



Economic Forecast 2010

Speech by Bosworth Todd before the Louisville Rotary Club
Louisville, Kentucky – January 7, 2010

The decade that just ended was one of only two-10 year periods over the last two centuries where stocks had a negative return. The other was 1939. This is based on an analysis of the total return of Large Cap U.S. stocks by Strategas Research Partners.

Last year, 2009, was indeed a wild one. We saw the S&P 500 fall 25% to the March low and then rise 66%, closing out the year up 23% to 1,115.

We had predicted a 15% gain for 2009. However, it remains 25% below where it was 10 years ago. It's small comfort to realize it rose 440% the previous decade.

Since 1925 stocks have done much better than bonds or gold. Stocks returned 10% a year, corporate bonds 6%, and gold 5%. The reverse is true for the last decade. Gold almost tripled and bonds doubled while blue chips fell slightly. Pick your starting point and you can convey whatever message you want.

The world economy is responding to the dramatic fiscal and monetary stimulus taken by governments around the world.

In the U.S. business activity made a major turnaround in the second quarter of 2009, but it has yet to bring jobs with it. While layoffs and new claims for unemployment benefits have declined in recent months, job prospects for unemployed workers have continued to deteriorate. Some forecast it will take nearly four years for this politically sensitive rate to drop below 6% again.

The market environment can be described as a "sweet spot" for stocks for the next six to nine months. There is plenty of monetary and fiscal stimuli, low interest rates, falling inflation, and improving profitability.

China has led the recovery process. It was the first country that applied a massive stimulus package. Our economy is one step behind China, in term of recovery.

Bull markets in foreign stocks, particularly emerging market equities, could easily become the dominate investment trend of the coming decade.

The economic theme driving this trend is that emerging markets are displacing the American consumer as the engine driving the world economy. Think of Brazil, India and China.

CHINA

In looking back at the past decade, we can only look in awe at the speed with which the Chinese government responded to the breathtaking collapse in exports caused by our credit crunch. While we and the other developed nations teetered on the verge of a second Great Depression, the historian Niall Ferguson recently observed in the Financial Times that China suffered little more than a minor slowdown, thanks to an effective government stimulus program and massive credit expansion. China is in the midst of a major industrial revolution. Our GDP was eight times that of China at the beginning of this decade. Now we are only four times larger. Jim O'Neill, Goldman Sachs' Chief Economist, believes China will overtake us by 2027.

Ferguson says China has adopted the concept of capitalism, the scientific method, and the ethics of work and saving as ends in themselves. They have yet to adopt our legal system based on private property rights.

I'll give you a recent example of their progress.

CHINA EXAMPLE

China streaked ahead of its western rivals over the Christmas weekend by unveiling the world's fastest, longest passenger train service. The train raced 660 miles in less than three hours between two major cities. The journey previously took at least 11 hours. One government advisor said "Expressways are not suited for China, which has large numbers of people but little space to spare. China should learn from Japan and Europe." By contrast our highest speed train, Amtrak Acela, takes three and a half hours to go the 180 mile between Boston and New York. The Chinese spent \$17 billion on the construction of this rail line over a four and a half year period, or \$25 million per mile. The government intends to complete 10 thousand miles of high speed rail line by 2012, allowing passengers to travel between most Chinese provincial capitals in eight hours or less. One reason for the large construction spending is the fact this train travels along 400 miles of elevated tracks and tunnels, on 70% of its length.

FRUGALITY THE NEW FASHION

We are in a prolonged period of credit contraction in the opinion of David Rosenberg, former Chief Economist at Merrill Lynch. He reminds us that, even with the stock market rally, household net worth has contracted nearly 20% over the past year-and-a-half, an epic \$12 trillion dollars of lost net worth, a degree of trauma we have not seen before. Thus, frugality is the new fashion and likely to stay that way for awhile. We are undergoing a shift towards prudence and conservatism by consumers and investors.

BROAD RECOVERY UNDERWAY ALBEIT FRAGILE

The global recovery process remains unstable because so much of it has been generated by government rather than the private sector.

Governments around the world have done everything possible to lower interest rates and pump liquidity into the financial system, with one single goal: to stop chaotic deleveraging and to lessen the liquidity crunch occurring in the financial system. So far, their efforts have succeeded in creating a sense of stability.

So long as interest rates stay at low levels, our economy should continue to recover.

However, such stimulus will not be sustained forever and large budgetary deficits need to be made up either by issuing more debt or through raising taxes.

We realize that once recovery does take hold, the market will begin to look for higher interest rates. This will likely be a period when stocks begin to cool off. That is still some months away.

OUR FORECAST FOR LAST YEAR

Last year I forecast 15% gain in the stock market, the S&P 500. It actually rose 23.5% for the year, despite a 20% drop in the first two months. I had projected a -1% decline in real GDP. It was worse, -2.5%. I don't know why I thought that interest rates on 10 year treasury bonds could possibly remain at a depressed 2.1% rate and, in fact, they did not. The rate is now back up to 3.9%. I was close on my inflation projection with an estimate of zero. It actually declined to -0.4%. I thought unemployment might rise from 7% to 9% during the year. It was worse at 10.2%.

I did say it was risky to sell after a collapse of this magnitude because the future is never predictable. Furthermore, the dividend yield of 3.1% on stocks at that point certainly beat the 2.1% on treasuries.

OUR FORECAST FOR 2010

In 2010 I forecast a real GDP gain of about 3%, a modest forecast indeed for a recovery year. The Consumer Price Index should rise slightly, about 1%. Yields on the 10-year treasuries will likely rise further, to approximately 4.2% in 2010. The unemployment rate will likely remain unchanged at about 10%. S&P earnings are expected to recover to \$72 by this time next year. Using Baa corporate bond yields, which currently stand at 6.1%, as a proxy for capital costs, "fair value" for the S&P should be around 1,200, which means the market should rise about 6% this year.

I forecast that oil will rise about 10% to \$87 per barrel and in similar fashion gold should also rise 10% to about \$1,170 an ounce. The Euro will partially recover about 6% to \$1.51.

One might ask why my inflation forecast is a paltry 1%. Mr. Bernanke has purchased over \$1 trillion of mortgage backed securities and \$3 trillion in treasury securities since March. He

acquired these assets in the customary central bank way, by creating the money to pay for them at a very low interest cost too, about ¼ of 1%. The answer to my question is that the velocity of money has dropped sharply because of fear, thereby offsetting the increase in the supply. Banks for example, are not inclined to boost their lending at this time.

Hopefully, Mr. Bernanke will be smart enough to withdraw the stimulus before animal spirits return and velocity returns to normal. Otherwise we face a terrible inflation.

DOLLAR HAS DROPPED 98% IN VALUE SINCE 1930

Of course, history does remind us that paper currencies are a wasting asset. The noted financial writer, Jim Grant, said in a December 5th article in the Wall Street Journal that “Paper currencies are wasting assets. In time, they lose all their value. Persistent inflation, at even seemingly trifling amounts, adds up over the course of half a century.”

About the time I was born the exchange rate for an ounce of gold was \$20.67. It’s now \$1,070, having lost 98% of its value in terms of gold. Yes, it’s true the price of an ounce of gold has grown over 50 times during that period. But remember, it pays no dividend. The S&P 500 Index also rose 50 times since 1930. But, by adding back reinvested dividends, a dollar invested in the S&P would now have grown over 1,200 times, not 50.

THE DOLLAR

How concerned should we be about the trade weighted dollar? I am not too concerned about it. The dollar has stabilized over the last few years. The dollar is very close to a long term secular low that goes back 50 years. I would be very surprised if it breaks to a new low over the year. It seems every time we have a crisis the dollar strengthens.

STOCKS OFFER GOOD VALUE

What other intangible investments can we think of besides holding cash? Certainly it is no fun holding money market funds which yield practically nothing. There is some appeal to intermediate term municipal bonds which yield about 3.5%. I much prefer to own stock in large capitalization, domestic and foreign, companies. It is important to include foreign stocks in the mix because non-U.S. stocks now make up 70% of the world market.

FOREIGN STOCKS ARE ALSO APPEALING

It appears to me the Obama Administration’s is pursuing policies which will increase the cost of doing business in America, such as higher taxes and a costly healthcare plan will encourage investors to deploy some of their capital outside of the U.S. in search of higher returns.

STOCK PICKS

Last year our five stock picks returned 22%, the S&P 500 gained 23.5%.

However, our picks did drop only 17% in the first 2 months when the market collapsed 25%, primarily because a Gold ETF was one of our selections. My picks for 2010 include five stocks

and one exchange traded fund. The dividend yield on the list is 2.7% and long term growth, in my opinion, is about 12%. They derive, on average, 80% of their earnings from abroad, which I think is an attractive feature at this time. There are two holdovers from last year: McDonald's and Phillip Morris International. There are also three new ones.

Aflac (AFL, \$48) is a Georgia-based company, the world's largest underwriter of supplemental cancer insurance policies. Their largest market is Japan but they are increasing their penetration of the U.S.

Qualcomm (QCOM, \$48) is a maker of chips for cell phones and other consumer hand-held devices and is the owner of a portfolio of patents that makes it the dominant provider of key components found in the most advanced cell phones. It is benefitting from the demand for upgrades of these phones to handle more complex applications particularly those employing lots of video.

Novartis (NVS, \$52) is a Swiss-based drug company with a diverse line of healthcare products and has a number of potential blockbuster drugs in the pipeline.

McDonalds (MCD, \$62) with 33,000 restaurants throughout the world, 80% operated by franchisees, has enjoyed impressive sales gains in difficult times, thanks to menu enhancements and remodeled stores. Like Louisville-based YUM! It has a significant and expanding presence in China.

Philip Morris International (PM, \$49) was spun-off from Altria two years ago to separate its domestic business from its foreign business. Its foreign operations have had a history of steady growth and above average profit margins. Also, it is reasonably free of litigation risks.

These five stocks are selling at about half their intrinsic value based on our "Black Box," a dividend discount model.

I-Shares FTSE / Zinhua China 25 (FXI, \$44), is an I-Shares exchange traded fund and is an attractive way to invest in China. This \$10 billion fund is like a no-load mutual fund. It is based on an index of the 25 largest stocks traded on the Hong Kong Stock Exchange. The Chinese market is quite volatile. This fund has an annual return of 20% over the last five years, but it has varied from a gain of 83% in 2006 to a 48% loss in 2008.

SUMMARY

In summary, I believe having a significant portion of your liquid assets in a list of large U.S. and foreign stocks with a reasonable dividend offers the best protection of your assets. I say that because predicting the future is more uncertain than normal because of the presence of huge, but temporary government stimulus.

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