Marathon Investment Management

Happy New Year and a Happy New Decade!

Preface

Before we give a review of last year and the last quarter, a little positive news would be appreciated. The Commerce Department reported last month that productivity was rising at an annual rate of 8.1% in the July – September period. This is the biggest jump since 2003 when labor costs were falling at a 2.5% rate[1]. Furthermore, the Conference Board said its Consumer Confidence Index rose to 52.9, up from a revised 50.6 in November – an increase for the last 2 months[2]. Retail sales jumped 1.3% in November and were more than twice that of Wall Street's expectations [3]. Sales climbed 1.9% versus a year ago, their first gain since August 2008, the Commerce Department reported[4]. Retailers finished the year with a rise of 3% versus December 2008 for stores open at least a year, according to Ken Perkins of Retail Metrics[5]. December was the fourth month in a row of year-over-year sales increases[6].

The Institute for Supply Management's manufacturing index rose 2.3 points in December to 55.9, the highest since April 2006[7]. Demand both domestic and abroad rose as manufacturing increased in China, Indonesia, and Europe. The report suggested the U.S. economy is growing quickly enough to avoid slipping into a double-dip recession.

Finally, the Treasury Department reported last month that it expects to recover all but $42 billion of the $370 billion it lent to ailing companies since the financial crisis began last year[8]. The portion lent to banks actually shows a slight profit.

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2009

In many respects 2009 was a banner year. From October 11, 2007 when the S&P 500 hit an intraday high of 1,576 to its March 6, 2009 intraday low of 666 – a drop of 57.7% - this broad index finished the year up 23.4%. Nevertheless, at year-end the S&P 500 still is down 29.25% from its historic high.

For other indices please refer to the chart below[9]:

Index	**2008**	**2009**
Dow Jones Industrials	-33.8%	18.8%
Standard & Poors 500	-38.5%	23.5%
Wilshire 5000	-38.7%	26.5%
Russell 2000	-34.8%	25.2%
Morgan Stanley EAFE	-45.1%	27.7%
Long-Term Treasury Index	24.0%	-12.92%
Intermediate-Term Treasury Index	11.35%	-1.41%
Municipal Bond Index	-2.47%	12.91%
Gold	3.91%	22.86%
Silver	-25.44%	47.64%

Many companies in sectors that fell the hardest in 2008 and early 2009 led the rebound for the remainder of last year including autos, basic materials, financials, and international companies. The market seems to benefit from the Federal Reserve's pledge to keep interest rates low for the 'time-being'. Most investors anticipating growth of corporate earnings, feel the market's positive momentum will continue in 2010. A major concern of investors is how the markets will fare once the Federal Reserve starts restricting some of the unprecedented amount of cash it has pumped into the financial and industrial sectors – the so-called exit strategy.

Many of the international markets, as represented by the Morgan Stanley EAFE index, led the recovery in 2009 – especially in emerging markets. The Indian Sensex index rallied 81% and China's Shanghai Composite returned 80%. The Brazilian - Bovespa gained 83%, which put it within 7% of its 2008 record[10].

International funds, particularly Latin American funds, outperformed all other investment sectors for 2009. These funds surged 14.2% in the final quarter and more than 113% in 2009[11]. China-region funds gained 9.82% in 2009's fourth quarter, and 69.27% for the year[12]. The weakest performance of the major international markets was Japan where the Nikkei index finished up 19%. Even though the U.S. dollar lost value relative to foreign currencies in 2009, it still gained 2% against the Japanese yen[13].

Last year also saw strong appreciation in commodities – from corn to crude. For the year gold bullion rose 22.86% to $1,095/troy ounce. Crude oil closed the year at $79.36/barrel up 77.9%. Crops such as corn, soybeans, and rice have rose more than 50% in 2009. Rising demand especially in "third world" nations and central bankers' easy-money policies are fueling inflation expectations and boosting commodity prices.

The Lost Decade

The Standard & Poors 500 index has turned in its first losing performance over the course of a decade, having fallen 23% from 1,469 at the start of 2000 to 1,126 year-end 2009[14]. Another way to summarize the decade is that stocks are now worth $2.5 trillion less than 10 years ago – and that is before inflation.

Referring to the New York Stock Exchange (NYSE), the Wall Street Journal reported that the first 10 years of the 21st century was the worst performance period for U.S. stocks in their 200 years of recorded history. From the end of 1999, the NYSE has dropped about 0.5% in value per year[15].

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Finally, and most dramatically, the tech-heavy NASDAQ Composite index started the decade at 4,069, then rose to 5,048 by March 10, 2000, fell to a low October 9, 2002 of 1,114 and finished 2009 at 2,269 – a drop of 44.2% for the period![16] Looking back, bonds, gold, CDs and even stuffing money in a tin can would have bettered the return of stocks.

It is worth noting that the decade of the 1990's was the best in history with a 17.6% average annual gain. It is natural to look backwards when basing a future strategy – many investors after the 1990's overlooked high valuations and companies that paid little or no dividends when implementing their investment strategy.

Going Forward

The New Year has begun with a bang. The Dow Jones Industrials ended the first week of the new decade up 190 or 1.8%, to 10,618, its highest level in more than 15 months[17]. Kopin Tan for Barron's points out that "a strong 5-day start has led to further gains 3 out of every 4 years in the Dow's history[18]." The S&P 500 rose for the fifth time in the last seven weeks while the Russell 2000 rose 3.1%. Those familiar with the "January effect" are pleased with the results so far - namely how the first week goes, so goes the month, and the year. Recall that January was weak in both 2008 and 2009 – and the resulting pain many of us still feel.

When looking forward for 2010 I feel Martin Regalia of the U.S. Chamber of Commerce said it best… the outlook is a combination of 'the good, the bad and the ugly'… "the good news is that we're growing again. The (bad) is that we are probably not going to grow at a very high rate. The ugly part is that in the long run, we're facing some truly daunting problems" tied to out-of-control fiscal policy[19].

A Dialog with George

Often client communications are few, far between and short. Many clients are located outside the Denver Metro area, in fact we have clients on all continents except Antarctica and Australia. In this last section I suggested a few questions that may be of interest and I provided a brief response as we see it.

Question: Fourth quarter 2009 earning season has started, what do you expect?

Answer: Comparisons are always of the recent quarter with the comparable quarter a year ago – this ought to be easy and very positive considering fourth quarter 2008.

Question: Where will the unemployment rate go this year?

Answer: Last year corporations severely cut all 'unnecessary' expenses including new hiring. Late 2009 consumer spending rose after a very depressed level in 2008 and most of 2009. We anticipate businesses maintaining a cautious approach going forward with modest hiring of new full-time employees vis a vie part-time.

Question: When will interest rates rise?

Answer: They are beginning to rise already, and a strengthening U.S. dollar anticipates higher rates. The U.S. Treasury sold more than $2.1 trillion in notes and bonds in 2009. Secretary Geithner and Federal Reserve Chairman Bernanke have stated that an 'exit strategy' to reduce debt will be initiated 'soon.' This strategy may keep interest rates rising modestly. This may prove to be the challenge of the year – both here and abroad. The Federal Reserve's goal to re-absorb part of the $8.2 trillion in emergency funds to industry without creating a double dip recession is what we will be watching closely.

Question: What are the prospects for higher inflation?

Answer: The anticipation of inflation helps to create it. The rising prices of precious metals and commodities are strong signs of anticipated inflation. Concerns of the success of controlling 'deficit' spending by the federal government will have an effect on future inflation. Our concern is possibly a 1980 type of stagflation where we experience significant inflation, slow growth and high unemployment.

Question: What are the other challenges we are facing that will affect the economy and the markets?
Answer: We will remain invested but cautious starting out for 2010. Our concerns include sovereign risk i.e. Greece, Dubai, etc; the success of exit strategies both here and abroad; slow economic growth; business investment, and the health of financial institutions with growing willingness to ease credit. About $70 billion worth of commercial mortgages will reset in early 2010 – an immediate concern that we will watch closely.

Question: Early last year many investors sold their equities at very low valuations and then locked in low interest bearing CDs and Treasuries. Since March 2009, equities have rallied strongly. Why do investors have such poor market timing?
Answer: Market-timing is like trying to drive forward by only looking in a rear-view mirror – it is a speculation at best. Markets are dynamic and therefore portfolios need to be monitored and adjusted considering investment objectives and the relative value of investments – equity, debt, and alternatives. Develop an investment strategy that fits your material needs and your risk tolerance – implement it – then stick with it. We are here to help so call us and we will set up an office or phone appointment!

Wishing you a healthy and successful 2010!

Sincerely yours,
George Gumbiner
President

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Footnotes:

1. www.msnbc.com, Productivity rises by largest amount in 6 years, 12/7/09.
2. www.msnbc.com, Consumer confidence extends rise in December, 1/1/10.
3. Investors Business Daily, Retail Sales Gains Suggest Recovery 12/14/09, page A1.
4. ibid.
5. Investors Business Daily, Retailer December Sales Easily Beat Views 1/8/10, page A1.
6. Wall Street Journal, Retail – Sales Gain Is Most in Years 1/8/10, page B12.
7. Investors Business Daily, Manufacturing Data in U.S., Asia, Europe Show Faster Growth 1/5/10, page A1.
8. www.msnbc.com NYT: U.S. forecasts smaller loss from bank bailout, 12/7/09.
9. Wall Street Journal, Rebuilt Markets Must Stand Alone 1/4/10, page R2.
10. Wall Street Journal, Would Stocks Return to Pre-Crisis Form 1/4/10, page R3.
11. Investors Business Daily, Latin American Lead World Stock Funds 1/6/10, page A6.
12. Barron's, A Path Back to Fund Fitness 1/11/10, page L15.
13. No Load Fund X, Sharp Reversal Led to Excellent Returns 12/31/09, page 1.
14. www.msnbc.com, Will next decade be another bubble-popper?, 1/1/10.
15. Wall Street Journal, Investors Hope the '10s Beat the '00s 12/21/09, page C1.
16. The Denver Post, Worst on Record 1/3/10, page 16A.
17. Barron's, Cheery News Boosts Stocks at Start of 2010 1/11/10, page M3.
18. ibid.
19. Investors Business Daily, Slow Recovery In '10 1/4/10, page A1.