

DANIEL A. OGDEN
ALISON PECK

February 19, 2010

A Busy Year

2010 is only seven weeks old, but already, a lot has happened.

1. Greece is on the edge of default and their government bonds are trading like junk bonds.
2. The Chinese authorities have begun tightening credit in an effort to cool off their booming economy and head off an inflation threat in 2011.
3. These two events produced the largest correction in stocks since the market low of last March.
4. Scott Brown won in Massachusetts, shocking the political class in both parties. More on this below.

In spite of the recent weakness in stocks, most economic news has been positive. The Asian boom continues, growth in the US was strong in the 4th quarter and appears to be continuing in early 2010, and US stocks have held up better than most other markets, particularly when compared to Europe.

We think the upshot of all these will be a stronger US dollar and continued outperformance by US stocks. Greece has reminded investors that all countries are not equal risks. This revelation is similar to the one in 2007 when investors first understood that all mortgages aren't the same.

History tells us that national, or sovereign, defaults come in bunches. That suggests that Greece is the beginning of a process, not the end. And while Europe is in worse shape than we are here, California could be our version of Greece. The result of these fiscal disasters will be continued deflationary pressure and a series of shocks that will encourage investors to reduce risk.

The easiest way for global investors to reduce risk, while avoiding zero yielding cash, is to invest in dollar denominated securities. If the cash goes into US bonds interest rates will stay low and if some of it goes into stocks, the S&P will have a good year.

Where we're headed:

Continue to allocate equity investments toward Asia, but new purchases should be in high quality US companies with the ability to increase dollar based earning power. Favored sectors are Technology, Energy, and Industrials.

Below are the assumptions we sent to clients in December. Most continue to hold up, but careful readers will notice no mention of any countries going broke! Then there was Greece.

We've added a section on politics---tax policy could be the big surprise of 2010.

The Economy:

The Great Recession ended in the US in the 3rd Quarter. Asia appears to have embarked on a significant boom, while Europe muddles along and Japan seems set for a third lost decade.

Deflation continues to be the immediate problem. The cure may produce inflation sometime in the future, but the primary threat investors face is a prolonged deflationary depression. The US has avoided a Depression scenario, however looming tax increases threaten a slow growth future.

Deleveraging will be a drag on parts of the economy for several years. Less credit will be available as banks strengthen their balance sheets and raise capital. Less credit available and less demand for credit will reduce growth for years.

The US consumer will not spend freely any time soon, and the high current savings rate will persist. The job market will show signs of recovery in 2010.

The China/USA financial alliance will continue. The Federal debt will balloon, but it will be financed largely by the Chinese savers through the purchase of our Treasury Bonds.

Markets:

The liquidity driven rally ended in January. The bull market can continue in 2010 but only if profits lead the way.

Interest rates will remain low for the foreseeable future. The Federal Reserve will keep rates low to combat deflation and spur growth.

Investors are being forced out of cash through historically low money market rates---essentially zero. As long as rates remain low, cash will migrate into bonds and secondarily, stocks.

The dollar will remain the preeminent currency in the world. However, all currencies will weaken when compared to hard assets.

Emerging markets, led by China, will remain the place where equity investors find the most opportunity.

Technology and energy will be favored sectors within stocks.

Gold will become respectable as an investment.

Politics:

The market is pricing in large tax increases in 2011 and beyond. This has been a reasonable reaction to massive deficits in Washington. However, since the special election in Massachusetts and the retirement of Senator Bayh this week, a major shift appears likely in the fall.

At a minimum these surprising events should produce a moderation in the proposals coming out of Washington and at the extreme, we might see a major shift in our assumption about higher taxes.

DOCK STREET ASSET MANAGEMENT

The potential default in Greece and the threat of more like it in the Olive Belt may serve as a warning to politicians everywhere that spending needs to be controlled. We'll see.

Best regards,

A handwritten signature in blue ink, appearing to be 'D. Ogden'.

Daniel A. Ogden
dogden@dockstreet.net

A handwritten signature in blue ink, appearing to be 'Alison'.

Alison Peck
apecck@dockstreet.net