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February 9, 2010

Dear Clients and Friends,

If you really enjoy drama, 2009 had it all. Some economists have referred to the period of December of 2007 to July of 2009 as the Great Recession. Since World War II, it was the fifth slump, and also the longest and steepest. Luckily, most financial markets throughout the world staged a remarkable recovery, coming back from the brink of financial disaster thanks to various unprecedented rescue efforts by governments around the world. *(Source: Newsweek, The recession is Over, August 3, 2009)*

Many investors who had left the market dove back into stocks and bonds, encouraged by the government's efforts to restart the financial system and stimulate the economy. Once investors concluded that a financial Armageddon was no longer at hand, the stock market began its remarkable recovery.

The Dow Jones Industrial Average finished the year up 22.7%. Although this is impressive, please note that its total return from its low on March 9th through December 31st, 2009 was 59.3%, its fastest climb since 1933! Unfortunately, as of December 31, 2009, the Dow remains down 26.4% from its all-time high of 14,164 on October 9, 2007. *(Source: WSJ, Rebuilt Markets Must Stand Alone, January 4, 2010)*

The S&P 500 gained 26.5% for calendar year 2009, the second best performance of the decade (behind the 28.7% gain in 2003) and the 11th best result in the last 50 years (i.e., the years 1960-2009). In the same 50-year period, the S&P 500 has gained an average of 9.4% per year (total return). From its bear market low on March 9, 2009, to December 31, 2009, the S&P 500 had a total return of 67.8%. *(Source: BTN Research)*

The NASDAQ Composite also had a great year and ended up 43.9% total return as of December 31st, 2009. It also had a significant rebound since its March low, ending the year at 78.9% higher! *(Source: BTN Research)*

The U.S. Gross Domestic Product (GDP), the broadest measure of economic activity, grew at a rate of 2.2% during the third quarter, confirming that the recession ended during the summer. The advance estimate for the fourth quarter is 5.7%. Economic activity usually improves sharply for various reasons after most recessions. After a mild recession, GDP growth averages is estimated to be about 2%, while recovery rates usually average more than 6% after a more serious recession. *(Source: Bureau of Economic Analysis)*

Stock market valuations, while not cheap, aren't so high that investors see better opportunity in other asset classes. When you look at the other alternatives available, there are not a lot to choose from. Interest rates on Treasury Bills are down to about zero and long-term bonds will probably drop in value if interest rates are increased. There is always real estate; unfortunately many investors believe its outlook is unclear. Of course there is gold and other alternative investments, but it is important to note that these investments involve higher risk and may not be appropriate for all investors. Therefore, diversifying into a wide variety of stocks makes sense for at least a portion of your portfolio.

So, after its substantial rise, is the stock market now overvalued? While the current rally is strong and sharp, it is important to remember that it comes right after the worst stock market drop since the 1930s. It still hasn't really come close to recovering the ground it has actually lost from its peak on October 9, 2007.

Unfortunately, it is difficult to say whether the stock market rally of 2009 was truly an improvement in the nation's basic economic condition or merely a sea of liquidity injected by Capitol Hill. When the Federal Reserve Board loosens monetary policy as it has and reduces short-term interest rates to about zero, capital often flows more quickly to stocks and bonds than into the real economy.

[The Global Economy](#)

The world's stock markets came roaring back to life in 2009. During 2008, the stock markets of many emerging and developed countries fell dramatically and as many investors peered into 2009, no forecast looked too dire. However, many countries have come out of the recession stronger than most economists expected. During 2009, many stock markets recouped all their losses they had suffered in 2008.

The Dow Jones World Index, excluding the U.S., soared nearly 40% in U.S. dollar terms during 2009. *(Source: WSJ, World Stocks Return to Pre-Crisis Form, January 4th, 2010)*

The total return for the MSCI Emerging Markets Index for 2009 was 74.5%. *(Source: MSCIBarra.com)*

There are a number of reasons for this significant rebound. Many emerging markets were not as affected by the downturn in their economy as compared to the meltdown of the economy of many developed countries. For example, populous countries such as China, India, and Indonesia did not dip into a recession; they merely suffered slower growth. Another reason was the political and social consequences of the Great Recession have been milder than predicted.

China's economy also bounced back from the economic downturn and the total return for the Shanghai Index was 80.0% for the year ending December 31, 2009. *(Source: WSJ, China's Exports Surge 18% in December, January 11th, 2010)* China spent a significant amount on various stimulus programs, with their growth forecast at 8.3% for 2010. Its growth has been at such a high pace that China overtook Germany last year as the world's largest exporter! *(Source: Associated Press, A Look at Economic Developments, January 13th, 2010)*

Most countries in Europe experienced a respectable rebound in the recession, earning 29% for 2009. Unfortunately, Germany did not participate. According to Germany's Federal Statistics Office, Germany's economy (Europe's largest and the fourth-largest in the world) shrank 5% in 2009, a record amount for the post-war era, due in part to a slump in exports and business investments. This GDP data, coupled with other European indicators, could make the European Central Bank and the Bank of England more cautious as they consider when to start reducing their monetary-stimulus measures. *(Source: WSJ, January 14th, 2010, German Economy Posts Biggest Postwar Slide)*

Is The Recession Really Over?

As the New Year and new decade dawn, recovery seems to be underway. Unfortunately, a smooth recovery is by no means certain—and, in fact, hasn't even started for tens of millions of unemployed Americans or for many state governments, which lag behind the national economy in climbing out of the hole.

There were several major courses of action that the U.S. government took in order to bail us out of our Great Recession, including:

- Passed \$787 Billion Economic Stimulus Package
- Reduced interest rates to a record low of 0.25%
- Purchased mortgage-backed securities in order to help stabilize the prices of mortgages

Let's review in detail these important subjects noted above.

Federal Budget Deficit

AMERICA'S SKYROCKETING PUBLIC DEBT



In order to jump-start the economy, the Fed put together a stimulus package that currently amounts to the staggering sum of \$12.8 trillion, which approaches the value of everything produced in the entire country last year. The Fed has cranked up the printing presses and printed up an additional \$2 trillion of money last year to inject into the economy. The magnitude of the Fed's actions today has been unparalleled. There is also \$9 trillion more of global stimulus packages. In fact, it is the first time in history where almost every Central Bank in the world was printing money. And it is not over yet. While the majority of this money has not yet hit the streets, it soon will. And when it does, many economists are worried that it will in turn reignite another great inflationary force. (Source: *Business Week, The Fed's Next Act...*, January 11, 2010)

The amount of stimulus money spent thus far is staggering. The Federal Reserve and other U.S. agencies have lent, spent, or guaranteed \$8.2 trillion in emergency funds to resuscitate growth. U.S. public debt has surged to \$7.7 trillion, according to the Treasury Department, up from \$6.4 trillion a year ago and from an average of \$5 trillion in 2007. (See chart.) (Source: *Business Week, The Fed's Next Act...*, January 11, 2010)

During the fiscal year 2009 (the 12 months ending 9/30/09), the U.S. collected \$2.1 trillion of tax receipts and spent \$3.5 trillion, resulting in \$1.4 trillion deficit, an all-time record, up \$459 billion from a year ago. (Source: *Dow Theory Forecasts, December 7th, 2009*)

Over the past year, U.S. Government debt has risen from 41% of the nation's output of goods and services (GDP) to 53%. Without big changes in taxes or spending, it is estimated to rise to 85% of GDP by 2018, 100% by 2022 and 200% by 2038. (Source: *WSJ, Economic Reality Drives Agenda, December 24th, 2009*)

Inflation vs. Deflation

Inflation may be subdued today but many economists and investors worry that rampant inflation is a looming threat. "I ask anyone to give me an example of an economy beefed up by huge amounts of fiscal and monetary stimulus that did not inflate tremendously when the economy improved", says hedge-fund manager Julian Robertson, of Tiger Management. (Source: *Kiplinger's Personal Finance, Our Take on Inflation, January 2010*)

We aren't experiencing massive inflation yet because to do so, in addition to creating more money, you must also use it. Banks are not lending. Instead, they are using their created money to repair their bottom lines. When banks finally start to put that money into the economy, it is likely that inflation will increase. But for now, inflation appears still a ways off and instead deflation is considered to be a higher concern because of the unusually large amount of unused labor and production capacity that we are experiencing today.

Inflation Hedges

Certain investments act as a hedge against inflation because their value can rise at about the same pace. (Note: These strategies/products may not be appropriate for all investors.)

Some of the best inflation hedges are:

Treasury Inflation-Protected Securities (TIPS). These long-term IOUs are issued and backed by the Federal government and start out with a fixed annual interest rate, just like other Treasury securities. The government adjusts the amount of principal based on the CPI, although you are guaranteed to receive the original value of your investment at maturity even if the CPI has dropped. You give up current yield today for protection against the possibility of inflation increasing in the future. Investors should be aware that the TIPS principal is adjusted downward for deflation, and interest payments may be less than they would be if inflation occurred or if the Consumer Price Index remained the same.

Stocks. They often provide an even a better hedge against inflation than gold, as we will see in a moment.

Real Estate. Real estate has been extremely volatile and therefore it would be best to reevaluate your current situation before you invest more money in this area. Understanding inherent risks such as interest rate fluctuation, credit risk and economic conditions are important when considering an investment in real estate.

Commodities. These are raw materials, crops, metals (including gold), timber and oil.

The price of commodities is subject to substantial price fluctuations of short periods of time and may be affected by unpredictable international monetary and political policies. The market for commodities is widely unregulated and concentrated investing may lead to higher price volatility.

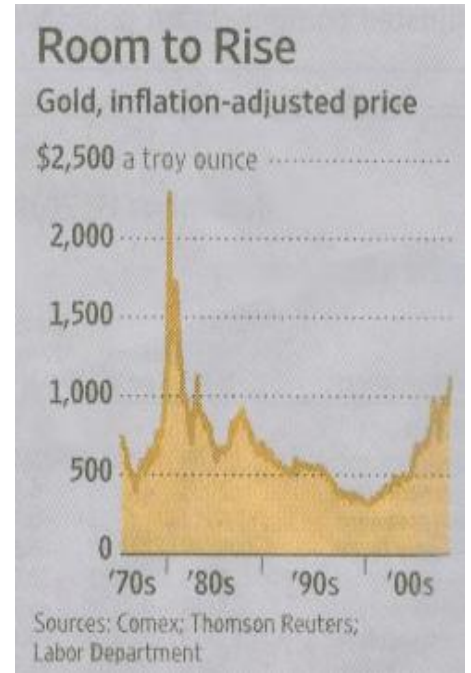
Gold

For centuries, investors have turned to gold in times of trouble, and predictably, in late 2008 gold prices headed up from around \$700 an ounce. Panic has now abated, but fear still remains – of inflation building up in the global economy, or the U.S. dollar continuing to fall. As gold hit \$1,200 an ounce in 2009, greed seemed

to take over from fear as the main motivation to buy. *Source: Money Magazine, Alternative Investments-Gold, January/February 2010*) Remember – a general rule of thumb about investments is that if it increases too much in a short period of time, there is usually an even greater possibility that it might go down even faster.

As you can see from the chart, gold *is not* a very good hedge against inflation; however, it is a good indicator of *chaos*! That is why gold is known as a key measure of investor anxiety. For example, many investors are still rightfully worried about many unresolved concerns such as the possibility of going into another recession, the devaluation of the dollar, trade and budget deficits, and interest rates going up, just to name a few. They argue that gold will hold its value until these issues are resolved.

Gold is trading near its record high right now and has rewarded investors who bought in at the right time. But over most long periods gold hasn't been the most spectacular investment, while stocks have generally done well. For example, for the period of 1926 through March, 2009 the S&P outpaced gold, with nearly double the return. In fact, the returns on Treasury Bills also outperformed gold with far less risk during this period. *(Source: FundAdvice.com, Will Your Investments Be Protected, May 21st, 2009)*



Historically, gold has been one of the best investments if the dollar declines sharply; however, gold may not be appropriate for all investors given the higher risk involved with these investments.

Unemployment

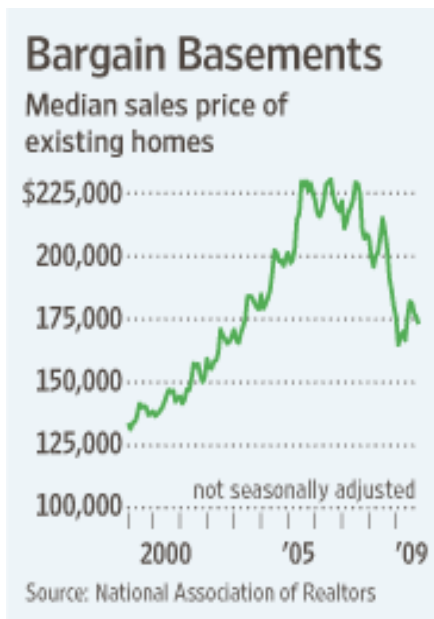
The downturn that started in December 2007 delivered a significant blow to U.S. workers. In two years, the economy shed 7.2 million jobs, pushing the jobless rate from 5% to 10%, and 15.7 million are now unemployed, according to the Labor Department. *Source: WSJ, Even in a Recovery..., January 12th, 2010*)

Disappointment continued with the December employment data. Jobs on non-farm payrolls fell by 85,000, keeping the unemployment rate at 10% and frustrating hopes of a marginal gain. Fortunately, there has been an improvement in the private sector where job losses averaged 76,000 per month in the fourth quarter, down from 695,000 in the first. *(Source: By The Numbers January 11th, 2010)*

Temporary employment has posted solid gains three months in a row. Since temps are usually the first to be fired in an economic downturn and the first to be hired in a recovery, this is considered a leading indicator of employment trends. Unfortunately, various positive job market indicators so far haven't added up to gains in total payrolls. Time is of the essence in re-starting the economic engine, and without jobs the recovery could sputter out. *(Source: Barron's, Upside-Downside, January 11th, 2010)*

The stimulus package stopped the markets' freefall, but now that all that money has been spent, many consumers are left wondering where all the jobs are. Many consumers are concerned that when the large government programs end and the Federal Reserve steps back, the economy will falter sharply. Still, it is important to remember that the stimulus package includes a lot of infrastructure spending which has yet to occur, and some of that might just replace cash that would be normally spent by the state governments.

Real Estate



From the beginning of the real estate downturn in mid 2006 to June 30, 2009, the median price of an existing home nationwide fell about 30%. As you can see from the chart, the median home now sells for \$174,000 – about what it sold for in 2003. (Source: *WSJ, Ten Questions on the Volatile...*, November 17th, 2009)

In the second half of 2009, the housing market seemed to catch its breath as the incentives offered by the Fed lured procrastinating buyers and helped move the glut of foreclosures that had been dragging down home values. (The number of U.S. mortgages that are currently past due or in foreclosure is estimated at 7.5 million, or 14.4% of the total.) Sales picked up and home prices stabilized after a 3-year downward spiral. Unfortunately, it appears the correction in the housing market isn't over yet. Credit is still tight and unemployment has continued to remain high. (Source: *Time Magazine, The Year in Briefing, December 28th, 2009 – January 4th, 2010*)

Nationwide, sales of existing homes rose 9% in the past year, driven mainly by the government's tax credit for first-time homebuyers. (Source: *WSJ, Housing is Shaky with US Aid, December 11th, 2009*) In addition, there are actually fewer unsold newly built homes on the market today than at any time since May 1971 – now down to 7 months supply, at the current sales pace. That is the lowest level in nearly 3 years and a marked improvement from the 12.4 months supply in January, 2009. (Source: *WSJ, New Home Sales Drop 11.3%, December 24th, 2009*)

Household Net Worth and Consumer Spending

Even with the equity rally and the stabilization of housing in 2009, household net worth has contracted almost 20% over the past year and a half. That is an epic, unprecedented \$12 trillion of lost net worth. As households assess the damage, the impact of the shocking loss of wealth on spending patterns is likely to be significant. Many people have changed their attitude toward discretionary income and credit and seem to have undergone a major change towards prudence and conservatism.

At least a bit of good news – the net worth of U.S. households rose 5% in the third quarter as the stock market continued rebounding. It is also very likely that the fourth quarter will help continue the increase of their net worth due to the markets continuing to rise. (Source: *WSJ, U.S. Households' Net Worth Rises, December 11th, 2009*)

The big question still remains, "When will the American consumer start spending again?" That doesn't sound very sophisticated but it is the key to understanding when we will get out of this recession and what the recovery will look like. The American consumer is the single largest factor in the global economy; our spending is currently equal to the entire economies of China and India added together and then doubled. (Source: *Newsweek, Get Out The Wallet, August 17, 2009*)

Interest Rates

Ben Bernanke, the Federal Reserve Chairman, reduced interest rates in order to help stimulate the economy. Unfortunately, things are not working out as planned.

Consumers are complaining that banks appear to have reduced their lending. This can be explained by the fact that many bankers are responding to the incentives generated by the economic policies of the Treasury and Federal Reserve—first and foremost, the Fed's policy of near-zero interest rates. Banks can now raise short-term money at very low interest rates and buy 10-year Treasury Bonds at around 3.5%. Mr. Bernanke has promised to maintain this policy for an “extended period” to keep interest rates down, which translates into an extended opportunity for banks to engage in this interest-rate arbitrage. Why would a banker take on traditional loans with their risk of loss? Instead, financial institutions are happy to service their new, best customer: the U.S. Treasury. *(Source: WSJ, The Health Bill is Scary, December 17th, 2009)*

The Fed's policy makes sense if their primary goal is restoring bank profitability by generating cash flow. It is a terrible policy if the goal is fueling small business, the engine of economic growth and job creation. Large, non-financial corporations usually have access to dollars from the banks, public credit markets and internally generated funds. Unfortunately, this is not so for many small businesses, which usually depend heavily on banks for credit.

Credit conditions have always played a big role in the business cycle. That is why the patterns in borrowing and lending, especially among businesses, deserve special attention now. Credit is essential in replenishing inventories, purchasing new equipment and expanding payrolls, all of which will be needed for a self-sustaining recovery. *(Source: Business Week, A Lifeline of Credit..., November 30th, 2009)*

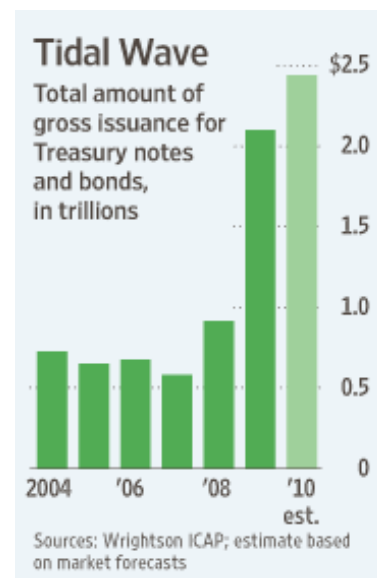
The Fed is under pressure to start increasing interest rates. However, Mr. Bernanke wants to wait before raising the rates because he wants more evidence that the recovery will be sustainable without as much government support.

While banking officials are still weighing in on the question of *when* to raise interest rates, they are most likely looking at the even more complicated question of *how*. Although there are a number of different ways to accomplish this, it won't be as simple as it has been in the past due to the complex maneuvers that the Fed has taken to get the economy back on track. There are pros and cons to each possibility and it is still unsure which one or which ones in combination they might use to hopefully implement this policy in the near future without causing a lot of chaos. *(Source: WSJ, As Fed Uses Fewer Tools..., December 14th, 2009)*

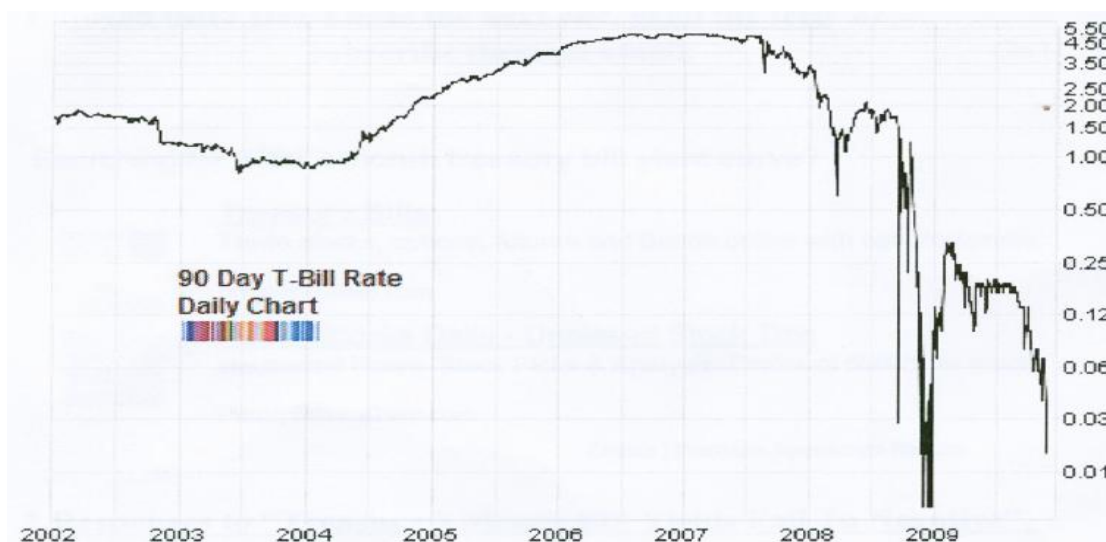
Let's now discuss a subject that many investors do not quite understand. In order to help tame the recession, the Fed purchased over \$1 trillion of mortgage-backed securities. *(Source: Time Magazine, December 28th, 2009)* This is considered to be a major reason the recession did not last longer as it helped stabilize the prices of mortgages and other similar securities. Remember—a higher volume of purchases and sales in an investment usually equals a more stable price. Having many buyers and sellers helps reduce volatility, whereas fewer buyers and sellers usually results in higher volatility. Unfortunately, the Fed has recently announced a plan to reduce their purchases of mortgage-backed securities in March. Assuming that Mr. Bernanke sticks to his plan, it is uncertain how Wall Street will react to this action.

Tidal Wave of Treasuries

It was a record year of debt sales by the U.S. government. The Treasury sold more than \$2.1 trillion in notes and bonds during 2009, more than in the previous two years, to fund a widening budget shortfall and finance programs to rescue the banking system and support the economy. (See chart to the right.) Yet despite the supply onslaught, buyers—from foreign central banks to U.S. households and domestic commercial banks—flocked to the sales, bringing the government's borrowing costs down to historic lows in 2009. That provided further support to the economy because Treasury rates are often the benchmarks for interest rates charged in many types of corporate and consumer borrowing.



Interest rates have gone down so low that the yield of the 3-month Treasury bill fell from 5% in 2006 and is now 0.06%. (See chart below.) Yes, that's right; 6% of 1%. In fact this is such a low number, most people cannot relate. For example, if someone invested \$100,000 in Treasury Bills, at this low interest rate, he would earn only \$60 for the entire year! There is a famous saying, "I am more concerned with the return OF my money than the return ON my money." The low interest rate indicates that inflation isn't bothering investors much. In addition, this could be a sign from the Bears that they don't see any other investments that they feel confident will make any money in the near future. (Source: *Kiplinger's Personal Finance, Where to Invest in 2010, January 2010*)



Source: U.S. Treasury

A renewed faith in the status of our financial system and ultra low interest rates on Treasury debt sent many investors piling record amounts of cash into corporate debt, despite the dismal economic backdrop. (Source: *WSJ, Uncle Sam Gave Bonds a Leg Up, January 2nd, 2010*) The key issue was U.S. government support. The U.S. made it clear to nervous investors that the financial system and credit markets were going to lead the broader economy out of recession, and put up trillions of dollars to that end.

Credit markets put in a stellar 2009, with records shattered in asset class returns and debt issuance. The investment-grade benchmark index, Barclay's Capital U.S. credit index, was up 16.2% for the year, its best annual return since 1995. Merrill Lynch's benchmark high-yield Master II junk index earned 57.4%, another record. As a result, yields on investment grade bonds shrank throughout the year, tightening to 1.6% on December 30th compared with 4.9% on January 2, 2009. Interest rates on junk bonds fell to 6.5% at the end of 2009 from 18.1% at the beginning of 2009! *(Source: WSJ, Uncle Sam Gave Bonds a Leg Up, January 2nd 2010)*

Many companies seized the opportunity to buy back their bonds maturing in the next few years and to sell new, longer-term bonds that locked in the lower cost of financing available today. U.S. companies raised \$1.06 trillion in US dollar-denominated investment-grade bonds and another \$147.7 billion in speculative-grade debt. *(Source: WSJ, Uncle Sam Gave Bonds a Leg Up, January 2nd, 2010)*

Timing the Market

One of the major mistakes many investors make is chasing prior year's best performers and avoiding last year's worst performers. It feels natural to avoid what singed us and seek something soothing. For example, in May of 2008 to March of 2009, the S&P 500 Index dropped more than 50%. U.S. government securities were one of the most worry-free investments during the financial crisis. While stocks were losing more than half their value, 10-year treasuries returned more than 10% during that same May-to-March period. And so – no surprise here – investors poured record amounts of money into these so-called “safe” bonds. *Source: Time Magazine, Thought Bonds Were Safe..., October 5th, 2009)*

Unfortunately, risk in financial markets has an irritating habit of following investors around. The big rush into Treasuries ended up being a mistake for many investors. In 2009 many investors sold Treasuries and purchased riskier investments, such as corporate bonds and stocks. Treasuries *lost* 3.3% in 2009, which is the second-worst annual return since 1973. This just shows how an investment can have a great return one year and then a dismal one the next year. *(Source: WSJ, Uncle Sam Gave Bonds a Leg Up, January 2nd, 2010)*

A similar risk exists today in the corporate and municipal bond markets. There is certainly a cause for caution. The spectacular returns of corporate bonds are not likely to be duplicated in 2010, according to many analysts. In addition, many bonds have extremely low interest rates and their value will most likely drop if interest rates increase in the future. Remember – it does not take a large rise in interest rates to cause the value of a bond to decrease and this effect is usually pronounced for longer-term securities. Keep in mind that any fixed income security sold or redeemed prior to maturity may be subject to a gain or loss.

In order to help minimize your risk:

- Reduce your long-term exposure. Bonds that mature in seven or more years are more vulnerable to price swings than those maturing in less than three years.
- Ladder your bonds, spreading your money evenly among different maturities.
- Invest in Treasury Inflation-Protected Securities (TIPS). Yes, their market price could fall if interest rates rise, but they offer an investor added confidence that regular Treasuries do not: their value will at least keep pace with inflation.

“They lost money on their house, they lost money on stocks,” says Tom Atteberry, co-manager of the FPA New Income Fund. “They put money in bonds because they think it's safe. And interest rates are going to rise

on them, and they're going to lose money on bonds, too." (Source: *Time Magazine, Thought Bonds Were Safe...*, October 5th, 2009)

Please note that 70% of investors were "bearish" on the U.S. stock market on March 11, 2009, or just two days after the S&P hit a closing low on March 9th, 2009 at the end of a 17-month bear market. By comparison, only 26% of investors identified themselves as bearish during the first week in January 2010. (Source: *By The Numbers, January 11th, 2010*)

And remember – according to our good friend, Warren Buffett, who stated:

"The only value of stock forecasters is to make fortune tellers look good."

Many investors have asked the question, "What are the consequences of having low interest rates?" Unfortunately, there are many negative reasons for having such artificially low interest rates as we are experiencing today:

- As mentioned earlier, banks can take advantage of paying out a low interest rate and make a decent profit on the difference between what it can earn vs. what it costs them, which reduces their willingness to loan the money out.
- Low interest rates can also be a catalyst for inflation. Although this is not a major concern at this time, this problem could arise at any time. Remember – low interest rates encourage people to spend and borrow more (with less interest expense), which in turn can lead to inflation. A higher interest rate does the opposite – it usually discourages people from borrowing due to the higher costs, which in turn curbs the possibility of inflation.
- The U.S. dollar is affected dramatically by interest rate changes. If interest rates are increased, then the dollar usually gets stronger. The primary reason for this is that higher interest rates caused increased demand both in the U.S. and from many overseas investors who purchase Treasury securities. A lower interest rate usually will result in less demand for Treasuries and the dollar getting weaker. Let's discuss this in detail.

The U.S. Dollar

The main event for the world's currencies through most of 2009 was the steady and steep decline of the U.S. dollar. The dollar slid almost 17% between March 2009 and late November against a number of major currencies—the biggest decline for the dollar in any 8-month period since 1986. (Source: *Business Week, What to Worry About Now, December 28, 2009*)

What does a weak dollar mean in practical terms? It means higher prices for American tourists traveling overseas. It can benefit U.S. companies by making the price of their goods and services more reasonable to foreigners. For consumers, a falling dollar can mean higher prices on imports, as foreign companies try to offset currency losses by raising prices. For investors, a declining dollar can be a benefit when you own foreign bonds and currencies, as these investments translate into more dollars. However, if the U.S. dollar gets stronger, some market watchers think investors in foreign stocks and bonds may suffer.

What's bad for the dollar is usually good for gold and non-dollar-denominated assets. Therefore, the falling dollar has attracted a lot of excitement among commodity investors, particularly gold enthusiasts. Since commodities are priced in dollars, their value rises when the dollar declines. This partly explains the

resurgence in gold prices (GLD), which is currently worth about \$1,100 per ounce. Since the beginning of 2009, GLD has gained around 25%. *Source: Research Magazine, Dealing with the Dollar, January 1st, 2010*

China has become increasingly vocal in its concerns about a weakening U.S. dollar. Why? China's holdings of U.S. Treasuries over the past three decades amounted to \$800 billion at the end of July 2009, making China the largest creditor of the U.S. *(Source: WSJ, Deficit Budget Woes, January 5th, 2010)*

It appears that China is not going to ditch the dollar any time soon, but it wants to reduce its dependence on the dollar. In the near future, China will probably continue to buy Treasuries to keep its capital control in place. Given the size of its reserve, it has yet to find an alternative to the dollar. China also knows that any major move away from the dollar could set off a selling spree and cause the country's vast reserve to shrink at a faster pace. Therefore, it has no choice but to act deftly to balance the need to slow the shrinking of dollar assets with the need to diversify. *(Source: Morningstar, China and the U.S. Dollar, November 2009)*

One of the various items to also take into consideration is the domestic savings shortfall, which means that we must depend on foreign investors, such as the Chinese, Japanese and Russians, to purchase about half the Treasury Bonds we currently sell at auction. The question is—will they? It is very likely, but probably at the price of higher interest rates and a cheaper dollar. Unfortunately, this is a high-stakes confidence game. There could be scenarios that we hopefully will not have to face:

- A foreign sell-off of bonds
- A Treasury-bond auction for which, figuratively speaking, no one showed up.

Either would most likely force the Fed to raise interest rates much sooner than intended.

The fundamental problem is that the U.S. has massive budget deficits and artificially low interest rates. Economists have long been concerned about how an aging population and growing healthcare costs, along with other issues such as Social Security, could cause the U.S. budget deficit and its public debt to balloon to a level that could possibly undermine confidence in the U.S. dollar. *(Source: WSJ, Deficit Budget Woes, January 5th, 2010)*

America now needs to convince the world that the U.S. government can get its finances back in order.

What to Expect For 2010

The economy appears to have turned a corner, but it is best not to be too optimistic about the economy continuing its dramatic upturn. The stock market isn't likely to repeat 2009's incredible gains. "The recession is over, but it probably won't feel that way until a year from now," says Nariman Behravesh, chief economist at IHS Global Insight. *(Source: Money Magazine, Make Money in 2010, December 2009)*

And you cannot depend on Uncle Sam to help out with a new economic stimulus package. The combination of prior spending and the loss of tax revenue brought about by the recession has already caused the federal deficit to soar to a record high of \$1.42 trillion (the largest since World War II). *(Source: Money Magazine, Make Money in 2010, December 2009)*

Still, it's the Federal Reserve, even more than Congress or the White House, that probably will have the greatest influence on the economy. The key question is "Will the Fed continue its efforts to keep short-term interest rates low and get credit flowing?" Diane Swonk, chief economist of Mefirou Financial, believes the answer is yes, noting, "The Fed will do everything in its power to prevent another recession. And they're the ones with the bazookas." (*Source: Money Magazine, Make Money in 2010, December 2009*)

The Fed's next act could be its hardest—engineering an exit strategy that reduces the burden on the taxpayer without risking a double-dip recession. Most stock investors seem increasingly confident that it can happen, but it is far from certain that such a delicate procedure could be successful. If the Fed abandons its zero-interest rate too soon, it could ruin an economic recovery that is already undershooting its forecast. If the Fed waits too long, cheap money might insulate new asset bubbles like the kind that led to the credit crisis in the first place.

With the market up more than 60% since its low on March 9th, 2009, most investors are probably feeling a lot better about their portfolio than they did a year ago. The question is: "Will the stock market run out of steam?" The movements in the market are nearly impossible to predict in the short term because they depend on so many variables. And while huge news can move stocks in the short term, investors don't always react as predicted.

We all know Mark Twain was right when he observed that, "The art of prophecy is difficult, especially with respect to the future."

That being said, here are some market-moving forces that are likely to figure prominently in the near future:

- **Oil prices** – High energy prices raise the cost of doing business for many companies. Oil prices have more than doubled over the last 12 months, but still remain 45% off all-time highs. If the current prices remain between \$70 and \$90, as many analysts expect, this may be good news for stocks.
- **A weak dollar** – Since the start of 2009, the U.S. dollar has fallen significantly against most other currencies. Weakness in the dollar helps U.S. exports and tends to boost commodity prices, favoring energy and materials companies. Unfortunately, while a weak dollar is not necessarily bad for the U.S. economy, it can create problems with other countries, which can in turn affect stocks.
- **Inflation** – While energy prices have risen in recent months, overall inflation appears to still be in check. A big increase in inflation would be bad news for most stocks, as most investors currently assume that low inflation will allow the Federal Reserve to keep short-term interest rates low.
- **Housing** – The good news in this sector is that the bad news is no longer getting worse. Home sales are on the rise, though they remain well below levels common during better economic times. Inventories are shrinking and the base of foreclosures and home prices throughout many parts of the country is moderating. However, the first-time homebuyer tax credit has made the underlying market difficult to assess. More meaningful tests of the housing market's health will occur when the credit expires in April and when housing prices once again begin to rise.

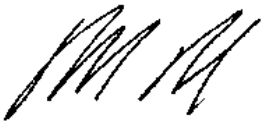
Will any of these forces alone be enough to spark a lasting upward or downward move? Probably not. However, it is best to pay close attention, as these four could seriously affect the market.

Summary

We know there is a lot of information in this report covering a number of very important subjects. However, we understand that there are still a significant number of additional worries and concerns that were not discussed in detail, including Homeland Security, Climate Change, National Health Plan, Income and Estate tax law changes, State's economic woes, and Social Security, to name a few. We will be more than happy to review these and any other important issues that you have during our next meeting.

Thank you again for allowing us to help you with your financial goals and we look forward to seeing you soon!

Yours Truly,



Ronald J. Rich, CFP®



Thomas M. Steinmetz, CPA, CFP®

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Due to volatility within the markets mentioned, opinions are subject to change without notice. Information is based on sources believed to be reliable; however, their accuracy or completeness cannot be guaranteed.

Indexes cannot be invested in directly, are unmanaged and do not incur management fees, costs or expenses. No investment strategy, such as asset allocation, can guarantee a profit or protect against loss in periods of declining values. International investing involves special risks not present with U.S. investments due to factors such as increased volatility, currency fluctuation, and differences in auditing and other financial standards. These risks can be accentuated in emerging markets.

There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment. Rebalancing investments may cause investors to incur transaction costs and, when rebalancing a non-retirement account, taxable events will be created that may increase your tax liability.

This optimism about the future does not minimize the fact that we have gone through one of the worst economic periods in market history. Remember that equity markets are volatile and an investor may lose money and there is no guarantee that securities will appreciate.

The price of commodities is subject to substantial price fluctuations of short periods of time and may be affected by unpredictable international monetary and political policies. The market for commodities is widely unregulated and concentrated investing may lead to higher price volatility.

In general, bond market is volatile, bond prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. The investor should note that funds that invest in lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. The investor should be aware of the possible higher level of volatility, and increased risk of default.

Investments in real estate have various risks including possible lack of liquidity and devaluation based on adverse economic and regulatory changes.

Sources: Wall Street Journal (11/17/09, 12/3/09, 12/9/09, 12/11/09, 12/14/09, 12/17/09, 12/21/09, 12/24/09, 12/28/09, 12/31/09, 1/2/10, 1/4/10, 1/5/10, 1/11/10, 1/12/10, 1/14/10,), Newsweek (8/3/09, 8/17/09), Money (December 2009, January/February 2010), Business Week (11/30/09, 12/28/09, 1/4/10, 1/11/10), New York Times (1/2/10), By The Numbers (12/21/09, 1/4/10, 1/11/10, 1/18/10), Barron's (12/7/09, 1/11/10), Times Magazine (10/5/09, 12/28/09), Kiplinger's Personal Finance (1/2010), Morningstar Stock Investor (November 2009), The Economist (1/2/10) © MDP, Inc.

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