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Prepare for a Trading Range Market

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The best economist that I follow, Paul Kasriel, Chief Economist at The Northern Trust, wrote that the global economy should move ahead with mixed economic momentum with a modestly positive growth trajectory spread over the year. He predicts the US economy should grow at 2.5% in 2010; unemployment should peak at 10.5% in mid 2010; and the CPI inflation index should average 2.5% throughout the year. He expects that the major challenge will be the continued lack of lending and expects the Federal Reserve to keep monetary policy unchanged at least through August 2010. While I have seen both higher and lower forecasts from other economists, Paul's predictions all sound like very reasonable targets to me.

The key question is how the market will react to this steady type of economic growth path. How much has already been anticipated and built into the current market valuation? At current levels the market does not appear overly cheap or overly expensive. If Paul Kasriel is right and the Federal Reserve tightens in August, then the stock market could drift higher for the first half of the year until it senses enough economic growth that would cause the Fed to raise rates.

In my last quarterly market comment, "The Market is at a Crossroads", I stated that the market was likely to move into a trading range for the foreseeable future. I continue to believe that is the current path for the market and we are now in the middle of that trading range. The Dow Jones Industrial Average closed the year 2009 at 10,428 and, in my opinion, is likely to stay within the range of 9,750 to 11,500 (see attached chart) for most of this year. While there may be substantial volatility, I expect that the stock market will muddle through the first half of the year with an upward bias. Our plan for making money in this environment requires several core strategies:

Strategy #1 – Income, Income, Income!

In a trading range market, investors need extra income. We have added income to our portfolios directly with bonds and with income equities such as utilities, pharmaceutical companies, energy pipeline income trusts and natural gas income trusts. I expect to maintain a meaningful income equity exposure and am considering new investments in related areas.

Strategy #2 – Underweight Debt-Laden Companies, Industries, Countries and Municipalities

As we remain in a deflationary world, declining asset values continue to damage corporate balance sheets, particularly for more leveraged companies (GE), industries (real estate), municipalities (New Jersey, New York) and countries (United Kingdom and Eastern Europe). Their income increasingly goes to paying off their bondholders. These areas are riskier than expected.

Strategy #3 – Remain Invested but Diversified

Our core plan is to keep you invested in the market according to your Investment Policy Statement. In an environment that is too hard to call, proper diversification and patience is required. Wall Street needs volatility to survive and I expect that it will continue to be created in 2010. Be prepared to ride out volatile markets.

Positive Economic Signs

I believe that the fundamental picture for the U.S. economy is modestly improving. The shock of the collapse is fading as people move on to what it will take to succeed in the new environment. In fits and starts we are discovering a new baseline level for “new normal” economic growth.

- November’s Employment report was stronger than forecast. The data seems to suggest that the period of job-cutting is coming to an end. However, there is a big difference between stopping the job-cutting and actually entering a period of job-creation. A modest rebound in hiring may be one of the coming surprises in early 2010.
- December’s Chicago Purchasing Manager’s Survey rose to a new high level for the year, reflecting stronger new orders, production and employment.
- Corporate earnings have been exceeding expectations, albeit the bar is set quite low. We expect this to continue for another quarter or two.
- The Federal stimulus plan is just starting to kick in – over 65% of the spending will occur in 2010 and 2011. Infrastructure-related stocks should benefit.
- Interest rates are starting to drift higher based on stronger economic growth.
- Global economic growth is stronger than growth in the US. The BRIC countries – Brazil, Russia, India and China were not affected as much by the credit bubble and have resumed their growth paths. Natural Resource countries – Australia, Canada, Russia and Brazil are seeing increased demand for their products from China and the emerging world.

All of these factors add up to the prospect of a bottoming pattern for the economy. In my opinion, economic recovery should continue, with fits and starts, throughout 2010 and 2011. This would correlate to a stock market that trades within the range of 9,750 to 11,500 (DJIA) for an extended period of time.

Other Worries

Interest Rates are Near their Lows for this Cycle - Income investors have had a banner year in 2009! This is unlikely to be repeated in 2010. As the economy recovers and commodity inflation returns, interest rates are likely to move higher in 2010 or 2011. The issue is when. We do not see the Federal Reserve raising rates until at least mid-year 2010, probably later. For the time being, we will enjoy our bond interest income and hope for the best.

Expect More Defaults – Similar to Dubai, we expect to hear about more defaults both internationally and domestically. International candidates for debt problems include Spain, Ireland, United Kingdom and Eastern Europe. Domestically, the risk areas are in commercial real estate, mortgage loans, municipalities and over-leveraged companies.

Real Estate Values Should Continue to Drift Lower – With an overhang of inventory, lack of qualified borrowers and potentially higher mortgage rates, real estate remains troubled.

Balance Sheet Restructuring will Continue - Both consumers and businesses have too much debt relative to current asset values. They will continue to repair their balance sheets and pay off debt as they are able. This type of “balance-sheet recession” results in a limited appetite for new borrowing or large investment purchases from the private sector. Even when banks want to lend, investors may not choose to add to their debt.

Other Investment Ideas

Consumer Related Stocks Should Continue to Lag – Consumers cannot repair their balance sheets and spend more at the same time. Stores should continue to close and retail stocks should continue to lag.

Technology, Health Care and Material Stocks Could Outperform – Industries that are not as dependent upon financing have an edge in this environment.

We Continue to Hold Quality Bonds – The credit rally in bonds is mostly over as bonds are back to pre-crash credit spreads. Some areas such as “junk” bonds have even become overvalued. We remain fully allocated in our bond portfolios with mutual funds or ETF’s that invest in investment grade or better bonds.

Speculators Should Continue to Invest in Emerging Markets – Prospects for future global growth remain centered on emerging market countries. We believe investors should prosper with a healthy allocation to emerging market stocks in spite of their strong volatility. They should continue to attract capital during the first half of the year.

Tooting our own Horn

We are very pleased with the performance of our clients’ portfolios in 2009. I hope that you will be pleasantly surprised by your year-end results. Our goal is to maintain current income and preserve our clients’ capital for the long term.

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