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OBSERVATIONS ON THE MARKET

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The story for 2010 is liquidity. Everything else is secondary when there is so much cash sitting around. It may seem too easy, but the liquidity that has been pressed into service is preventing the story line from turning into a tragedy. China is the first country to turn the liquidity spigot off. Last week they announced that they were going to tighten bank credit in China. However, since China's economy is growing at a 10% rate or better, a preemptive move on their part should be considered a positive. The rest of the world is still busy trying to make sure we can get the economy to Act II. What makes 2010 hard to predict, is a combination of three factors. How far we have come in a short period of time, structural changes in the economy (higher debt and potentially higher taxes), and the winds of political change.

The credit markets have been the biggest success story of the past 12 months. Corporate bonds have returned to pre-2008 levels. It is as if the crisis never occurred. High yield corporate bonds have surged over 50%, and many lower quality borrowers have been able to refinance their bank debt, which has been a major factor in keeping the default rates lower than anyone thought possible just 12 months ago. This does not mean the entire credit universe has experienced the same success. The market is very bifurcated with the market for jumbo home loans still costing 1% or more than conventional home loans. Commercial real estate loans are very difficult to secure. The over-simplified explanation of the credit market seems to be; if it is publicly traded debt, the markets are strong. If the debt

is privately negotiated with a bank or other source, credit is tight.

There is a popular view that the economy is experiencing a structural shift to a lower growth rate due to the higher public debt load. Before you assume this is a given, consider that after World War II, debt to GDP was at a comparable level as today. Even with the debt pay down that occurred over the next decade, the economy still managed to grow fairly robustly. This time may be different, however, there is also the emerging market economies that are in a position to pick up part of the slack that may develop in our economy.

Once the central banks start to pull liquidity out of the world's economies, both the stock and bond markets should experience some pull back. The difficulty with trying to guess how the year ends is that the stimulus should continue to hold the markets up, but once removed, we will struggle to regain footing. Who knows when that day arrives? The best way to deal with an uncertain future is to consider equities that pay dividends.

If forced to pick, the market will close higher and interest rates will be ½ % higher. However, this drama is sure to have a few unexpected surprises in it. Last year surely did. This feels like two aces showing and all the chips are in the pot. It looks promising, but you never know. Current market valuations are hard to judge because we are in a recovering economy. What looks expensive today is not necessarily in 6 to 12 months.