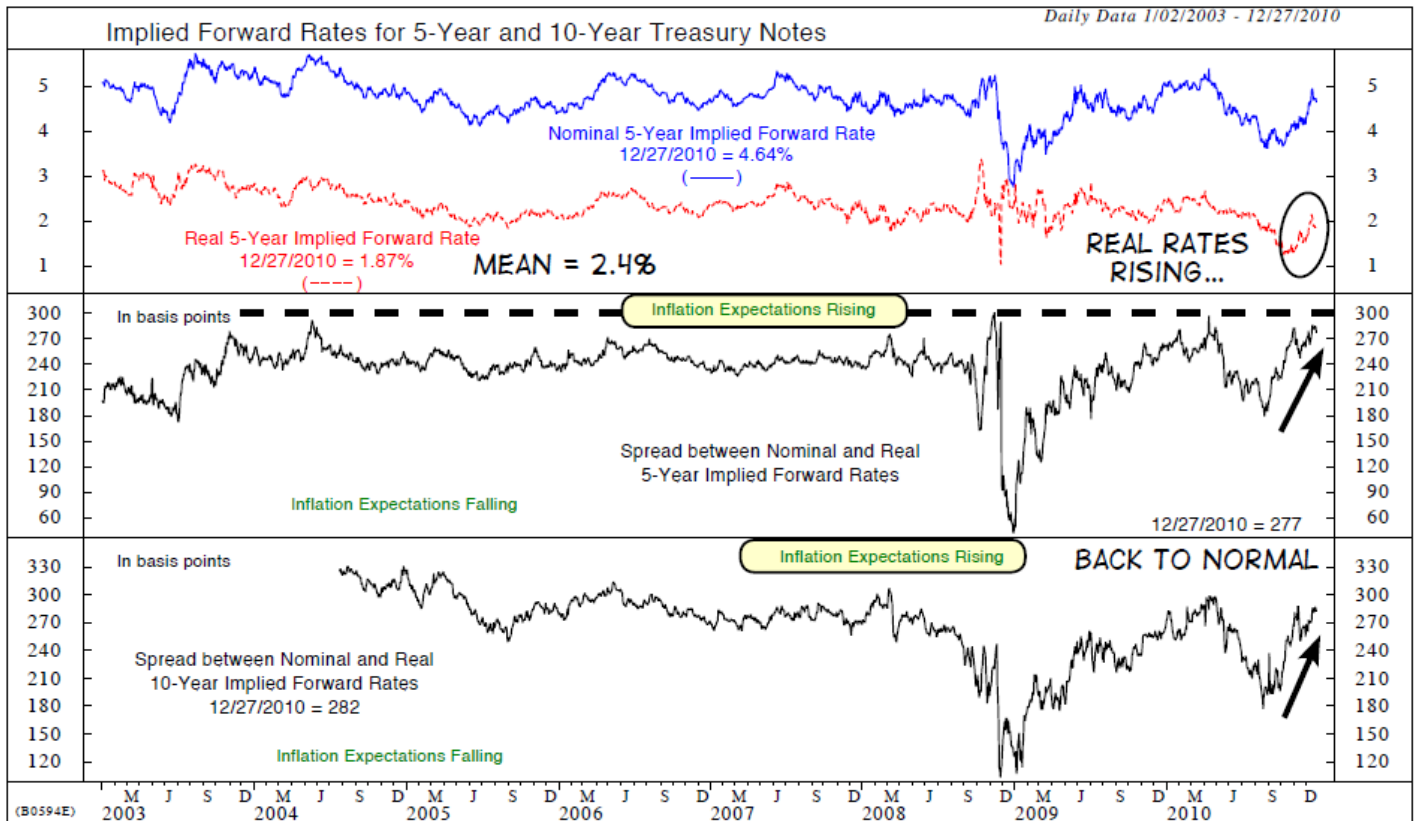
We may, therefore, see renewed volatility in Europe at some stage.



Inflation & Interest Rates

Many producer prices are going up, putting upwards pressure on inflation. However, this is currently a good thing as it is **soothing Government fears of deflation**. In many cases, producer and commodity price increases are being absorbed by retailers who are frightened to pass on higher prices for fear of losing revenue. **Therefore, inflation is rising but only back to acceptable levels.**

A similar story is true for Interest Rates; the charts below show three ways to say **interest rates look set to rise but only to 'normal' levels, off historically low levels.**



Our Quarter 1, 2011 Investment Review will contain a full analysis of current market conditions.

Past performance is not indicative of future results. This commentary is not intended as investment advice or an investment recommendation it is solely the opinion of our investment managers at the time of writing. Nothing in this commentary should be construed as a solicitation to buy or sell securities. Charts provided by Ned Davis Research.