

BEWARE OF THE "UNKNOWN UNKNOWNNS"

Bill Miller is a well known Mutual Fund Manager for Legg Mason. For 15 straight years his funds beat the S&P 500 index, ranking him as one of the top money managers in the United States. He had an expression: "If it's in the press, it's in the price." In other words, what is commonly known or anticipated has already been discounted and factored into the market. So, consensus thinking isn't much help when it comes to outperforming the market or more importantly, staying out of trouble. Remember the technology stock bubble in 2000, the New Economy and the for-sure winners of the future like Nortel?

Let me be more specific on how the consensus opinion can be misleading. Here's a quote from Time magazine, "The U.S. economy remains almost comatose...the current slump already ranks as the longest period of sustained weakness since the Great Depression...once-in-a-lifetime dislocations...will take years to work out. Among them: the job drought, the debt hang-over, the defense industry contraction, the banking collapse, the real estate depression, the health care cost explosion and the runaway federal deficit." Is this a fair description of current conditions? Nope. This was published in September, 1992. The Dow Jones was around 3000 on its way to doubling by the fall of 1995 and eventually to over 12,000 at the height of the "tech mania" in 2000. Who would have guessed? Certainly not those who focused on the problems of the then challenging environment. Only those who saw solutions to the problems benefited. Conversely, when projections are rosy it pays to understand what could go wrong.

Why do I bring this up? Well, it's the beginning of the year and all the soothsayers are supposed to come out with their predictions for the upcoming year. Last year, I put together a list of ten potential surprises. The hit rate was OK as 4 or 5 came to pass. The two most critical ones that helped our performance were understanding that the economy would perform better than consensus, and having an appreciation for the sovereign debt crisis that was brewing in Europe.

It was tempting to put together another list of 10 surprises for this year, but it's a bit of a mug's game. To come up with a true surprise, one has to concoct something absolutely outrageous, which isn't very helpful to an investor. And second, in former Secretary of Defense Donald Rumsfeld's words, it's really the "Unknown, Unknowns" that jump up and bite you.

So this year, I thought it might be more constructive to challenge some of the consensus views and add a couple of "Known Unknowns" that are just off the radar screen. I'll leave the future forecasts to the fortune tellers and economists.

But before I get to handicapping my list of "Known Unknowns", I think it's worth laying a little ground work as to what main underlying factor is influencing this market. If you get this one right, the rest of the issues are mostly short-term noise. Since the bottom of the market in March 2009, I have said to focus on liquidity, not the economy, if you want to know where the market is headed. That hasn't changed.

Bottom line, there are two huge secular forces battling it out. One is the deflationary forces of very slack labour markets and overcapacity in goods-producing industries versus the inflationary monetary policies being promoted in the developed economies through "Quantitative Easing". This match is currently at a stalemate for inflation, but very stimulative for financial markets.

Until the real economy, i.e. businesses, starts to soak up some of this surplus cash, it's game on for financial assets, especially the stock market. Yes, there are things that we need to be aware of that could derail this bias, but failing some adverse outcome, all that liquidity has to go somewhere.

If I had to bet on a resolution to this battle, it would be that governments remain committed to monetizing the debt rather than endure the pain of austerity, even in the face of what we are seeing forced upon some of the peripheral European economies such as Greece, who unfortunately do not have a financial printing press.

History supports me on this one. Governments traditionally either inflate or default their way out of difficulty. I think the U.S. may choose one route while Greece, Ireland, and possibly Portugal choose another.

The shift from Quantitative Easing to full scale debt monetization is only a small step from buying bonds in the secondary market, as they are now, to direct purchases from the treasury. Maybe it's time to read up on the Weimar Republic of Germany.

So, liquidity forms the base of my strategy while the tactical issues that we need to address, as we currently know them, are contained in my list of "Known Unknowns". One could write pages on each of these topics, but I'll spare you the time at the sacrifice of some details and get directly to handicapping these issues.

Through this, I think you'll get a pretty good understanding of where I stand on the market.

KNOWN UNKNOWNNS

1. Foreign Sovereign debt defaults
2. U.S. economy stronger than anticipated
3. Inflation heats up requiring a change in Central Bank policies
4. States and Municipalities threaten default
5. Chinese economy slows
6. Bond yields rise
7. U.S. gets religion and addresses its overspending and entitlement programs
8. Commodity prices including oil and gold decline
9. U.S. dollar strengthens
10. Unknown Unknowns

As you review this list, it's probably the first one, and especially the last one that are likely to have the biggest influences on the market this year.

1) Sovereign debt defaults and downgrades

Underlying this issue is a lingering sense that things will end badly. Debt levels for many countries are so high that they have eliminated the available response options and are forcing the issuance of more debt. Purging the system by allowing defaults is no longer an option until there is eventually no other choice.

However, in the near term, the deficits will benefit from the cyclical economic expansion, which could last for awhile.

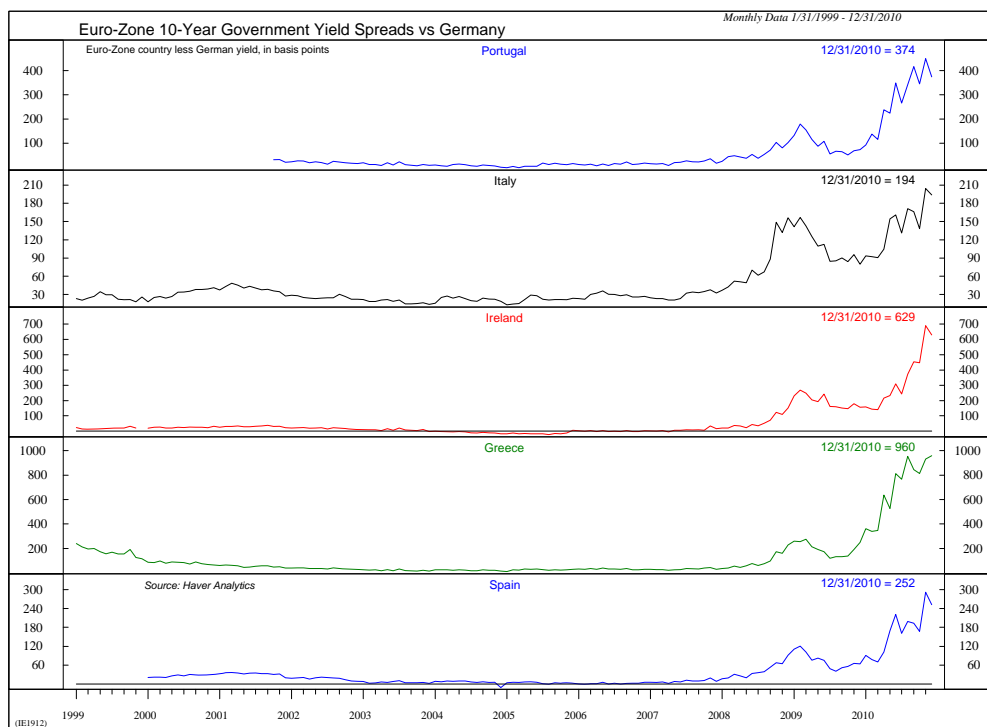
The trigger to falling into the monetization quagmire is probably the economy lapsing back into recession.

On balance, what we have seen is a substitution of government debt for private sector debt. So although liabilities are still very high, the nature of default risk has changed. Central banks can print their way out of the problem while corporations and individuals cannot. Therefore, absolute default risk is lower, while inflation risk becomes higher.

The problem is that central banks are being forced to support what is core to the problem. More debt is not the solution, but rather a deferral that will eventually comprise sovereign government's ability to support any further debt burden.

With that as a background, you're hearing almost a daily debate on the likelihood of default by Greece, Ireland, Portugal and possibly Spain and Italy (PIIGS). There are many ways to handicap the outcome of this controversy; many quote the price of Credit Default Swaps which are essentially the cost of insurance and they are increasing in price.

Another way to measure how acute the issue has become is to look at the spread between the interest rate each of the PIIGS has to pay relative to the German interest rate.



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The above chart shows that the cost of borrowing has escalated for each of them since the start of 2010, and is currently spiking higher, suggesting greater risk, once again.

In the first quarter, a number of these countries plus several European Banks are going to be coming to the market for financing, and the cost of this financing is going to compound their problems.

For Greece, even if they meet their budgets, we will see the debt to GDP ratio climb to 150% in 2012 from 130% in 2010. For Ireland, the debt to GDP ratio could rise to 130% from 25% in 2007 due to bank debt guarantees.

The consensus view is that the European Union, the European Central Bank and the IMF can forestall the problems until 2013 when the current 750 billion euro European Rescue program runs out.

I wouldn't disagree with this, but eventually I think the odds favour Greece, Ireland and possibly Portugal having to consider a default.

However, Spain and Italy will probably avoid this. Spanish banks are in much better shape relative to the housing market. Delinquencies there have peaked and the debt to GDP is 63%, about 20% below the Euro area average.

Italy has far fewer bank solvency issues because it didn't suffer from the same credit and housing issues that many other countries experienced.

Although Germany puts up resistance to any further support, one only has to look a little below the surface to see that the Merkel Government will eventually have to provide further assistance.

At the end of 2009, French and German banks had a combined \$958 billion exposure to the residents of Greece, Ireland, Portugal and Spain. German banks also had a major exposure of \$177 billion to Ireland. It's unlikely that her government will allow Sovereign risks to impair their own banks.

Collectively, banks headquartered in Europe have \$1.6 trillion in loans outstanding to residents in Greece, Ireland, Portugal and Spain.

Paradoxically, those who worry that the Sovereign debt problem can't be deferred are selling their Euros and buying U.S. Treasuries.

Unfortunately, the U.S. could be the next Sovereign debt casualty. No one expects them to default, but on December 13th, Moody's Investor Services warned that the Obama Agreement to extend the Bush tax cuts raises the chance of a negative outlook for the U.S.'s triple A credit rating, unless offsetting measures are enacted. That wouldn't be good for U.S. interest rates or the dollar.

2) U.S. economy could be stronger than anticipated

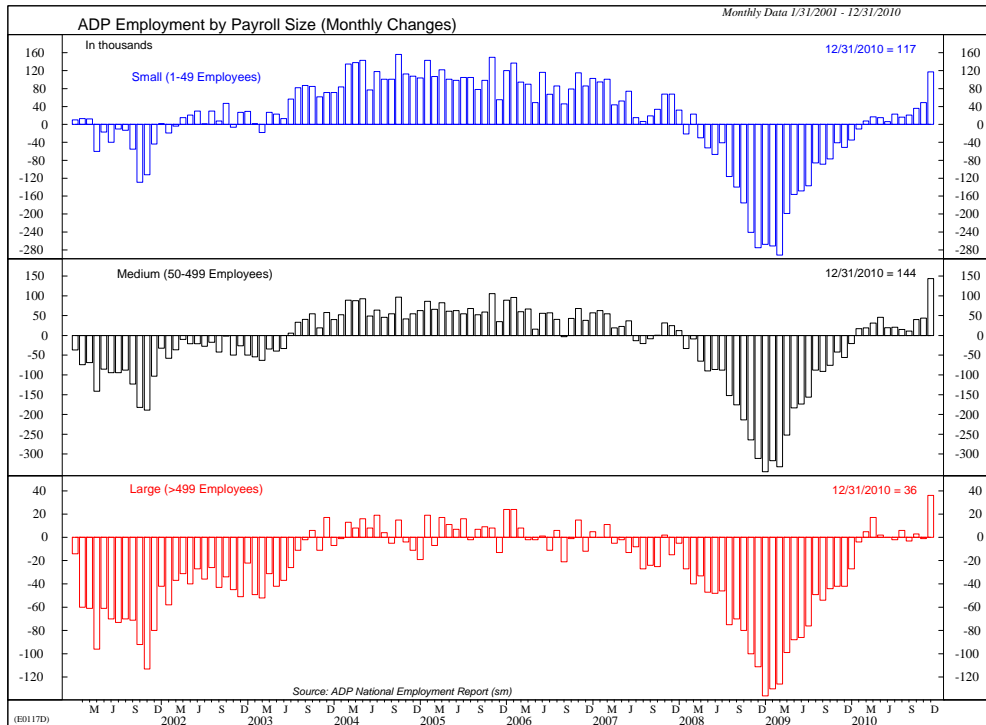
It is interesting that we've recently seen a significant shift in investor sentiment that favours a stronger economy and a move away from a double-dip outcome, and it's being expressed in the outlook for the stock market.

I've been in the "stronger" camp for quite awhile and still believe the economy will become self sustaining. So let me touch on a number of factors that I think will influence the economy this year.

The bears point to the housing sector, and it's true there is a significant inventory of homes in foreclosure that will hit the market. However, new housing activity is at record lows, household formations exceed one million per year, and housing affordability, due to low mortgage rates, is the highest it has been in decades.

You may not get a bounce here but we've likely seen the worst.

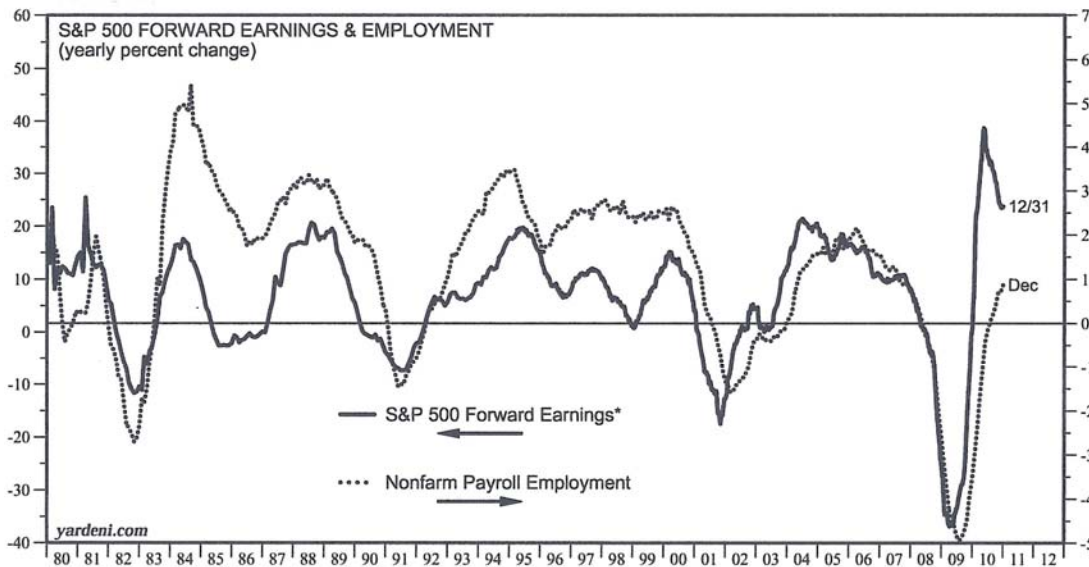
In November, the confidence level of U.S. small business rose to the highest level since the recession began. Plans to hire, make capital expenditures, and invest in inventories all rose. What is important about this is that the majority of jobs are created by small businesses. According to ADP, nearly 60% of all payroll gains in November come from small firms, which is the most since the start of the recent recession. See top two clips of the following chart for employers with less than 500 employees.



There are other employment surveys and indicators that also show improvement in hiring expectations such as those by Manpower Employment Outlook Survey. Even job postings on the Internet rose to 4.7 million in December from 2.7 million a year earlier.

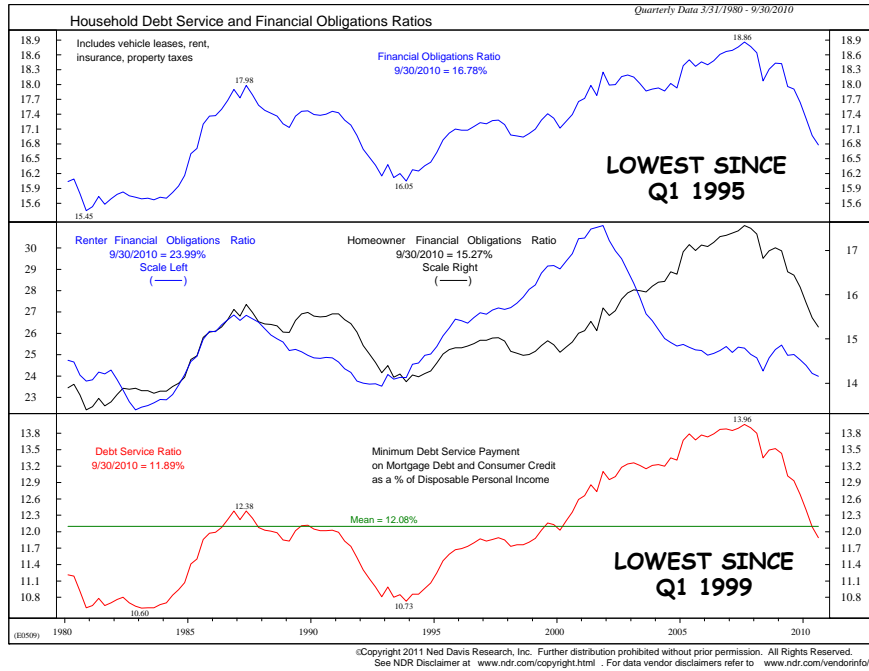
Furthermore, corporate earnings prospects and employment have one of the strongest correlations as seen in this next chart. And corporate profits are projected to reach new highs this year.

- Profits Cycle -



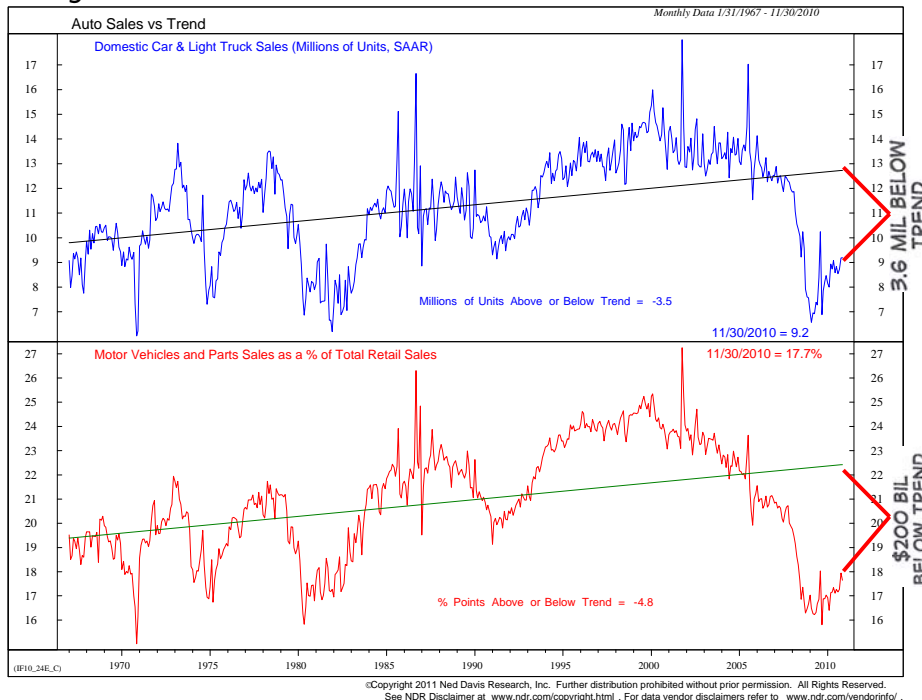
The drag on employment is coming from the declines in state and local government workers.

Obviously, any improvement on this front would help consumption. Currently, this is showing up in auto sales where there is some pent-up demand being released by improving household balance sheets.

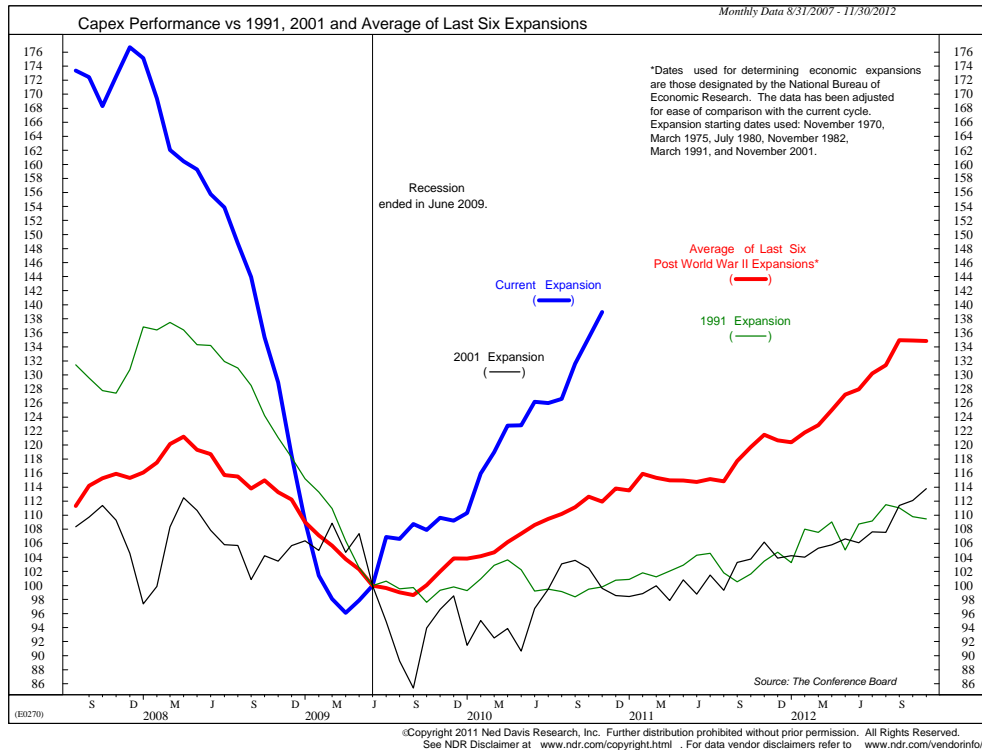


Individuals certainly need to pay down more debt, but when one looks at the household financial obligation ratio, top clip of the above chart, one can see that it has now fallen for 7 consecutive quarters to a level not seen since 1995.

If auto sales revert to their long term trend, as seen in the chart below, there is a potential 3.6 million unit improvement amounting to about \$200 billion in sales.



A further push could come from a recent survey that indicated that nearly 75% of respondents planned to spend part of the recent payroll tax cut that is effective January 1st, while 42% expected to spend most of it. There is also the catalyst of the 100% allowable deduction in the first year for qualified business investments. Non-financial corporations are currently sitting on roughly \$1.9 trillion in cash and liquid investments which could further boost capital spending.



As seen in the previous chart, the current expansion has been better than the average of the past 6 expansions. Again, several surveys suggest that corporate managements feel that the time is right to plan higher capital expenditures and increase employment.

Bottom line, I still expect a reasonable economic recovery; one that could surprise on the upside.

There is a dark side to this, however. First, economic improvement requires capital which will compete for dollars that could otherwise go into the stock market. Historically, strong economies correlate with poor stock market performance, especially when the central banks decide to raise interest rates and withdraw liquidity.

We're probably not at that stage yet, but it certainly bears watching as sooner or later the Federal Reserve will have to stop the monetary stimulation and have to reverse its course.

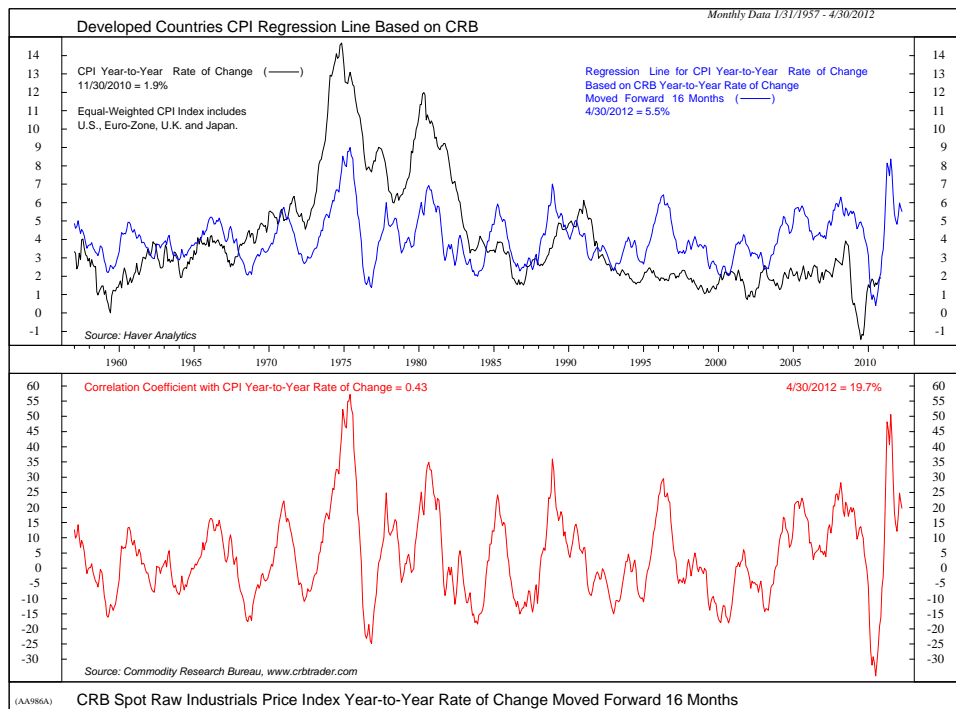
The best environment for this market is slow economic growth, low inflation, and low interest rates. When any of these start to change, it will adversely affect the market outlook.

3. Inflation heats up, requiring a change in Central Bank Policy.

Inflation in the U.S. is likely to stay around 2% as there are still excesses in labour and manufacturing, real estate and a desire by households to pay down debt.

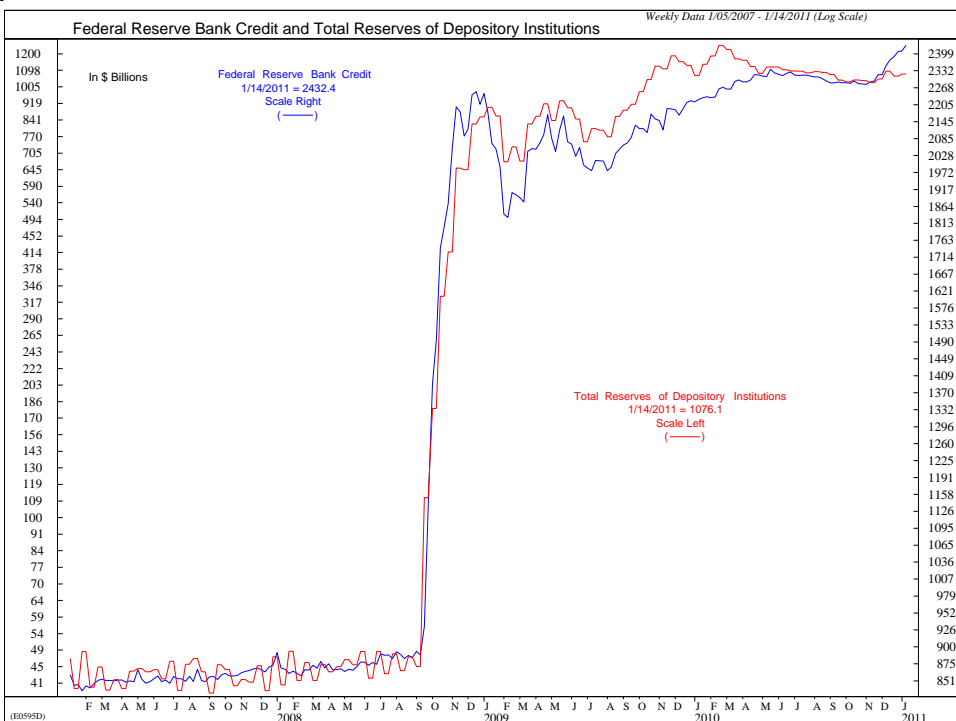
However, there are things to be concerned about. Consumer price inflation in China is about 5%, mostly driven by the food component which is up over 10%. Without agricultural commodities, Chinese inflation approximates that of the U.S. around 1.6%. How they deal with this problem will have an impact elsewhere. Their options include higher interest rates which would probably cause a generalized economic slowdown – not good for commodities or world GDP growth. They could approve price controls or they might let the yuan appreciate to cut the cost of imports. That would be good for North American exporters. However, China isn't the only one facing higher inflation. Brazil, Russia and India (BRIC countries) are also facing price increases of between 5.2% and 8.6%.

Although inflation doesn't seem to be a threat in the developed world, I do remember a period referred to as "Stagflation"; no economic growth but high commodity prices and higher CPI inflation.



The chart above compares the CPI in developed countries to the CRB Raw Industrial Price Index (i.e. commodities). It bears watching as everything from oil and metals to agricultural commodities is appreciating.

However, the biggest gorilla in the room is the Quantitative Easing policies being practiced in the U.S. and Europe. The potential problem can easily be quantified by measuring the reserves held by the banks at the Federal Reserve.



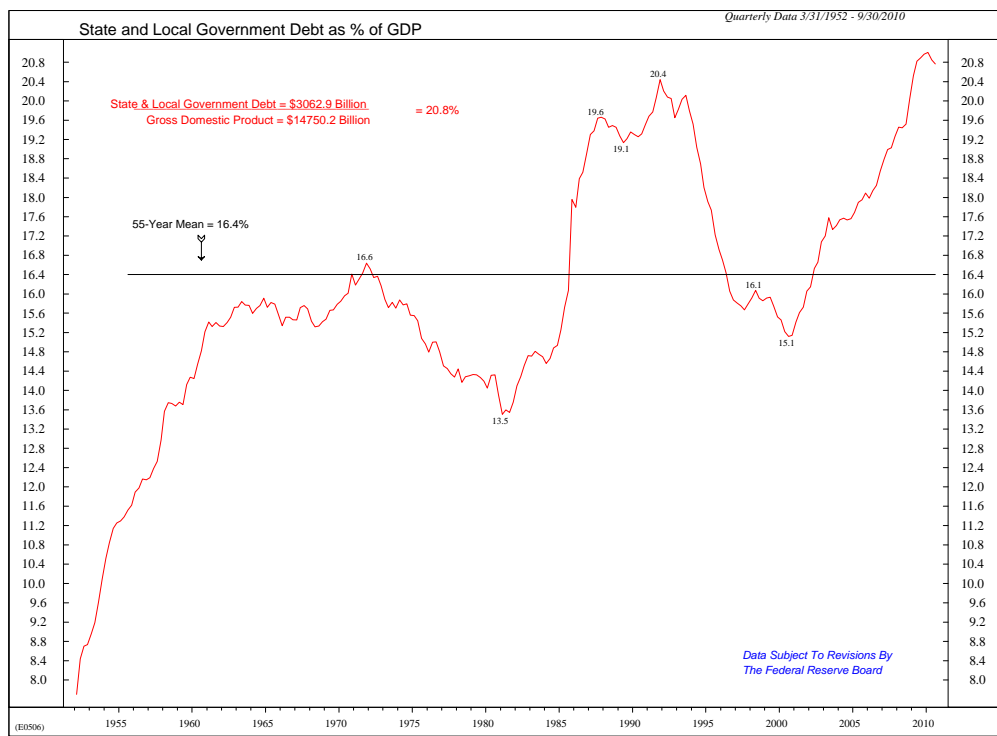
This is potential spending power and latent demand pull inflation if the banks start to lend it out. So watch bank lending and M2 which are currently comatose for any change.

4. States and Municipalities start to default creating a sovereign debt problem for the U.S.

This concern got some traction when Meredith Whitney, former managing director of Oppenheimer & Co, appeared on the T.V. show "60 Minutes". She predicted hundreds of billions of dollars in losses and between 50 and 100 municipal defaults this year.

It's true this could be a problem, but will likely be deferred until at least July 1st when most states have to come up with new budgets. In 2012, it would appear that the states will collectively have about a \$140 billion shortfall.

However, this isn't Europe. For one thing, combined state and local indebtedness is nowhere close to their levels as a percentage of GDP and again it is assumed that if push comes to shove, the Federal government will step in.



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I agree this is going to be a problem. But let's look at some of the facts. 50 to 100 defaults and hundreds of billions in losses is unprecedented. In 2010, there were 6 muni failures down from 10 in 2009. The record was \$8.266 billion in 2008. One also has to appreciate that this is a \$2.8 trillion market. According to Moody's, there have only been 54 muni defaults from 1970 to 2009. In fact, states cannot file under Chapter 9 bankruptcy and creditors cannot petition a municipality into bankruptcy. The entity has to do it voluntarily. The municipality then has to be authorized to file and only half of the states allow this.

Right now, state revenues are starting to improve. In the 3rd quarter, state and local tax revenues rose 5.2%, making it the fourth consecutive quarter of improvement. This problem bears watching, but the resolution is probably in more layoffs and budget cuts including changes to pension benefits. This means slower overall economic growth, but it is a step in the right direction.

On balance, there is some complacency on this issue which bears watching.

5. Chinese economy slows

I won't spend much time on this because it is well documented in the news. The slowdown threat focuses on three main issues:

- Inflation causing the Central Bank to further restrain credit;
- A housing market bubble which could burst;
- Banks riddled with bad loans.

There's probably some truth in all of this, but the odds are that China will be able to work its way through this.

6. Bond yields rise

I wrote about this in my September quarterly and suggested that there was a convergence of five groups that were the predominate bond buyers which drove yields lower.

- a) Those fleeing the Euro
- b) Central banks recycling trade dollars
- c) Individuals looking for better than money market yields
- d) Banks parking surplus reserves
- e) Federal Reserve purchases through Quantitative Easing (QE2).

It didn't take long after that commentary was written for things to reverse. Since the August 1st peak, the government bond index is down 13.5% and only the Federal Reserve through QE2 is still a buyer.

Other foreign central banks have ceased buying. For the last 52 weeks they have purchased, on average, \$7.5 billion bonds per week, but recently they have been selling at a \$3.6 billion pace.

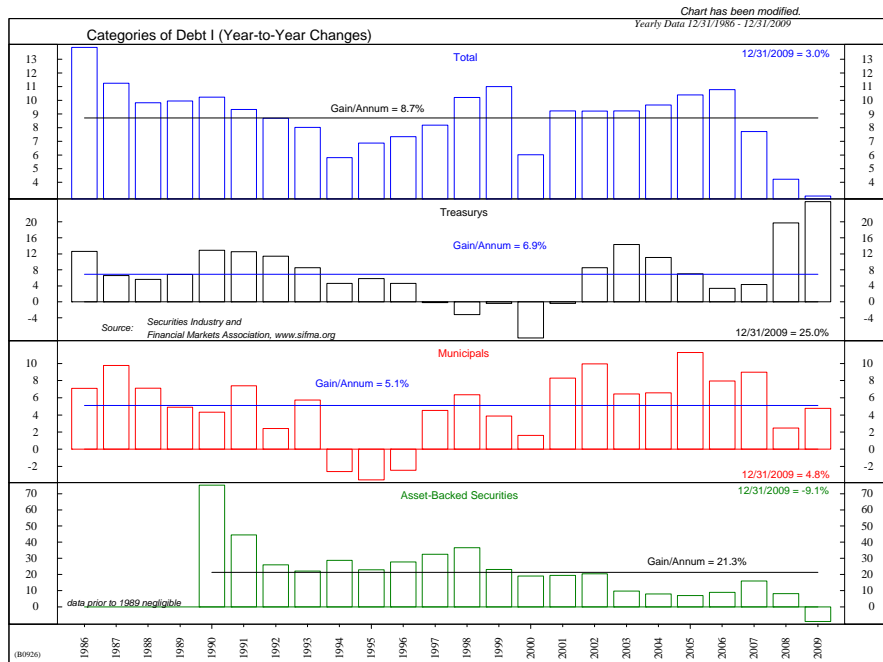
Bankers, especially the 18 primary market makers who trade with the Fed have also been selling. Between November 24th and the end of the year, their holdings of Treasuries declined from \$81.3 billion to \$2.3 billion.

Individuals also reversed direction in November. After putting more money into bond funds in 2009 than in the previous 19 years in total, withdrew \$5.6 billion, mostly from Municipal bond funds. That was the first outflow since December, 2008. The trend continued in December with an additional \$13.0 billion flowing out for the 3rd straight week of redemptions.

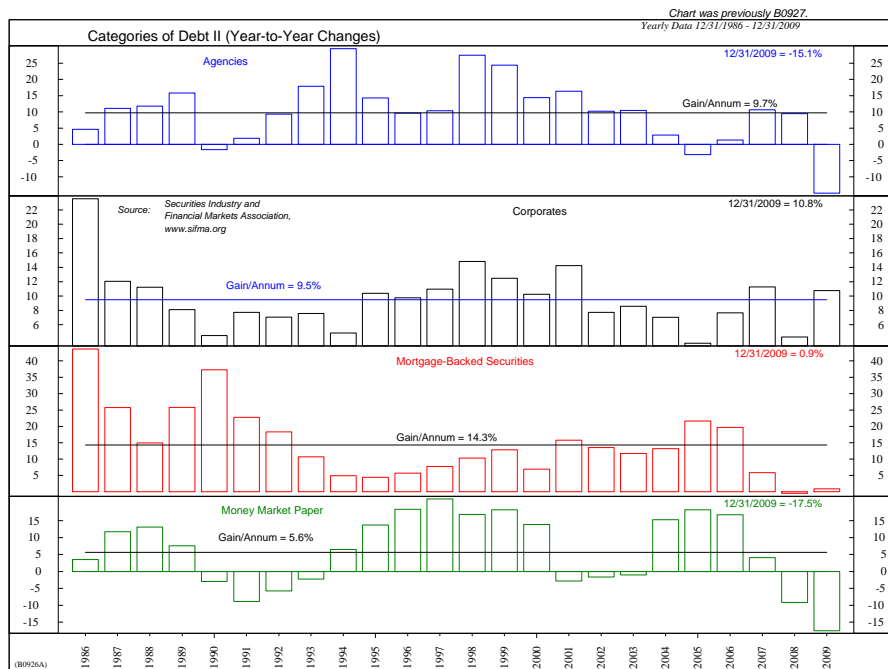
Normally, I would be negative on interest rates as this flow of funds and a stronger economy work against the bond market. Although I think rates can work their way higher, I'm willing to bet that this rise can be contained.

First, Fed purchases of bonds will account for roughly 75% of the expected federal deficit this year.

Second, there will be a reduction in total supply.



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Government issuance will be higher, but as seen in the lower portion of this Chart, new issues of asset-backed securities, agencies and money market paper have declined.

Again, being wrong on this one could have major consequences for the market, should rates move significantly higher.

7. U.S. gets religion and addresses its overspending and entitlement programs

This one is a long shot, so I won't spend much time on it. However, a White House Commission did come up with a common sense set of proposals to cut the deficit. It included cutting the defense budget by \$100 billion, raising the Social Security age to 69, increasing the tax on gasoline by 15 cents, lowering the corporate tax rate

to 25%, limiting federal spending on health care, banning Congressional earmarks, repealing the alternative minimum tax, eliminating interest deductibility on mortgages over \$500,000, cutting the federal work force by 10%, cutting farming subsidies, taxing capital gains and dividends at the higher rate, which is levied on wage income and drastically lowering and simplifying individual tax rates to 9%, 15% and 24%.

And who said everyone in Washington is an idiot? Maybe it's just those that don't take a clue from these proposals. Regardless, there isn't much support for these recommendations, but at least they're on the table and the day of reckoning is coming.

8. Commodity Prices including Oil and Gold decline.

We all know the emerging market demand story for commodities and the fact that China is consuming every commodity in sight.

Demand outside of the emerging markets is also stabilizing if not starting to improve, so the bias here has to be for higher commodity prices. But how much higher? It isn't like they haven't already doubled or more. Oil is \$90.00 not \$35.00 and gold at \$1,400/oz is a long way from its low of roughly \$250/oz ten years ago and a double from its low in 2008.

Obviously, weaker economic activity, especially a slowdown in China, or higher interest rates would be negative for most commodities. The exception here might be agricultural commodities, where the price is more a function of supply than demand. Droughts and floods have a big influence on prices.

However, there is also a big influence coming from speculative buyers rather than traditional users and producers. These buyers have collected a "financial inventory" of commodities that could be liquidated, irrespective of the fundamentals influencing the commodity. This creates unusually high volatility and is hyper sensitive to the financial markets as we saw in 2008.

Right now, a number of commodities are "over-owned" in historical norms, something not seen to this degree since 1980 when the Hunt brothers got cleaned out trying to corner the silver market.

Some of this will come to a head in mid-January as the Dodd-Frank financial regulations law will require the Commodity Futures Trading Commission (CFTC) to set position limits for speculators in energy and metal markets.

However, this is unlikely to have a significant impact on commodities traded through the world markets unless other regulators take the lead and also impose limits.

A look at some of the major commodities will make my point.

Copper. It was revealed in December that one single trader holds \$3.0 billion of copper through the London Metal Exchange. That amounts to 80% to 90% of the LME inventory and about half of the world stock pile. J.P. Morgan Chase is reputed to be the owner in an attempt to start an Exchange Traded Fund (ETF) similar to that which is used to trade gold.

However, the LME also recently revealed that one company is short 40% of the LME interest for the March delivery. That's 42,856 contracts, covering 1.1 million metric tons of copper.

Aluminum also has one trader that reportedly owns 90% of the LME's open interest. Nickel and zinc have known single traders that own between 50% and 80% of the inventory and one firm also owns 40% to 50% of the LME's tin reserves.

Oil has similar financial ownership but is less concentrated.

Gold is a case all onto itself. According to a study done by Veritas Investment Research, nearly 40% of current gold demand is coming from financial investors, up from 10% in 2003.

Two things are driving this. The first is investors' sentiment to own gold as an alternative to fiat money. They see the Central Banks' Quantitative Easing leading to trouble and inflation. The second big influence has been the creation of ETFs which make the acquisition of gold quite simple. The exit could be equally as simple, however.

We hold gold stocks in our portfolio as insurance against some of the sovereign debt problems that we see and against the possibilities of greater inflation. But I can't say that I'm comfortable with the positions, so we are underweighted relative to the index.

Fundamentally, without more financial owners, gold should head lower. Gold supply from mining has been contracting for a decade but is now expected to increase by approximately 25% over the next three years. This will require demand to grow by 5% per year compared to only 1.1% growth over the past decade, which includes the 4-fold increase by investors.

Fabrication demand, mostly jewelry, is down 25% while recycled gold now accounts for 40% of supply versus a decade long average of 25%.

So fundamentally, higher gold prices will depend on more financial investors. A stronger U.S. economy, dollar or higher interest rates won't help. However, the insurance value remains and crowd psychology could drive prices higher. But beware, we might be hearing the "Bell Ringing" as one can now buy gold from vending machines in Europe and in Florida. How easy can it get? Meanwhile, the gold stocks which discount future conditions are not keeping up with the spot market that reflects current factors. Maybe they're telling us something.

9. U.S. dollar strengthens.

This variable is really a function of some of the preceding issues. If things go sideways in Europe, investors will again flee to the perceived safety of the U.S. dollar.

If commodity prices continue to escalate, the resource currencies like the Canadian dollar will continue to do better.

If U.S. interest rates rise, the dollar will probably also rise.

Lots of moving parts to this one, so I'll hedge my bets with an expectation of a modestly lower U.S. dollar.

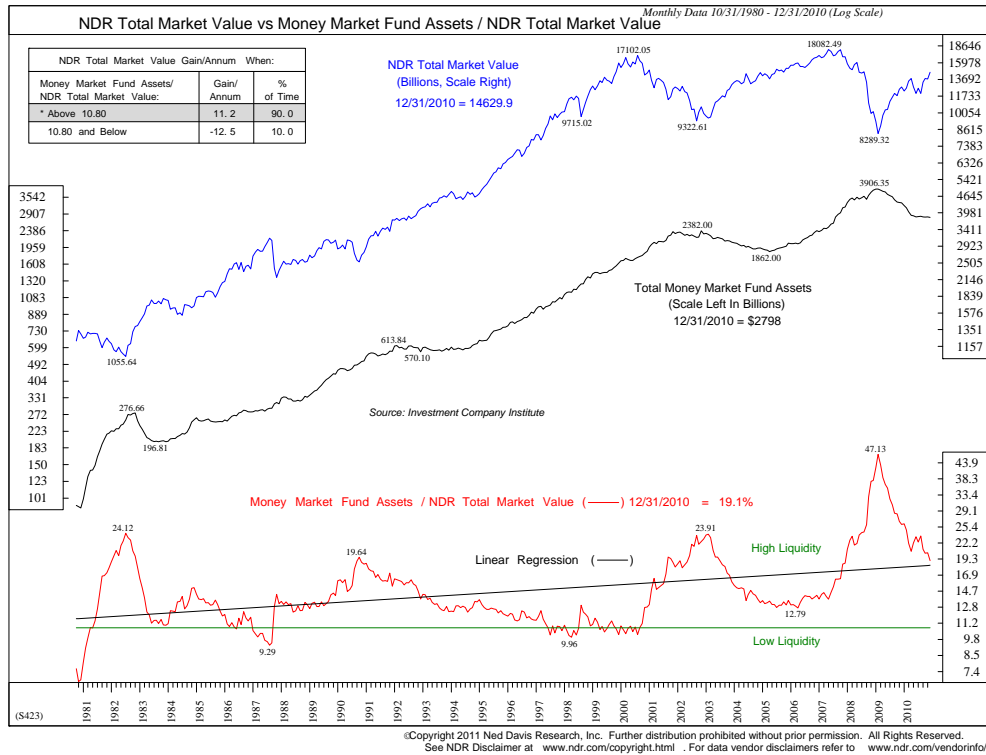
10. The Unknown, Unknown.

What can I say?

SUMMARY

As I said at the outset, liquidity is the most important variable and it's still positive.

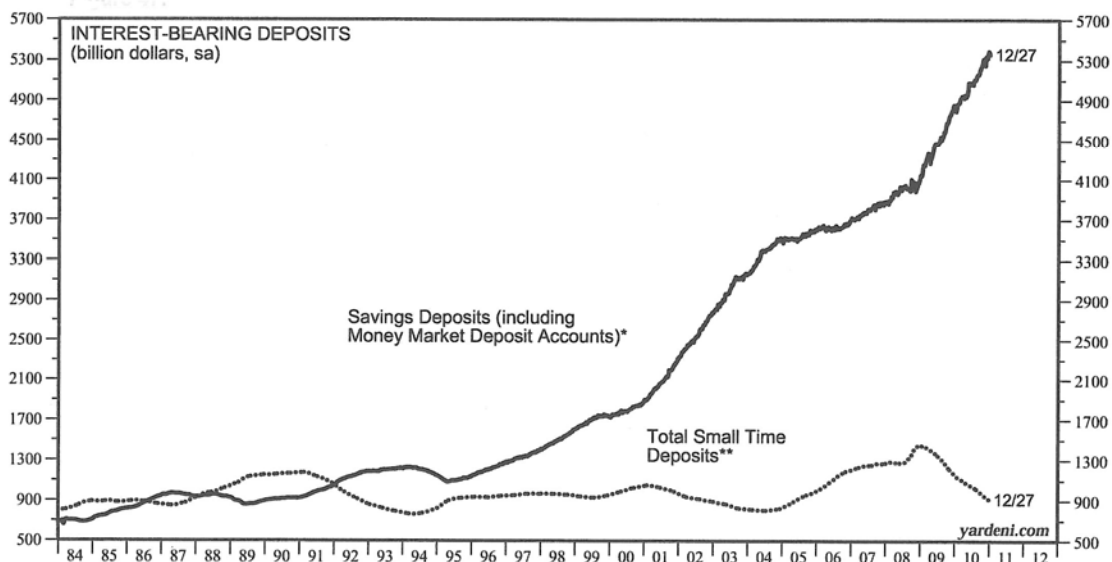
I've shown this chart before.



It shows that there is still about \$2.8 trillion invested in money market funds, which at 19% still represents a relatively high percentage of total stock market value.

I'll throw in another one which includes savings deposits and small time deposits.

- Liquid Assets -



This suggests that there is close to \$6.3 trillion in investments earning essentially nothing. Some of this is going to look for better returns, especially as confidence recovers.

You can add to this that the S&P 500 corporations are sitting on \$3.5 trillion in cash and short-term deposits. That's 2.7 times more than 10 years ago. It amounts to 13% of total assets, which is a record high.

These companies have 5 options with respect to the cash.

- 1) Increase dividends
- 2) Repurchase shares
- 3) Merge or make acquisitions
- 4) Capital spending
- 5) Hire more employees

Likelihood is that the money will get spent on all of the above. The first three help the market, and the last two help the economy.

How it gets spent will be tempered by two things. First, 69% of the cash is held by financial corporations. They might be less inclined to spend on share repurchases, or cap ex but they could embark on the others.

Second, this increase in cash does not represent a reduction in overall corporate debt as longer term liabilities have risen proportionately. There are also complications with some of the cash being held outside the United States.

Although, I doubt corporations will just pay out the cash and be left with a leveraged balance sheet. However, the dividend payout ratio for the S&P 500 has declined to 30.5% from an average of almost 59% over the last 85 years. With corporations set to report the most profitable 4th quarter on record, dividends for the S&P 500 companies are estimated to grow to \$38.00 from \$25.00 now according to Bank of America's Chief Economist.

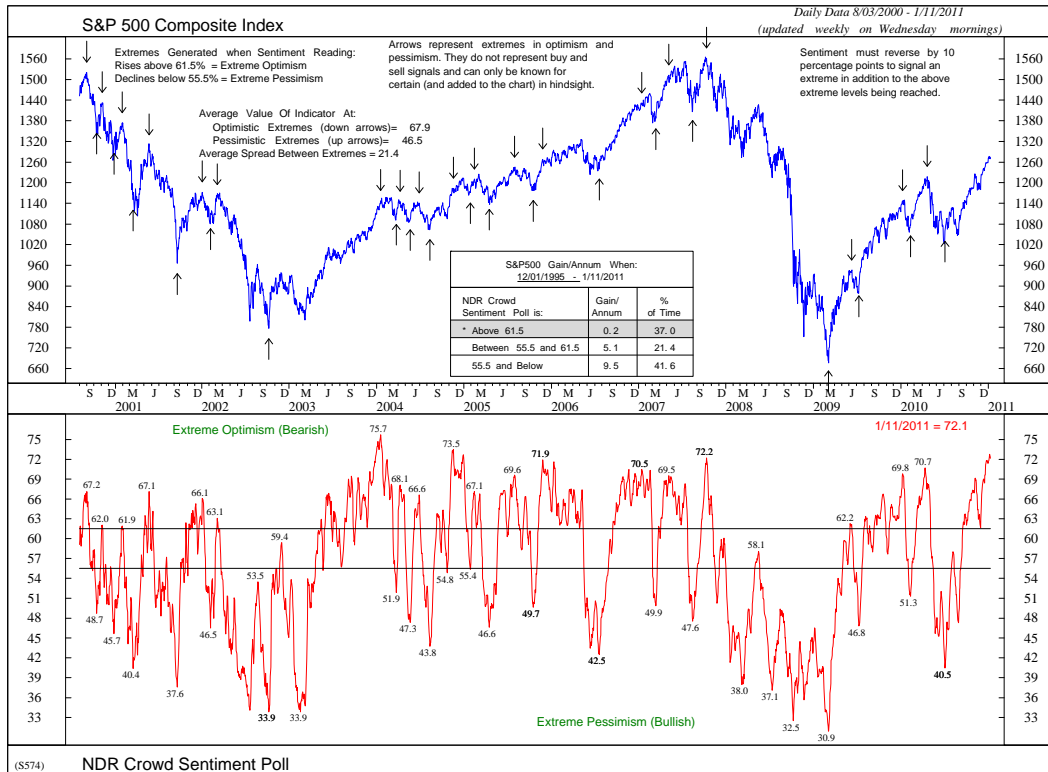
Mergers and acquisition are also picking up. The third quarter was the busiest in two years with \$5.63 billion of deals. That's a 59% year over year increase and brings the total value of transactions in the first nine months to \$1.48 trillion.

With projected slow economic growth and still reasonable corporate valuations, what better way to grow earnings than to buy a competitor.

So, although I'm cautious on what could come out of left field, I still have to go with liquidity, improving fundamentals, and reasonable valuations, especially when compared to bond yields.

That said, I can also assure you that there will be some setbacks this year. But unless they are fundamental and threaten the financial system, they will provide an opportunity to put our liquidity to use.

In the very short-term, my only hesitancy is the market sentiment.



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We're moving into the New Year with pretty high expectations as everyone is now cautiously optimistic on the economy and bullish on the market.

This even includes Federal Reserve Chairman Ben Bernanke who said, "higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending". An old adage says, "Never fight the Fed."

So, I would feel better if we had a good sell-off before things resume.

GRC/amh
January 12, 2011

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