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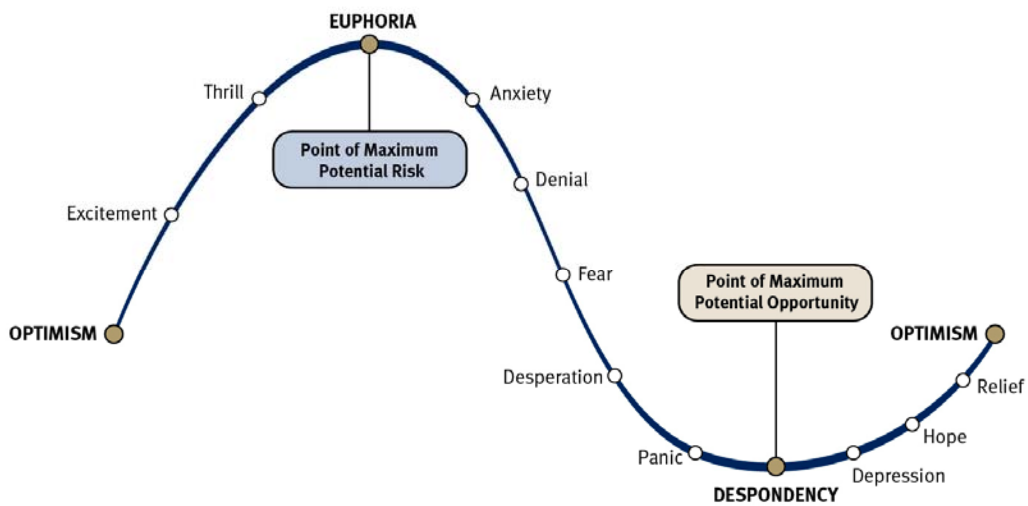
"THE CASE FOR OPTIMISM"

It's never easy to figure out the most appropriate investment mix for the current environment and the last couple of years have been particularly difficult. Sometimes, reducing complex matters to simple metaphors can be helpful. For example, when Wayne Gretzky was asked how he managed to score so many goals he famously replied that he just tried "to skate to where the puck was going, not where it has been."   Another simple idea…how do you find a lost horse: go to where the horse was last seen and ask yourself where you would go if you were a horse? With these thoughts in mind, my goal in this report is to skate to the horse (future investment returns) while avoiding the manure.

Much can be learned from the "cycle of emotions" chart below.



When investors become too euphoric, be on the look out for risk – conversely, when the media and investors become panicked and pessimistic, look for opportunity. As Warren Buffett would say: "be fearful when others are greedy, and greedy when others are fearful." Investor sentiment was euphoric in the summer of 2007 and, as we now know, that was a time of great risk. On the other hand, when investors were consumed by doubt and despair from October of 2008 to March 2009, one of the great investment opportunities of the last seven decades presented itself.

With the intent of keeping things simple, let's examine events of the recent past, the lessons learned from them, and try to determine where financial market rewards may be found over the next couple of years.

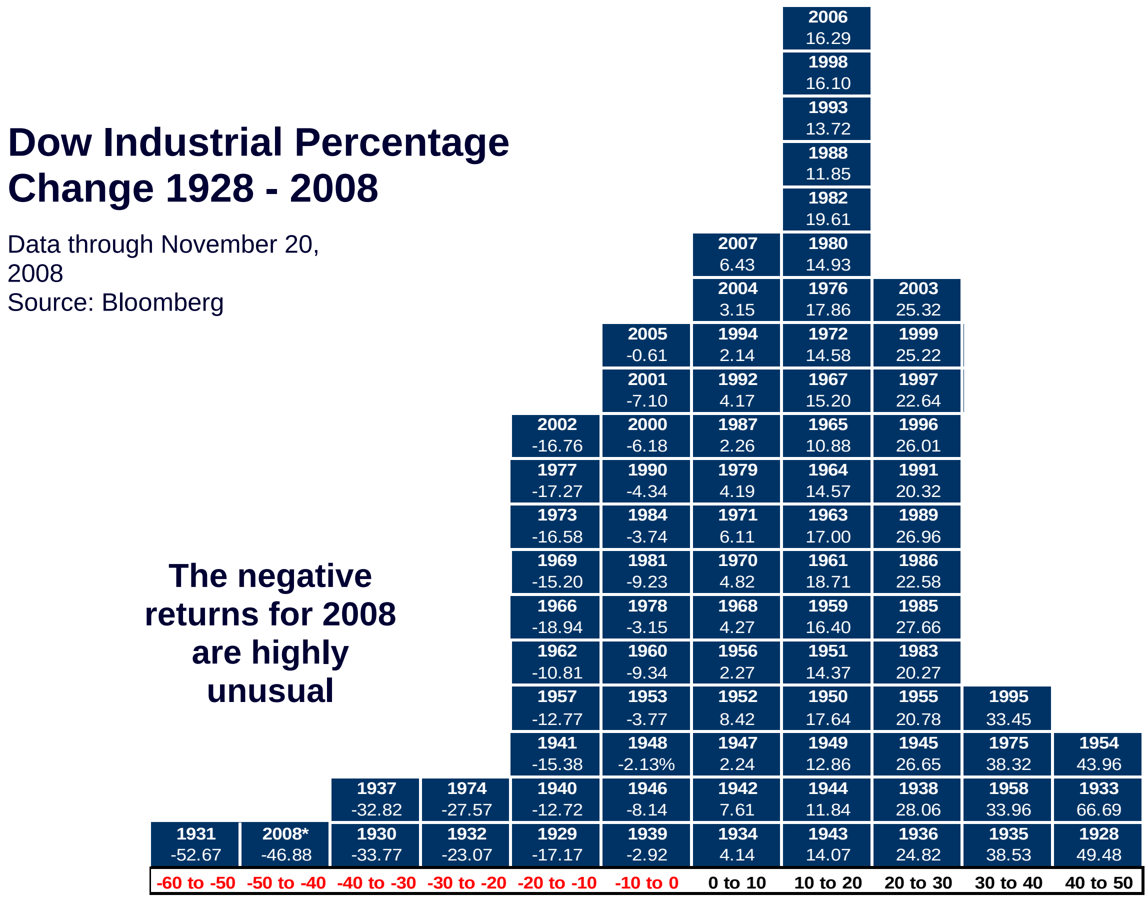
One year ago, the Fed prevented the forced liquidation of the entire financial system by taking unprecedented action to stabilize assets priced for complete failure. They did this in conjunction with policy makers around the world and pulled financial markets back from the brink of the abyss.

Many of the policies implemented were controversial; particularly TARP, but they have served their purpose: the financial system has stabilized, the economy began to grow again in the 3rd quarter and employment is finally bottoming. Over 75% of S&P 500 constituents reported positive earnings surprise in both the 2nd and 3rd quarters and many other economic data points are improving as well.

Despite this, people are still skeptical about the state of the economy and most economists and market prognosticators feel the market has run too far, too fast and is due for a significant correction. The Dow and S&P have risen over 55% from their lows in March yet only 40% or so of investors are bullish. There is about $3.5 trillion sitting in money market funds making little to no return. Bond fund inflows this year have totaled $330 billion while equity funds have had net outflows of $28 billion. Hedge funds and institutional money managers have been buying into this rally, but individual investors continue to pay down debt and sit on the sidelines. Eventually, however, people will seek not just the return of money; they will look for a return on money.

I don't believe they are going to find that with bonds. Since interest rates peaked in the high teens in 1981 we have had a 30 year bull market in bonds. Now that rates are essentially at zero, they have no where to go but up. So, if you own 10 year bonds at
3.3% and hold them to maturity you are going to beat the long term rate of inflation by about ½%. Investment grade bonds offer somewhat better returns and high yield bonds and preferreds may still be decent buys, but the sizzle is going to be in equities.

To put this year's market rally in context, let's have a look at historic returns since 1928. As seen on the chart below, the worst single year return was in 1931 when the Dow lost 53% (1928-1932 saw a decline of 89%).

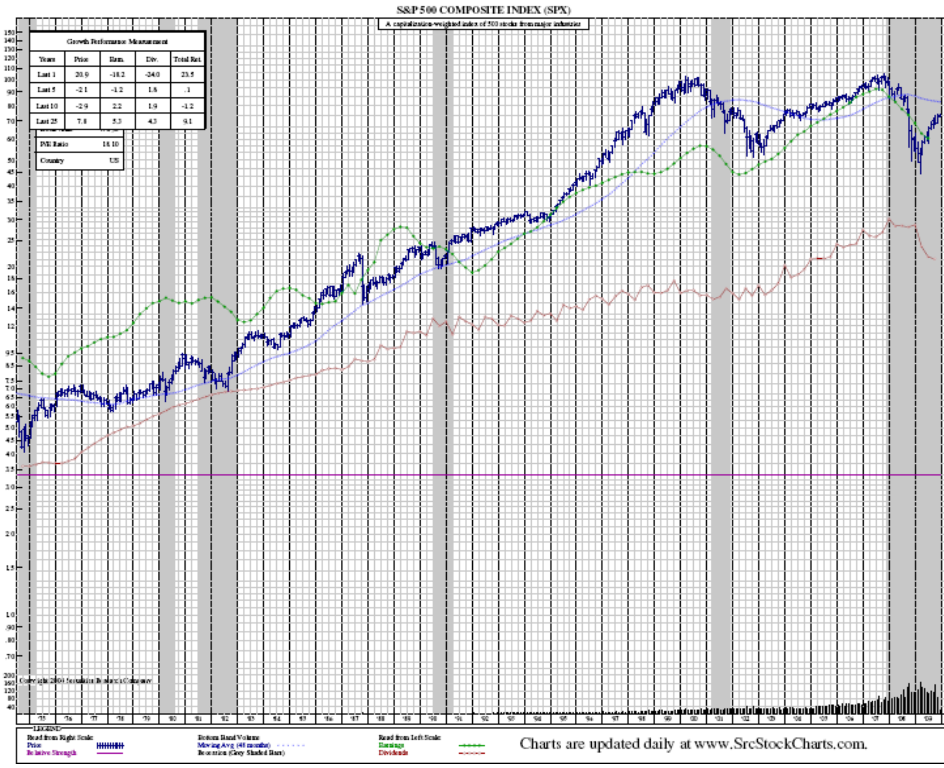


Dow Industrial Percentage Change 1928 - 2008*

Last year was the second worst on record down about 47% (peak to trough down almost 60%). On close examination, you can also see that markets often revert from one side of this chart to the other…extremes create a reversion to the mean. Year to date, the Dow is up by about 18% which would put it in the tallest stack of 10-20% returns. So, despite the impressive rally from extreme lows, returns thus far this year are not uncommon at all.

On average, since 1960, post-recession recoveries have resulted in financial markets rising 32% higher than their pre-recession peak. If that trend holds true in the current cycle the S&P 500, which peaked at 1,550 in the fall of 2007, could rise to over 2,000 and the DJIA which peaked at 14,156 could exceed 18,500…gains of over 80% from current levels. I think we would all be pretty happy to see that happen.

However, it is possible the future could be even better than that following the double dip recession of 1980-82 the DJIA and S&P 500 rose 250% by 1987 and on the heels of the 1991-92 recession they rallied 400%.



Additionally, in the last 160 years there have been only four periods with negative 10 year annualized returns for equities. This happened during the civil war, the early 1930's, again in the late 1930's and now: the total return for the S&P 500 over the last decade is -9.9%. Each of the previous 3 periods of disappointment resulted in a powerful upwards reversion to the mean and impressive annualized returns. We have now built a 10 year base that may provide the platform for a generational investment opportunity.

I recently did quite a bit of archival research and I'd like to share some of the headlines appearing in the NY Times from 1981 through 1987 which are illustrative of investor concern during that period:

December 20, 1981: "How the Crunch stole Christmas…point the finger wherever you will, there's a Grinch out there and he stole Christmas...unemployment is the highest since the recession six years ago."

March 3, 1982: "…is depression lurking, some businessmen, fighting for their companies survival, worry we already have one."

June 27, 1982: "Rising trade barriers stir memories of US depression."

January 9, 1983: "States report recession is squeezing budgets."

July 9, 1983: "The real end of the recession…the National Bureau of Economic Research…announced the trough of the downturn came last November."
By this time the Dow had rallied 56% from the bottom – similar to what we have experienced this year.

August 3, 1984: "Index of economic trends fell again in July…widely seen as confirming a slowdown in the nation's economic growth."

April 28, 1985: "The Nation; a Fed official's slowdown fears…a growth recession must be considered a new threat."

February 12, 1987: "Specter of a recession seen in falling dollar."

You get the drift; bull markets climb the wall of worry…the Dow rose 250% during this period. We are just beginning that process anew. The 1980's bull market lasted 1275 trading days while the average rising cycle lasts 958 trading days, so we are about 18% into this one. By the way, unemployment peaked at 10.3% in 1982, about the level we are at now, and everyone worried about a jobless recovery…within 3 years unemployment was down to just over 5%.

I believe we are well on the way to economic recovery. Less than 20% of the $787 billion stimulus provided by the American reinvestment and recovery act has been spent, so there is plenty of fuel for the fire over the next couple of years. GDP has gone from negative 6.8% in the first quarter to positive 3.5% in the third. By the end of the year $220 billion in TARP funds will be returned to the government with significant profits attached (most recently CitiGroup, Bank of America and Wells Fargo have announced the repayment of TARP money). Corporate profits have reappeared as margins have expanded. Consumers have reduced debt and rebuilt balance sheets. Confidence is slowly reasserting itself and that will lead to a rise in consumer spending. The deep inventory depletion of the last two years will lead to a replenishment cycle and an increase in manufacturing capacity utilization. Corporate revenues will reaccelerate and employment growth will resume. Earnings should grow at least 20% compounded over the next 2-3 years. Mortgage delinquencies will decline along with unemployment claims and the threat of inflation is muted which means the Fed won't tighten quickly and the odds of a double dip recession are extremely low.

RBC Wealth Management's Chief Technician recently put out **chart 6**

Chart courtesy Bigcharts.com and RBC Wealth Management

which shows the 4 month moving average for the Dow crossed the 13 month moving average on a bullish uptrend on November 4th. This has happened only 6 times in the last 20 years: each crossing has signaled either a bearish or bullish trend…the previous signal in February of 2008 was a negative one and preceded the deep correction we experienced last year. This is yet another reason to conclude that the recovery from shock therapy may be rapid and powerful.

So where do we find the horse – in this case investment returns? Thus far, the early beneficiaries have been: financials, emerging markets, small cap stocks, cyclicals, materials, consumer discretionary and low quality - high yield bonds. We still want to look for companies that are economically sensitive and can experience margin expansion as revenues grow more robustly. That continues to include these groups, but over time we will migrate towards more exposure to industrial commodities, stable dividend paying stocks, technology, telecom, utilities and consumer staples.

By the way, the price of gold has gone parabolic and I would be very careful about exposure to that commodity/asset class. Financial markets, in the U.S. and around the world, will have corrections along the way and our conviction will be tested. However, we have emerged from the worst economic environment in over 70 years and lessons of the past suggest the next decade may well be one of great promise and opportunity.

Regards,

Terry