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The Economy and Earnings are Up --- Stocks Down

What gives?

Lots of good news in the last couple of weeks, but we have nothing to show for it in our portfolios. More on why that is below, but for now here are some headlines:

- China reports more than 10% growth in the 4th quarter
- Intel and other tech companies blow past earnings estimates
- Index of Leading Economic Indicators hits a new high

The last item is illustrated below. Remember that this index is intended to predict growth or recession so it tells us little about current conditions. But the big bounce does support the case that US economic growth will be decent in 2010.



So what's going on in the stock market? The headline fear is monetary tightening in China and the slowing of growth that will result. On that news stocks are down around the world and commodity prices have corrected.

This is the process we mentioned in early November when we worried about our Federal Reserve raising rates too early. There's no sign of that, but the Chinese are in a very different place. Their economy is booming and unless the authorities cut back on bank lending, growth could get way too hot and inflation would become a problem.

The Chinese are tapping on the brakes now so they won't need to stand on them in the fall. Our research sources believe they are handling this well and that it indicates continued growth beyond 2010.

Stocks are also correcting simply because it's about time. 2009 was a great year in all markets (except Japan) and it's not a surprise that investors would want to cash in once the year ends and taxes fall into the new year.

We agree with those who see this as a buying opportunity.

Then there's all the other news of the week:

- 1) The election in Massachusetts turned out to be a very big deal. Whether you enjoyed the results or were appalled by them, as investors we need to make a judgment about how an event like this changes the environment.
 - Inflation assumptions could be tempered. Investors have figured that government spending and taxes would be rising for years. That may still happen, but it is much less certain since Tuesday.
 - The dollar has been strong since the election. This relates to our first point and suggests that the off-shore portion of our portfolios could see further weakness.
 - Tax increases loom for 2011 and investors have been concerned about that. The change of mood in Washington might result in smaller increases, which would be welcomed by the market.
- 2) Bank regulation will move forward. With the blessing of Paul Volcker, the President has proposed a significant shift in financial regulation. This fits with our belief that banks will become highly regulated utilities rather than the growth businesses they were until 2008.

We'll stay out of most of the financial sector until we know how the new rules will shake out. Even then we think the glory days of banking are past.

We have been selling stocks since November and recently we have cut back on our international portfolio. We don't think much has changed for the long-term, but for now US stocks look more attractive given better growth prospects here and a stronger dollar.

We are examining the 2010 assumption list we published in December to see what revisions are needed in light of all the news in January. More on that later.

Best regards,



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