

Winter 2010

How Much Upside Is Left?

We've seen a surprisingly powerful rally in the global equity markets since the lows of March 2009. The big question is whether this can continue.

Sensible indicators suggest that equities are now modestly overvalued, but modest overvaluation does not rule out further market upside. Markets tend to overshoot, liquidity is abundant, and we anticipate a post-recession, above-trend global economic growth spurt lasting several quarters in the United States and perhaps longer in emerging markets. We think equities are likely to continue rising in the first half of 2010, but we expect the gains to be modest. And we're already seeing signs that volatility is picking up.

We expect a slow-growth environment to develop in the second half of 2010 and persist for several years, driven primarily by ongoing deleveraging, caution from consumers and businesses, and a slackening of public spending. Many serious problems created by the debt bubble have not been resolved.

Commercial real estate problems are likely to further reduce the ability and willingness of banks to lend to small business, which will hurt the economy. We expect bank failures to continue in 2010. Many governments – from the federal level down to the city level – are also in precarious fiscal positions. The abundant credit they have been able to tap will probably become

constrained or prohibitively expensive. A sharp drop-off in government spending could also choke off the recovery.

Upside Risks

There are also, ironically, upside risks to the economy. In particular, if economic conditions, which have been improving rapidly recently, heat up too much over the next few months, the Federal Reserve Board may tighten its monetary policy sooner than we and the market expect. This would likely throw cold water on the equity rally.

Although we've considered adding higher-risk positions to our portfolios, we're holding off on that because of our ongoing concerns about the sustainability of the upturn. Our perception is that the market's upside is limited while the downside risks are persistent.

Equities: Emphasis on Global Quality

We continue to believe that valuations for global high-quality companies are reasonable – blue-chip stocks should be able to thrive in an environment where weaker competitors are struggling. Many of these large companies also have substantial operations in the growing emerging markets of Asia, and we think their core earnings strength should provide downside protection if the equity rally falters.

Although the overall equity allocations in our portfolios remain at the lower end of our target ranges, we're maintaining an overweight to blue-chip companies that operate globally.

Emerging-market (EM) equities have rallied even more than developed-market equities, with broad indices up approximately 80% in US-dollar terms since March 2009. However, we believe that EM equities are no longer "cheap" and may be vulnerable to a cor-

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rection in the short term. For those reasons, and the fact that it's difficult to make long-term growth predictions for this sector, we have gradually reduced the exposure to EM equities in most portfolios to what we consider a neutral weight.

Last November, we tilted many of our portfolios a bit more toward the equities of domestic companies than we normally would. The recent modest rally in the dollar has encouraged us to maintain this tilt.

Fixed Income: More of the Same

Municipal bonds and all classes of corporate, agency, and asset-backed bonds experienced spectacular rallies in 2009, while Treasury bonds lost value. The difference in yield between Treasuries and other bonds (the spread) has narrowed, but we don't expect it to narrow much more.

Within Treasuries, the spread between 2-year and 10-year notes is at a record level, and we don't expect that to change much in the short term either. Yields on longer-term bonds of all types are likely to remain elevated because of inflation expectations and a large and continuous supply. We believe it is prudent to limit the percentage of our fixed-income allocation that is invested in longer-duration bonds because inflation could pick up.

The bargain days of late 2008 and early 2009 are gone. Back then, credit concerns caused the yields on almost anything but Treasuries to skyrocket, but now we think valuations are reasonably fair. For example, 10-year triple-A municipal bond yields as a percentage of Treasury yields have dropped to about 85%, which is right around their long-term average.

Coupon levels on corporate bonds (the interest rates stated on the bonds) remain attractive, but we have some concerns about an uptick in fixed-income volatility. While we continue to hold corporates in our portfolios, we have reduced the allocation. If volatility picks up, we may be moving to other types of income-providing securities in some portfolios, such as Treasuries, floating-rate bonds, or stocks of companies that pay high dividends (such as utilities).

In tax-sensitive portfolios, we have increased the overall quality of municipal bonds because we worry about the ongoing budget problems facing almost all levels of government in many states.

Real Assets: A Modest Allocation

Commodities have done better than we expected, with crude oil and copper performing particularly well in 2009. We don't expect much more short-term gain from these levels. However, we see slightly more value in high-quality global producing companies, so we are likely to keep a natural resources equity position as part of the real assets allocation in many of our portfolios.

Measured inflation remains subdued while longer-term inflation expectations remain anchored around 3% or lower. We are aware of the large increase in the monetary base and are vigilantly watching for signs that bank lending and factory utilization measures are picking up. So far they haven't, and until they pick up significantly, we don't expect much change in the inflation rate.

Therefore, we will continue to keep a modest allocation to real assets in most of our portfolios.

US Dollar: Hanging on to Recent Gains?

Recently, the US dollar has gone up about 6%, a welcome event after declining 15% between March and

November last year. This modest rally is the result of stronger-than-expected growth in the US economy coupled with a bevy of problems in countries as varied as Spain, Greece, Japan, and Dubai.

It is difficult to predict what the dollar will do next, but we think it is likely to stay around its current level for the next six months.

This article is the collaborative effort of our investment committee.

Curmudgeon’s Corner: Buy Gold Now?!

In 1979, the best selling personal finance book was Howard Ruff’s *How to Prosper During the Coming Bad Years*. If you’re graying around the temples you might remember it. It advised you to avoid the stock market and focus on holding gold and silver as an inflation hedge. The book was a runaway success, selling nearly two million copies by the end of 1979. It went on to become the best-selling personal finance book of all time (2.6 million copies in print).

Back in the late 1970s, the collective American outlook was pretty dour – like it is now. The inflation rate was high and on the rise. An Iranian oil embargo pushed up the cost of energy dramatically. To most people, the Carter administration seemed to be wimpy and ineffective.

Gold rose to meet Howard Ruff’s predictions, from \$220 to \$550 per ounce in 1979 alone, peaking in early 1980 at about \$850 per ounce. Unfortunately for Ruff acolytes, however,

it fell sharply from there, and by the summer of 1982 it was trading around \$300 an ounce. Inflation fell too, from a peak of around 15% in 1980 to about 3% in 1983. For the rest of the decade – with inflation an increasingly distant memory – gold traded in a narrow range around \$350. As Table 1 illustrates, stocks and bonds did much better.

So let’s take another look at Ruff’s bestseller. I guess Ruff was sort of right (just ask him). If you had been particularly nimble (and you bought the book early in 1979, before it leaped up the bestseller charts), you might have caught the meteoric rise in gold and then sold it and moved into stocks or bonds. You could have traded your way into a spectacular decade of returns through the 1980s. However, if you were a Ruff convert, you probably wouldn’t have been so nimble because you would have hung on to your gold to protect yourself against the indeterminate number of “coming bad years” that he predicted.

No One Has a Crystal Ball

I write this today, 30 years after the publication of *How to Prosper*, not to disparage Mr. Ruff. In fact, I

congratulate him for being both prescient and entrepreneurial in filling a product need.

Instead, I write to make several important points.

First, the consensus is often wrong:

- Who would have guessed in the throes of inflation in the late 1970s that stocks and fixed-rate bonds would turn out to be the best investment for the next decade, with its low inflation rate?

- Or, 18 months ago, at the end of 2008 when the world was coming to an end, did you think that stocks would be up about 30% in 2009?

Year	Gold	Stocks	Treasury Bonds
1980	15%	32%	-4%
1981	-33%	-5%	2%
1982	15%	21%	40%
1983	-16%	23%	1%
1984	-19%	6%	16%
1985	6%	32%	31%
1986	21%	19%	25%
1987	22%	5%	-3%
1988	-15%	17%	10%
1989	-3%	32%	18%
Compounded total return	-22%	504%	328%

Sources: Gold, spot price for one ounce, Bloomberg. Stocks, S&P 500 Index, Standard & Poor’s. Bonds, Ibbotson Long-Term Government Bond Index, Ibbotson Associates.

Second, I want to point out that diversification matters *precisely* because it is very hard to predict the future. At the end of 1979, a good old 60/40 portfolio – 60% stocks and 40% bonds – would have done very nicely in what turned out to be the coming *good* years of the 1980s, thank you very much.

Let us know what topics you'd like George Feiger to discuss on the monthly client call. To catch up on past client calls, go to www.contangoadvisors.com, and click on the link for the call you'd like to hear.

The World Hasn't Ended Yet

Third, we should remember that in our society, dire “end of the world” predictions often flourish, and in a provocative Geraldo Rivera sort of way.

As one Amazon.com reviewer of *How to Prosper* put it just last year:

I read the book around 1979 when it first came out. Everything the author says is completely plausible and happening now. The downside is I wish he had mentioned that it would take 30 years to happen! I missed the upside of the late 80s and 90s waiting for the end. I missed out on a fortune. Anyway, it does seem like the book is spot on for today's world.

A saying comes to mind: Fool me once . . .

So, Is Gold Going Up or Down?

And finally, I write this to point out that it is often precisely when we are the *most* bullish and bearish that we are wrong. I'll call this the “if you're asking your broker about it, you're probably too late” phenomenon. Who *wasn't* asking their broker about tech stocks in 1999, and who *isn't* asking their broker about gold as an investment today?

So is gold going down? I don't know – maybe it will and maybe it won't. Despite the fact that gold is near an all-time high again (as it was almost exactly 30 years ago, in 1980), we at Contango Capital Advisors are neither bearish nor bullish on gold. You will,

however, find gold mining companies (along with many other kinds of companies) in the mutual funds in many of our diversified multi-asset-class portfolios.

I do know one thing, though. I need to end this article quickly so I can run over to Barnes and Noble and get my copy of *How to Prosper in the Age of Obamanomics: A Ruff Plan for the Hard Times Ahead* (Howard Ruff, Berkeley Books, November 2009, \$14). What are the chances of Ruff being wrong twice?

About the author: Perry Piazza is director of investment strategy, responsible for asset allocation and portfolio development. Previously, he held a number of trading-related roles in New York and London with Citigroup and Morgan Stanley. He earned an MBA from Yale and a BS from the University of Delaware.

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