DECEMBER 2010: MARKET COMMENTARY

Although the economy remains sluggish, companies are finding ways to grow revenue and profits. We continue to believe that U.S. corporate profits and finances are in remarkably good shape bolstered by unprecedented cost cutting, financial deleveraging and balance-sheet strengthening. As expected, dividends are rising as companies return increasing levels of excess cash to shareholders.

Projected U.S. economic growth around 2% over the next 15 months is not terrific but doesn't point to a collapsing economy either. Recent revisions of past and future GDP point to possibly better growth numbers. In addition, we expect inflation to stay tame and access to funds very easy – both of which should provide a very attractive environment for corporate America. Even with the very thoroughly discussed weaknesses in the economy, numerous factors should continue to propel earnings higher.

In addition, even after the recent rally, we believe stock valuations remain compelling. Many U.S. stocks are trading at price-earnings multiples that are below average, especially when considered in the context of today's low interest rates. Free cash flows are rising and profits are up. More than 175 companies in the S&P 500 Index have initiated or raised dividends this year while only three have lowered or eliminated distributions. Even some technology "growth" stocks have joined in. Merger-and acquisition activity is also on the rise, and the impact of quantitative easing on the U.S. Treasury market will keep borrowing costs low.

These facts haven't gone unnoticed by sophisticated investors. According to Goldman Sachs Asset Management Chairman Jim O'Neill, the Standard & Poor's 500 Index may rise as much as 20 percent in 12 months and the dollar is poised to climb as U.S. economic growth tops investors' projections. Many other analysts also expect the U.S. equity market to outperform the rest of the world while the dollar strengthens from current levels.

Not only do various economic indicators point to increasing strength, **the Federal Reserve** – rightly or wrongly – appears committed to pushing the economy forward. If the Fed's current program fails to revive growth in the world's largest economy, it's expected to engage in another round of bond purchases, or "QE3".

Foreign markets also continue to provide significant new growth opportunities. Large emerging markets with rapidly rising household incomes in China, Eastern Europe and Latin America are importing more goods. Even while China tries to slow its economy, its gross domestic product soared 9.6% in the third quarter, and retail sales rose 18.8% in September alone. Brazil is putting in capital controls because their economic growth is attracting so much capital inflow that officials fear the economy could overheat.

Even some developing markets are bouncing back. In Europe, Germany continues to surprise on the upside, with the manufacturing and services purchasing indexes rising in October ahead of consensus forecasts. Its strength will likely offset weaknesses in other parts of Europe.

Consumer spending, income and confidence are all going up as well. While none of the numbers are spectacular, the trend is encouraging. Various issues from unemployment to on-going weakness in housing will dampen future growth, but the slow return of the consumer – even if not completely healthy – is welcome. The retail sector is reacting. Deals were harder to find this past Black Friday as retailers have adjusted their supplies down while demand is slowly increasing again.

However, the ride will continue to be rocky. Many companies are still hesitant to hire given the unquantifiable costs in the new health care law, changes in tax policy and vastly increased financial regulations. For many, these factors and more provide too many reasons to put off hiring plans. Unemployment will come down very slowly.

The European Union will also continue to face various challenges. While some pundits believe the European Union and Euro may dissolve, this conjecture seems unrealistically pessimistic. The Euro obviously has numerous challenges. However the costs and barriers to withdrawing from the common currency zone and re-establishing a national currency are overwhelming both politically and economically. Europe appears very likely to face real and public challenges that are likely to adversely affect the global economy. However, a European implosion is very unlikely and problems there will not derail an increasingly strong recovery beyond their borders. The biggest losers are likely to be German citizens who will disproportionately bear the cost of Greek and possibly other European overindulgence.

All this said, the outlook for more risk based assets such as stocks appears to be growing increasingly positive. The good news appears to have enough momentum to overwhelm inevitable bad news.

However, not all asset classes are likely to react well to increasingly positive economic news. Projections for bonds are quite negative. Interest rates are already low, and as interest rates eventually climb, principal values will decline as notes paying very low rates become less attractive. Unfortunately, many small investors have been piling into this area at likely just the wrong time.

Gold, another safety asset, is drawing more attention from nay-sayers. It seems likely that at some time in the future, gold prices will decline – possibly dramatically – creating a less than pleasant ending for investors who piled in during recent months. There are gold fans who correctly argue that the Fed is printing piles of money, gold carries intrinsic value as a hard asset, and gold is still well below its inflation adjusted high of $2,400 an ounce ($850 an ounce in 1980). A price collapse – or even decline – may never happen.

However, gold detractors can also point to increasingly problematic issues surrounding gold. When gold hit its 1980 high, the U.S. was at the peak of a high inflation trend. Now, we're fighting off deflation. And other gold-mania trends are disturbing such as gold in vending machines, gold buying stores popping up on countless street corners, and late night TV ads. Much of this is driven by the recent increase in the price of gold. However the SPDR Gold Trust increase of more than 19 percent this year vs inflation of barely one percent seems to resemble the real estate market in early 2007 and dot.com craze in the late 1990s. While prices could continue to climb, growing market skepticism is likely a good sign of general economic health – even if sentiments are wrong.

As we move toward the close of the year, it appears that the economy is settling into a more predictable and encouraging level of "normal" than we've seen in quite a while. Countless political and economic issues present many on-going challenges. Yet, conviction is growing that growth will continue and the U.S. will truly recover. For now, we'll have to wait to see how strong the growth will eventually become. However, as we've said many times, betting against America has never been wise in the past.

We wish you a wonderful holiday season.

Daniel Wildermuth and the Kalos Team
CEO/Money Manager

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