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## **Financial Market Commentary 4<sup>th</sup> Quarter 2009**

**January 18, 2010**

### **Summary**

**Stocks rallied for the third consecutive quarter. While the gains this time were not in double-digits like the previous two quarters, at just over 6% they were impressive nonetheless. Every domestic sector posted a gain. The stock market continues to be driven by the sense that the recession is over and that the Federal Reserve's policy of very low interest rates is just too investor friendly to pass up. At some point in 2010 interest rates will have to rise but rather than concerning investors, this knowledge has them scrambling to make as much as they can before the Federal Reserve acts.**

**With investors now convinced the economy is in recovery, the goal last quarter was finding areas that would benefit from an economic rebound. Real estate stocks, having posted the largest drawdown of any industry since its peak in early 2007, finally joined the rally late last summer. They were up another 9.1% in the fourth quarter. For the quarter investors tended to favor larger companies over smaller ones, but all of large companies' out-performance came before Thanksgiving. Since the dollar began rising in late November, smaller companies have taken the lead. Because smaller companies earn less on average from foreign markets, they are hurt less when the dollar rises. The dollar's strength in the fourth quarter illustrates an important fact about of international investing ... developed markets tend to have established currencies that are alternatives to the dollar. The Euro, pound and yen move independently of the dollar such that if they decline in dollar terms (as they did last quarter), the return to a dollar-based investor will also decline. Emerging currencies are usually either managed or pegged to the dollar such that currency movements have little impact on return. That is part of the reason why developed markets gained 2.2% last quarter, while emerging markets rose 8.5%. The other reason is that emerging markets are, as a whole, growing profits faster.**

**While the stock rally continued last quarter, the rally in bonds all but ended. With the economy in recovery there began to be upward pressure on long term interest rates, resulting in a slightly negative return for government bonds. Short term rates are near zero, so there is almost no return potential there. Investors seeking capital gains from bonds have been forced into lower rated**

(high yield) corporate bonds or international bonds. High yield bonds have done extremely well lately (6.2% last quarter) as default rates have fallen. Companies have been able to refinance at levels that were unthinkable when the credit crisis was in full swing. On the other hand, international bonds cooled last quarter as the "anything but the dollar" trade got too crowded and the buck began to rebound. Emerging market debt rose about 2.4%.

## Activity

As you recall, we have been putting 10-20% of most of our portfolios in individual stocks and closed-end funds. We looked at this as the opportunistic part of portfolios, and the remaining 80% or so invested in conservative mutual funds as the core portfolio. This strategy has worked well -- 2009 was a very good year for the stocks and closed-end funds in our portfolios. In the fourth quarter, therefore, we took some profits. We aren't seeing the kind of screaming buys now that there was a year ago, so most of the proceeds have gone into moderate risk mutual funds. There are two stocks we'd like to buy if the price hits our target. We did modestly increase the corporate bond and international stock components of the portfolios during the quarter. Corporate bonds are doing very well relative to government bonds now as risk concerns wane and the desire for better yields increases. We added about 2% to our international stock weighting on average because their relative under-performance last quarter has made them a little more attractive from a value perspective.

## Outlook

The markets' performance last year is amazing when you consider that one year ago the economy and the stock market were both in free fall and most investors would have been content just to stop losing money in 2009. It shows that you never know how a year is going to unfold, and even more importantly, that you should never assume that what has happened over the last quarter or year is just going to continue to the next one. Right now the consensus expects the first half of 2010 to be kind to investors as interest rates stay low. They expect the second half to be more problematic because interest rates are likely to rise, the effects of government stimulus should begin to ebb, and there will be increased political uncertainty. Our considerable experience as investment advisors tells us that the consensus will probably turn out to be wrong. Unfortunately, we can't tell you today how it is going to be wrong.

It is surprising how fast investor sentiment has recovered. History suggested it would take several years (if not decades) for investors to feel as safe in stocks as they did in 2007, but we are starting to see some of the same risk attitudes returning. It may be human nature to want to get "even", but taking extra risk in order to get to "even" as soon as possible usually results in tears, because the market doesn't care when you got in. It will frustrate you if you try to bend it to your will (but it can reward you nicely if you bend yourself to it).

*In Outlook section of last January's Quarterly Report we wrote:*

*"In the short run it is very difficult to be bullish. The economy is contracting in almost every sector and there is very little question that corporate earnings this year are going to be significantly lower. Certainly there are some investors that are going to abandon stocks altogether. This may surprise you, but we tend to read all of that information in a positive manner. Intermediate-to-long-term potential returns are the highest in at least 25 years."*

As you can see, we did not expect the market to gain 26% last year. We just observed that with stocks as out-of-favor as they were, history suggested that they presented an attractive buying opportunity. Perhaps to spite us, stocks opened 2009 by falling another 13%. The lesson here is that you never know when the turnaround is coming. All you can count on is that cheap stocks eventually get discovered, expensive stocks eventually under-perform, and frauds ultimately get exposed. If you are right and you are patient, you will be rewarded. Sometimes you get very lucky and it only takes days or weeks. Other times it takes months or years. Perhaps the best thing that any advisor can do for their clients is to be the voice of reason. In other words, to remind clients of certain truths of investing that they may soon forget when markets are especially weak or strong.

### **Commentary – The Block Tower Revisited**

We also wrote last January that there was an upside to recessions. Using the analogy of rebuilding a tower of blocks, we argued that the present deep economic recession was an opportunity for companies to get healthy through debt reduction and restructuring. Recessions are periods where speculators get punished and lessons are learned. Important structural reforms are made. They are painful to go through, but when they are over you often have the pre-conditions for a long economic expansion. Unfortunately, there is no guarantee that it is going to work out that way.

The financial authorities might have decided to facilitate a liquidation of those entities whose reckless policies contributed to the crisis (such as AIG and Fannie Mae) in as orderly a manner as the situation would have allowed. It would have been messy, and certain firms and investors would have taken large losses. The upside is that everyone would have learned to make sure that those companies they traded with had the wherewithal to make good on their guarantees. Instead, the government bailed out those entities with taxpayer money, allowing their creditors to be paid back in full and teaching us all that if you are going to lose money, try to lose so much that the government feels compelled not to let you fail.

Once the acute phase of the credit crisis was over, the Federal Reserve might have begun to raise interest rates again. To be sure this would not have been

taken well by the financial markets. On the other hand, savers would be getting a real return on their money. It would have signaled that the Federal Reserve was determined to pursue sustainable economic growth (even if it took longer to achieve) as opposed to taking the short-cut and try to re-inflate the speculative bubble that super-low interest rates caused in the first place. Whenever interest rates are maintained at an artificially low level, a speculative excess (inflationary price spike) forms somewhere – real estate, stocks, gold, oil, etc. – that inevitably ends badly (if there were no adverse consequence, central banks would always keep interest rates very low).

Again, once the markets had stabilized Congress might have moved purposefully to determine what caused the credit crisis and how it might be fixed. Like the Pecora Commission in the 1930s which investigated the Crash of 1929 and proposed reforms (Glass-Steagall for one) that enabled America to go more than half a century without another market crash, we might be on the way to making important changes in the regulatory structure of the financial industry. As it happens, the financial services industry is extremely powerful and our political system does not possess the integrity (I'm talking about both parties) to bite the hand that feeds it.

We should have had a longer and deeper recession than we did. I assumed that we would rebuild the tower from its base, so to speak, and prosper thereafter. Instead, we opted for a quick fix (government stimulus) in an attempt to emerge from the recession as soon as possible. This might have been okay if its costs had been offset by savings from financial reform (that made it clear that the government was not backing any private company) and health care reform (that included tort reform along with coverage reform). Thus, when the stimulus ends it is hard to see us avoiding a return to recession, and this time we will go into it with a much greater debt burden and a higher starting unemployment rate.

We continue to maintain a defensive posture for our client portfolios. While we have been fortunate to have participated with most of the market upswing over the past year we still remain cautious and have continued to reduce risk across the our client portfolios.

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