2011: ‘Growth Amidst The Potholes’

Cold and white enough for you? As we have embarked upon an old fashioned winter, I can’t help but tie together the similarities once the spring thaw ensues and our current economy. Experience tells us roads expand and contract with outdoor air temperature fluctuations, exactly the way I see 2011 playing out, periods of exuberance (expansion) with occasional bouts of sadness (contraction). In either case, all one needs to do is avoid the inevitable potholes. Sounds easy enough? Perhaps, but therein lies the challenge, so let’s examine what will influence both the domestic and worldwide economic story, in my humble opinion.

Being the eternal optimist, let’s begin with several positive factors: 1) Great Corporate Earnings – If anything, the financial crisis led corporations to become even more productive, vis-à-vis fewer employees, better just-in-time inventory processes and a massive accumulation of cash on the books, for future(?) use!? Maybe stock buybacks or greater dividends; either way, corporate earnings lend an air of confidence and continued support to future equity price advances. 2) Low Domestic Interest Rates – The Federal Reserve is currently on QE2 and unless the employment picture improves, markedly, I can see another sequel, QE3. It is the Fed’s intention to flood the investment markets with $$$, irrespective of inflation, in order to make the economy grow. Fine now, hell to pay later. 3) Worldwide Demand – Developed countries (deep recession) are just catching up to the emerging markets (shallow recession, if any), but the overall demand for commodities is on a torrid pace, with no end in sight. This means a chase for raw materials and the high bidder wins and end users (us) lose. Think of gas north of $ 3.00. If it is like this now, just wait for the summer driving season. We will get inflation from this worldwide growth, question is when? 4) Improving Business Environment; For Now. The Obama administration is in full campaign mode and has thrown Big Business a bone or less jawboning to get what all 1st term president’s want – a 2nd term. Beware the wolf in sheep’s clothing. Aside from GE’s Jeffrey Immelt, don’t drink the Kool-Aid from the White House. Be afraid, be very afraid.

Since there are two sides to every coin and being the brutal realist, let’s detail the multiple negative factors: 1) Irresponsible Financial Management – Where? Everywhere. Federal, State, Local, you name it. This situation needs to be solved NOW. How? Let’s start with balancing a budget. Individuals, families, we all need to do it. Demand this same action from your elected officials. Don’t spend what you don’t have. Period. 2) Insipid Inflation – What’s this? Simply, not the attention grabbing kind of inflation, but the everyday price rises, specifically food and energy. How many times have you heard, “Excluding the volatile food and energy components…” Last I checked, we need to eat, let alone get to where we want to go. This acts as a tax and sucks discretionary income from other parts of the economy, leaving fewer dollars to boost other areas of the economy. 3) Housing – Banging the drum, until housing recovers, the economy will sputter. Get government out of the way and let housing prices find their equilibrium. They will go lower in the short term, but the inevitable rise will occur and much quicker than Washington’s meddling. In fact, let’s eliminate subsidies to Fannie and Freddie, forcing banks and mortgage companies to make recourse loans, thus sound, accountable loans. Last, eliminate Fannie and Freddie altogether. The American consumer would finally see the money spigot turned off, rather than pouring money down the proverbial “black hole”. 4) Systemic Unemployment – The jobs market has shifted and many are not coming back. Get used to it and stop extending unemployment benefits to infinity and beyond. 5) Public Sector Time

Bombs – Yes, plural – Pensions and Health Benefits. Level the playing field so everyone has a 401(k) style retirement plan and everyone gets to pay for a portion of their Health Care. Isn't this the type of economic socialism President Obama envisions, where everybody has some skin in the game? In fact, taken one step further, I just found a solution to the elimination of public sector unions, an oxymoron if there ever was one. 6) Geopolitical Risk – Reminiscing about Billy Joel's song, "We Didn't Start The Fire", this sums up the unmitigated wild card on a global basis. Tunisia, Egypt, Chechnya, the list will grow in 2011. Probably another Middle East country is next, but don't count out South America, namely Argentina. Pray that cooler heads prevail, but be prepared to be nimble when called upon.

Crystal ball analysis over, what does it all mean? Equities will grind higher, especially in developed markets (US, specifically) as earnings support the short term, economic euphoria. Plus, this being the 3rd year in a presidential cycle, historically bodes well for stocks, while most bonds continue to offer paltry returns, vs. dividend-paying stocks. How long does this last? In my humble opinion, most of 2011, but once we get inside of a year before Election 2012 and especially if interest rates keep climbing, then the yellow caution flags will be waving furiously with a watch towards raising the black flag or rally- ending trend.

Current favorites: Large cap domestic and international stocks, higher-yielding, short term corporate bonds (not many, but they're out there), select preferred stocks (with specific maturity dates) and the biggest contrarian investment, short-intermediate general obligation municipal bonds. Stay on the top rung of credit worthy muni bonds and avoid the siren call of "other"(revenue) higher interest muni bonds. Eventually, higher interest rates will afford a plethora of cherry picking opportunities in other bond sectors, but "patience is a virtue, it is acquired by habit" (college philosophy courses).

In the meantime, stay warm, wherever you are, since P-Phil forecasted an early Spring (yeah, right) and Happy Valentine's Day to all and to all a good night!!! Have a great week…