

2011: A DEBT ODYSSEY

As we leave 2010 and look forward to 2011, there are a few macro events that will likely guide successful investing in the year ahead. Our growing national debt, I believe, will be the overarching issue that all other issues either contribute to or are impacted by.

At a recently hit new high of \$14 Trillion, our national debt is so massive that it defies comprehension.

First, the number itself is mind-blowing to me: \$14,000,000,000,000. Just seeing it in print with all of those zeroes makes my eyes cross.

Second, if you look at it in terms of distance, you can think of it this way: if you laid one dollar bills end-to-end it would make a line that stretches from the Earth to the Moon, not just once, not just ten times, not even 100 times, but 5,600 times. Remember those news clips of the Apollo astronauts that went to the Moon? Can you imagine them traveling there on 5,600 separate trips?

Third, if you think of it in terms of time, it looks like this: if you earned \$1 every second, it would take you 448,000 years to earn \$14 Trillion. Time is money, as they say.

The associated issues that come along with the increasing national debt – currently forecast to hit \$20 Trillion in the next few years – are: (1) Likely rising interest rates as the purchasers of our debt require higher returns to continue loaning us money; (2) Likely government budget cuts to defense and social programs; (3) Likely tax increases; (4) Likely continuation of our Federal Reserve's Quantitative Easing program; (5) Likely increase in inflation beyond the price increases in food, energy, and other commodities that we are already seeing; (6) Likely slow economic growth; and (6) Likely a sustained high level of unemployment.

In spite of our growing levels of national debt, as long as the Federal Reserve continues to provide liquidity to our economy through low interest rates and the Quantitative Easing program, we should see our stock and commodity markets perform pretty well. However, if the Federal Reserve provides any indication that they are going to stop the Quantitative Easing program, if they announce an intention to raise short-term interest rates, or if they say that they see any sign of inflation moving beyond food, energy, and other commodities, we will have a correction.

The correction, if it comes due to one of those factors, will be a knee jerk reaction by the short-term traders, the momentum investors, and the quants (the mutual funds and hedge funds that buy and sell based solely on movements in price – no fundamentals involved in their decision process). The rubber will hit the road after that as investment returns will be based solely on the prospect for corporate earnings and the impact to investor sentiment from the perceived direction of the overall economy. But, we are not there yet. As long as the Federal Reserve maintains its current policy, stocks and commodities – as well as short-duration, inflation protected, and adjustable rate bonds – are the safest place to keep your investment portfolio other than certificates of deposit.

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Analyst estimates for 2011 earnings on the S&P 500 are \$92 per share, up from \$82 in 2010. That is growth of just over 12%. However, throughout 2010, companies were far more likely to exceed estimates than fall short of them. The ratio was better than 4 to 1 in each of the four quarters according to Zacks Investment Research.

Since the end of the third quarter, more analysts have been raising estimates than cutting them. It is possible that 2011 earnings will be above \$92 and this will drive stock prices higher.

If we assume (and its always a big assumption) that the current P/E ratio of 15 for the market will stay in place, then \$92 gives us a target level of 1,380 for the S&P 500 in 2011 or about a 9% increase in stock prices above current levels.

If analysts are wrong and corporate earnings are greater than \$92, then the S&P 500 could be higher than that in 2011. If earnings are \$97, and P/E ratios remain the same, we could see a target level of 1,455 for the S&P 500 in 2011, or about a 14% increase in stock prices above current levels. This is not a prediction, but just food for thought.

If the Federal Reserve ends its liquidity program or if investor sentiment turns negative, then the 15 P/E ratio could be lower. As a downside, if corporate earnings come in at \$87 and the P/E ratio contracts to 12 we could see a downside target 1,044, or 17% downside – that isn't a prediction, but rather to give you some perspective on what we could see if the current situation changes for the worse. It's not the end of the world but rather takes us back to where we started 2010.

As we move into the third year of President Obama's term, particularly with a change in the control of the House of Representatives, it is interesting to look back in history to see what occurred. The news is good: (1) according to the Stock Traders' Almanac, the third year of a presidential cycle is almost always the strongest of the four and shows a positive return; and (2) historically, the political combination of a Democrat in the White House and a GOP controlled Congress has been the best of the four possible combinations for governing the country in terms of stock prices (remember the positive stock markets of the Clinton/Gingrich years?)

The world economy should be pretty strong in 2011, particularly in the developing world.

Asia will continue to grow at high single digit or low double digit GDP growth rates. The exception to that will be China as it tries to slow its economy in an effort to fight inflation of the food, energy and other commodity variety. Our focus in the emerging markets is on the non-China Asian markets of Singapore, South Korea, Vietnam, Taiwan, Indonesia and Malaysia, all of which should show strong economic growth as they benefit from demographic shifts that move much of Asia from subsistence living to middle class lifestyles. The same can be said for Latin American and Eastern European economies in our focus: Chile, Brazil, Argentina, Columbia, Panama and Poland.

The higher GDP growth rates and negligible levels of debt in these economies should provide investors with a reason to give the companies deriving earnings in those countries a premium valuation. This includes both companies domiciled in those countries as well as US companies that make significant sales to those countries.

COMMODITIES

As has been our focus for a number of years, the resources that are in limited supply but growing demand – and the companies that produce them – represent some of the best investment possibilities in the year ahead. With the demographic shifts in Asia and Latin America come increased demand for raw materials, energy and agricultural products. This will ultimately lead to increased earnings for the producers and increased value for the raw materials they are producing.

The growing earnings and increased value of the raw materials should continue to propel the stock prices for commodity companies higher in 2011, outpacing the broader S&P 500.

Fixed income will be a difficult asset class in 2011. We have already seen bond yields begin to rise as investors start to worry that the current Federal Reserve policy will bring about rising inflation, and with it, increased interest rates. No one wants to lock in 4% for 20 years if you can lock in 5% next year or 6% the year after that. The consequence of this is that bond yields rise and the market value of bonds falls.

In order to combat this, we have been reducing durations in bond portfolios for several months and shifting to a combination of short-duration bonds, inflation protection bonds, and adjustable rate bonds. Clients should see these changes in their portfolios when they review their statements.

THE DOLLAR

The dollar is likely to be strong in the near-term as it is the best of the big three. The problems in Europe with the weaker economies and their serial bailouts will continue to weaken the Euro. The demographic issues in Japan, along with their own national debt that is double their GDP, should weaken the Yen vis-à-vis the dollar. And, if the Fed does decide to end their Quantitative Easing program or raise interest rates, the dollar should rally significantly meaning that we would lower our allocation to foreign markets until that has run its course.

In the longer term, I think the dollar will weaken against a broader basket of currencies as international trade diversifies beyond the dollar into the Yuan or some other as-yet unidentified vehicle.

Many of you who read this that are not clients always ask how our investment performance has been. We have all sorts of clients, some that want us to just manage stocks for them, some just fixed income, others that are a blend of the two. Since everyone has different objectives, the more aggressive ones have higher returns than those you see below and the more conservative ones have lower returns than you see below, but these numbers are an average of all accounts that we manage in individual stock and bond accounts:

2010 Equity Management Performance:

22.62% Vs 15.07% for the S&P 500 Index

2010 Fixed Income Management Performance:

12.37% Vs 3.98% for the Bond Index

2010 Blended Account Performance:

19.45% Vs 12.94% for Composite Index

For those of you who ask about long-term performance, since 1998 our Blended Account Performance has averaged 10.26% compared to the Composite Index of 4.45%, and that includes managing through two stock market crashes and taking advantage of their subsequent recoveries.

IN SUMMARY

So, looking forward into 2011, as long as the liquidity engine from the Federal Reserve continues to pump money into our economy, the equity and commodity markets should continue to move higher. The bond market will likely be a difficult place to make money outside of the areas noted above, and the foreign markets may, for a period of time, be a smaller allocation within client portfolios than currently allocated.

We are in the process of performing a comprehensive review of our entire equity management program. We are looking at the companies we own in client portfolios in terms of what worked in the 1970's. What we have found is that despite rising interest rates, high unemployment, and economic malaise, companies that were able to increase efficiencies – either within their own operations, through the products they produce, within the services they sell to other companies, or in the production of energy and other means of output – were able to increase their earnings and stock prices greater than the broader market. In light of this, we will be repositioning accounts to focus on companies that fall within this efficiency concept in order to continue to provide returns that are better than the broader market and our competitors.

As I write on our blog, invest what you see not what you believe. I believe the national debt will be a big problem if we don't address it – and soon. However, what I see are rising corporate earnings and increasing stock and commodity prices as well as opportunities to beat the broader market by focusing on efficient companies – so that is how we intend to invest until we see something different.

If you would like to stay current on our investment management activities in terms of where we see the market moving and what we are doing with client portfolios, you can find that by visiting our blog at: <http://investmentblog.bankchampaign.com/>

If you are already one of our clients, we sincerely thank you for your business and look forward to working with you in the years to come. If you are not currently a client and you would like to discuss how we can manage your investments, please give us a call at (217) 351-2870 and ask for John Clausen, Charlie Osborne, or Mark Ballard.

Best wishes for a profitable 2011!

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