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August 12, 2010

Twelve Reasons to be Optimistic

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History suggests that, barring a catastrophic event, the next 12 months should see last year's stock market rebound continue. The Dow Jones Index opened the year at 10,428, made it to a high of 11,205 on April 26th, followed by a low at 9,686 on July 2nd, a high to low swing of 1,500 points. Now we are back to where we opened the year at 10,400 – basically unchanged. We have worked very hard to go nowhere in the stock market this year and feel like we have been through a meat grinder.

The economic press is currently debating whether the economy is in a summer lull or beginning a double-dip slow down into another recession. Market sentiment has moved decidedly bearish since early May when the European debt crisis and the gulf oil spill decreased prospects for global economic growth. The bearish stock market scenario is based upon the assumption that economic growth is not yet self-sustaining, money supply growth is still collapsing, consumer spending is stalled, unemployment is stubbornly high and bank lending is at a standstill. The average US consumer appears to be fearful and angry. Investor sentiment remains cautious.

However, I remain cautiously optimistic about the stock market and economy going forward for twelve reasons:

1. <u>The gulf oil spill crisis is under control</u>. The gulf oil spill occurred in late April and severely impacted the economies of the states along the gulf coast. In addition, it was an environmental embarrassment for all Americans. This has been one of the causes of slower economic growth and declining confidence since early May. Hopefully, the negative psychological effect will fade away during the remainder of the year.

2. <u>The Greek debt crisis and concern over a Euro meltdown was well managed</u>. When the bond market realized that Greece had been hiding its level of debt to GDP, its bond borrowing ability was shut off. The value of Greek bonds and those of several other countries (Italy, Spain, Ireland and Iceland) plummeted. European banks and institutions that owned these bonds faced significant losses and impaired capital. In response, the European Union (EU) and International Monetary Fund (IMF) offered a $1 trillion backstop to help EU countries issue new debt. This crisis forced Greece, France, Spain and the United Kingdom to make major cuts in their budgets and spending. While this is an intermediate-term negative for European growth, it is a positive for long-term

fiscal health. Overall, the response from high debt countries has been received positively by the financial markets.

3. Consumer spending during the holidays is projected to be 1-2% higher than last year. While consumers are grumpy, the Grinch is not likely to steal Christmas. Americans are programmed to shop and spend. Department stores are likely to offer discounts early and often as no retailer wants to be left with inventory. Optimistically, I have noticed new stores filling last year's vacant space and the major malls appear moderately active.

4. No-flation is historically good for the stock market. True deflation is very bad. We are currently in a period of no-flation with 1% inflation projected for the balance of this year and next year. Over the past 84 years, during periods of mild deflation to mild inflation, the stock market has performed well.

5. Polls show that the Republicans can take the House in November. This could result in "gridlock" and a more moderate and business friendly environment. Democrats and Republicans may be forced to work together. This is typically good for the stock market. In addition, the third year of a president's term is often one of the best years for stock market performance (2012).

6. Energy "Cap and Trade" legislation is dead. There will be no tax on carbon emissions for the foreseeable future. We may see good ideas, such as an improved electric grid and greater use of natural gas, become bi-partisan proposals next year.

7. Fiscal responsibility is returning to federal and state governments. A new dawn of fiscal responsibility is entering the political calculus of both parties, particularly after the November elections. State governments are being forced to cut back on pension and medical coverage promises made to state employees during good times. No state or municipality wants to become the next Greece. Fiscal responsibility is an intermediate term negative as there would be less government spending but it would be a long-term positive as it would reduce future government borrowing.

8. Corporate earnings season lived up to expectations, especially among large technology and industrial companies. Microsoft, AT&T, Caterpillar and MMM were major positive examples. While overall revenue growth was disappointing due to the slow economy, companies have used productivity gains and cost cutting to improve profits.

9. Ben Bernanke indicated that the Federal Reserve would become more aggressive at stimulating monetary policy if needed. In his recent testimony to Congress he urged politicians to refrain from tightening fiscal policy.

10. Mortgage and borrowing rates are low. Refinancing is a great option to possibly lower your costs. Homeowners with floating-rate mortgages are benefiting from very low rollover rates. This reduces one of the biggest costs in home ownership.

11. <u>Stocks appear cheap compared to bonds</u>. A 10-year US treasury bond yields 2.85%. The dividend rate for Exxon, Procter & Gamble, Kellogg's, Kimberly Clark, McDonald's, Coke, Intel and many big pharmaceutical firms and utility companies are all higher than the 10-year treasury yield. Investments funds are more likely to flow out of bonds and into high quality stocks.

12. <u>Potential for pre-election surprises.</u> For example, tax rates may not be increased as much as predicted. Since Democrats do not want to harm their election chances any more, I suspect they will offer a surprisingly moderate package of tax hikes. In particular, I expect they will extend the current tax rates for dividends, interest and capital gains for at least two years. This could partially offset higher tax rates in the top brackets. Election year surprises may help the stock market.

<u>The Bond Market is Being Driven to Extraordinarily Low Interest Rates</u>

Some experts are very concerned that the US economy may be moving to deflation and recommend buying US Treasury bonds. In addition, the bond market has also been driven by fear of further problems in the European bond market. Thirdly, the bond market suspects that the Federal Reserve may start purchasing mortgage-backed bonds again to drive long-term rates lower and stimulate the economy. These factors add up to a bond market that does not fear Fed tightening and the risk of higher losses. While these factors are positive for bonds in the short-term, I believe that current interest rates may be difficult to maintain over the long-term. Since I am not a believer in these end-of-the-world scenarios, I find it difficult to put new money to work in the bond market and would expect higher interest rates over the next twelve months.

<u>My Market Outlook</u>

Starting in May, the sovereign debt crisis, gulf oil spill and persistently high unemployment rates in the United States rocked investor confidence and created a grim mood among investors. If several of the above reasons to be optimistic occur, we are hopeful that confidence will return to the market this Fall. I believe that patience is the correct course of action.

Even though the economic recovery has been less than robust and hardly consistent across industry sectors, there seems to be sufficient reason to expect that progress will continue. Companies have returned to normal profitability levels while retaining record amounts of cash. Higher corporate earnings ***should*** result in higher stock prices sometime in the future.

We believe it is smart for investors to commit to long term investments, stay diversified, and don't react emotionally to every fluctuation. Remember the stock market usually rallies before the economy improves. If you wait until evidence of economic growth, you will probably miss the rally.

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

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