

NOYES CAPITAL MANAGEMENT, LLC

Personal Financial Planning & Prudent Investment Management

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The Recession is Over

By Scott P. Noyes, CFA® CFP®

I love it when the stock market melts up instead of down. Many of the worries and concerns of the last year have been managed or deferred. Investors are now being driven from zero interest rate money market accounts into bond funds and from bond funds into stocks. Yes, we believe it is safe to come out of hiding. Even residential real estate is starting to improve! It looks like the economy and stock market are reverting back to "Business as Usual."

According to the most recent employment report for the US economy, total employment has increased by 1.1 million jobs since January 1. About ¼ of the growth was in government workers; the balance in private sector jobs. Construction, forestry and transportation remain the weakest economic sectors. Growing areas include office workers, health care, temporary help and retail.

The economy is clearly improving in a way that looks like a textbook economic recovery, albeit from a very low starting point. Businesses are acting like they did in the 1980's and 1990's before the great credit glut, when you had to work hard to earn every dollar. Corporate earnings are improving through cost cutting rather than revenue growth. As we come out of this recession, the economy is constrained by lower household debt, higher personal savings and less consumption. For many people, the "American Dream" was built on credit which now has to be paid back. Americans have to manage their personal and business budgets more carefully and want their government to do the same.

1. **The recession is likely over.** The economy is improving albeit not up to past historical standards. Multiple economic indicators are improving and suggest the recession has ended. Even Alan Greenspan sees the economy and job growth gaining momentum.
2. **Interest rates should remain low throughout this recovery cycle.** The forces of deflation continue to remain strong and bank and consumer balance sheets remain weak. Even when the Federal Reserve decided to tighten, I suspect that short term rates will peak in the 2% to 3% range. Longer dated maturities may go up 1% from current levels.
3. **The government is likely to spend to stimulate the economy.** The Administration's proposals for a second stimulus bill are likely to receive bi-partisan support in an election year.

My best guess is that the stock market stays in a rally mode until late spring or early summer. In the fall we will worry anew about the negative impact resulting from the increase in taxes on those making over \$233,000 which will become effective in 2011 (see my write-up). There is likely to be selling of long-held assets with imbedded capital gains that are taxed at the current low rate of 15%. This selling pressure may keep a lid on the market during the second half of 2010. I would expect a continued stock rally next year based upon stronger economic fundamentals.

So far this year, the stock market has held within our previously described trading range of 9,750 to 11,500. After starting the year at 10,400, the Dow Jones Industrial Average declined into mid-February when it bottomed at 9,909. Now we are at a new high for the year at 10,900 and, with a little luck, should test the 11,500 target zone within the next few months.

Interest rates have been drifting higher as the economy improves. This is normal for the interest rate cycle. Investors have also been demonstrating their increased confidence by buying high yield bonds. The best gauge of inflation, the US Treasury Inflation Protection Bonds (TIPS) have been showing wider real rates but no increase in inflation expectations. While long term rates could go higher by another 1/2% or so, I do not believe that we will see meaningfully higher rates during this economic cycle due to the glut of labor and real estate resources.

The international story is also improving. Europe is muddling through its debt problems with Greece, Ireland, Italy and Spain. In addition, the Chinese government is tightening credit and raising interest rates due to too strong an economy and concerns about a real estate bubble. Together, these resulted in a more cautious atmosphere towards international investing and resulted in a rally for the US dollar.

In our judgment, the potential upside for the market is greater than the downside risk. We remain fully invested in stocks according to our clients' Investment Policy Statements. While markets never go anywhere in a straight line we believe that the greatest risk is being out of the market.

Our Market Strategy

We remain focused on building portfolios that succeed in all environments. In this light we have three biases in our portfolios:

- 1) **Be fully invested in equities according to your target allocation** - We believe that equities will outperform bonds over the next two years. While holding stocks may feel terrible at times, we believe that you will be rewarded for patience. Reminder – the investors who really lost in the crash were those who sold stocks and moved to cash.
- 2) **Add to credit exposure in bond portfolios** - In an improving economy, corporate bonds and higher yield bonds offer some income protection from future Fed tightening. We believe the Federal Reserve will be slow to tighten due to higher levels of unemployment.

- 3) **Emphasize tax efficient investing in expectation of higher future tax rates.** – For more affluent families, tax rates are likely to increase in 2011. We are deploying strategies to help minimize taxes in your investment portfolio.

Please call me at 973-267-8120 if you have any questions.

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