

THE YEAR IN REVIEW

This past year has been one for the record books.

We started 2009 with the worst January in stock market history, with the S&P 500 losing nearly 9%, followed by the second worst February on record, down 11%.

The economy experienced its worst recession since The Great Depression, credit markets stopped functioning, and the government took unprecedented measures to try to stabilize the financial system.

However, by early spring, when things looked their worst, a few positive signs began to appear. And when recovery came in the stock market — it was powerful. From the March 9th low, the stock market staged one of the strongest rallies in its history. Year to date, the stock market, taking into account the negative returns in January and February, is up approximately 25%.

With all the uncertainty, the mostly negative news that we hear from the popular media, and the seemingly irrational stock market behavior, our clients are asking a lot of good questions these days. In an attempt to briefly address these questions, we have come up with the DMKC “Top Ten” Questions that seem to be on a lot of our investors’ minds. Given the complexity of some of these questions, we will address half of the Top 10 in this quarter’s issue and we will continue in next quarter’s newsletter by addressing housing, deficits, healthcare, and market timing.

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1. Given all the bad news and uncertainty, why has the stock market gone up over 50% from March, and how can it continue to go up from here?

The stock market is forward looking in nature; it is an indicator of what is to come, not of what is currently being reported. But unfortunately, it doesn’t always accurately reflect the health of the market, due to investor psychology.

This is the tendency of fear and greed to overshadow the more important economic indicators, at least over the short term. In 1999, the market had priced in too much optimism with many retail and institutional investors flooding money into the market, especially into technology stocks. This excess optimism was corrected by the three year, 50% bear market, from 2000 through 2002.

In 2007, the market underpriced risk in the system and overestimated home price stability. Again, the rally was followed by the gains quickly being erased by a 50%+ bear market.

By March of this year, the market had not only priced in a severe recession, but also a government controlled financial system, deflation, and possible depression. The above examples clearly demonstrate the investor psychology mentioned earlier. In 1999 and 2007, greed was at an extreme. In March of 2009, fear was at an extreme.



Today, the market is looking past the current negative headlines and is pricing in a recovery in both the economy and corporate profits. Even though the current economic environment is still problematic, things are getting better. Job losses continue to be moderate (a peak of approximately 700,000 lost jobs in early 2009 to 11,000 lost jobs in November 2009). Banks are gradually working through their loan problems, raising capital in the private sector, and paying off government “bailout” money. The manufacturing sector is growing, housing has stabilized, and international economies are recovering.

Looking forward, it appears to us that there is a reasonable chance for this market to gradually move higher. As the economic trends continue to improve, there is considerable cash on the sidelines earning nominal returns that could again prime the markets as investors regain confidence. Corporate profitability is improving, and numerous reported earnings have exceeded expectations. Perhaps most important of all, we are still early in the economic recovery phase, and there is ample opportunity for additional growth.

2. When will interest rates rise?

To state the obvious, interest rates – at least on the short end – are at unsustainable levels. The overnight rate is near 0%, while one and two year treasury notes are yielding 0.29% and 0.76%, respectively. The Fed pushed rates to these levels during the height of the financial crisis and is reluctant to raise them until the economy is on more solid footing. The true test will be how the economy reacts as the Fed gradually pulls back on some of the programs put in place to stabilize the economy and financial system, such as the first time home buyers tax credit, various government guaranteed security purchase programs and the troubled asset relief program (TARP).

Our guess is that the economy will show progress in terms of self-sustainability and the Fed will begin raising interest rates in the first quarter of 2010. It will likely be a gradual shift in the Fed Funds rate (the rate at which banks borrow from each other) towards 2% initially, with the prime rate rising by a similar amount from 3% to 5%. Higher rates, while not typically good for the markets and economy, may be welcomed by investors as a sign of economic stability.

3. Are we going to have runaway inflation, given all the government spending and printing of money?

We don't think so - at least not in the near term. The classic definition of inflation is “too much money chasing too few goods.” As far as the “too much money” part, yes, the government has pumped a lot of money into the system, but to date, the private sector has taken more out due to a contraction in lending and borrowing. Therefore, one action has cancelled out the other and there does not appear to be an overabundance of money in the system. However, there is the potential for an imbalance if lending and borrowing pickup. Regarding the concern of “too few goods,” we have considerable slack in the economy with both labor and productive capacity being underutilized. Our economy has considerable capacity to increase production of goods and services with its existing resources and there does not appear to be any near-term danger of a shortage of goods being produced or excess demand being created. However, given rising commodity prices, a weak dollar, and stabilization in housing values, we do anticipate moderate inflation of around 1.5% to 2.5%.

4. Is gold a good buy?

We don't think so. There are two primary reasons that people buy gold. One is as a store of value in an economic crisis, and the other is as a hedge against inflation.



Although there are still many problems in the global economy (and plenty of risks out there), it seems to us that we are past the worst of the economic crisis.

As far as an inflation hedge, as we've stated, we do not think inflation will accelerate significantly from here. If inflation rises 2% to 3%, or even a little higher, we think there are better ways to protect against it, rather than by purchasing gold. Other reasons we hesitate about jumping on the gold bandwagon include:

- Opportunity Cost – Since gold does not generate income like other traditional inflation hedges, you give up potential yields by owning it.
- Historical Performance* – Gold has been a great investment since it bottomed in January 2001 at \$262. However, for the longer term, gold has been a very poor investment. For example, from 1980 (its last peak) to the present, gold has increased in value by approximately 45%. That compares to a 22-fold increase (2100%) in the S&P 500 index and an 11-fold increase (1000%) in U.S. Treasury securities over the same time frame. Even a standard checking account outpaced gold, returning approximately 92% from the early 1980's.

As noted above, gold as a long term asset does not have a stellar track record. It is more of a trading asset, and to earn a reasonable return, timing is critical. It seems to us that now is not the right time to buy gold, given its eight-year run. The risk/reward trade-off does not appear reasonable to us.

- Crowded Trade – It seems to us that too many people want to own gold, similar to technology in 1999 or real estate in 2007. Every time you turn on a financial news program, there is an advertisement for gold. You can now buy gold at Harrods, Ltd, the London department store,

and there have been significant capital inflows into gold mutual funds. These are all anecdotal signs to us that the cycle looks extended.

**Source: Bloomberg Article titled "Gold Can't Beat Checking Accounts 30 Years After Peak", dated 12/7/09 by Nicholas Larkin and Millie Munshi*

5. How can we have healthy economic growth with unemployment at 10% and a weak consumer?

This is one of the most common arguments put forth by the more pessimistic economists and stock market analysts, and with good reason. The consumer comprises 70% of the economic growth in the United States. With unemployment at 10%, debt to income levels extended, and a savings rate that will likely grow from the near zero levels seen prior to the recession, the consumer is not likely going to be the engine of growth. However, that doesn't mean we can't have a healthy economy. It will just look a little different than past recoveries.

We think the drivers of economic growth this cycle will be U.S. manufacturing, global infrastructure, and consumers from emerging markets. Therefore, the U.S. economy will be more export and manufacturing driven this cycle and less consumer driven, which we think is healthy as the U.S. consumer needs to deleverage and repair their balance sheets.

These trends also have implications for the kinds of stocks we want to own in the portfolios, specifically avoiding companies that generate most of their revenues from the U.S. consumer, and emphasizing multi-national consumer goods companies and global capital goods/infrastructure companies.

As always, please feel free to give us a call if you have questions regarding your accounts. ■



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INDEX VALUES AND RETURNS*				
	12/31/08	12/31/09	Price Change	Total Return
S&P 500	903.25	1,115.10	23.45%	26.47%
Dow Jones Industrial Average	8,776.39	10,428.05	18.82%	22.68%
Nasdaq Composite	1,577.03	2,269.15	43.89%	45.36%
Merrill 1-5 Year Bond Index**	106.81	102.09	-4.42%	0.23%
Consumer Price Index	0.10%	-1.80%***	NA	NA

*Results according to Bloomberg unless indicated
**Results according to Merrill Lynch at mindex.com
***As of August 2009