

The Surprises of 2010

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Byron's monthly essays are broadly recognized for their insight and perspective. If you would like to receive future monthly market commentary publications by Byron Wien, please email byronwien'scommentary@blackstone.com.

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The Ten Surprises of 2009

- 1. The Standard and Poor's 500 rises to 1200. In anticipation of a second-half recovery in the U.S. economy, the market improves from a base of investor despondency and hedge fund and mutual fund withdrawals. The mantra changes from "fortunes have been lost" to "fortunes can still be made." Higher quality corporate bonds, leveraged loans and mortgages lead the way**
- 2. Gold rises to \$1,200 per ounce. Heavy buying by Middle Eastern investors and a worldwide disenchantment with paper currencies drive the price of precious metals higher. In a time of uncertainty, investors want something they can count on as real**
- 3. The price of oil returns to \$80 per barrel. Production disappointments and rising Asian demand create an unfavorable supply / demand balance. Other commodities also rise, some doubling from their 2008 lows. Natural gas goes to \$9 per mcf**
- 4. Low Treasury interest rates coupled with huge borrowing by the Treasury send the dollar into a serious downward slide. Overseas investors become concerned that the currency printing presses will never stop. The yen goes to 75 and the euro to 1.65**
- 5. The ten-year U.S. Treasury yield climbs to 4%. Later in the year, as the economy shows signs of recovery, economists and investors shift their mood from concern about deflation to worries about inflation. A weak dollar, rapid growth in money supply and record-setting deficits (over \$1 trillion) are behind the change**

The Ten Surprises of 2009

- 6. China's growth exceeds 7% and its stock market revives. World leaders credit China's authoritarian government for its thoughtful stimulus policies and effective execution during a challenging period. The Chinese consumer begins to spend more and save less and this shift is behind the unexpected strength in the economy**
- 7. Falling tax revenues from the financial sector cause New York State to threaten bankruptcy and other states and municipalities follow. The Federal government is forced to step in and provide substantial assistance. The New York Post screams "When will the bailouts stop?"**
- 8. Housing starts reach bottom ahead of schedule in the fall, and house prices stabilize after dropping 15% from year-end 2008 levels. The Obama stimulus program proves effective and a slow growth recovery begins before year-end. Third and fourth quarter real gross domestic product numbers are positive**
- 9. The savings rate in the United States fails to improve beyond 3%, as most economists expect. The concept of thrift seems to have vanished from American culture. Peak job insecurity and negative growth drive increased savings early in the year, but spending resumes as the economic growth turns positive in the second half, making Christmas 2009 the best ever**
- 10. Citing concerns about Iraq's fragile democratically elected government and the danger of a Taliban-controlled Afghanistan, Barack Obama slows his plan for troop withdrawal in the former and meaningfully increases U.S. military presence in the latter. In a hawkish speech he states that the threat of terrorism forces the United States to maintain a strong military force in this strategic area**

The Ten Surprises of 2010

- 1. The United States economy grows at a stronger than expected 5% real rate during the year and the unemployment level drops below 9%. Exports, inventory building and technology spending lead the way. Standard and Poor's 500 operating earnings come in above \$80**
- 2. The Federal Reserve decides the economy is strong enough for them to move away from zero interest rate policy. In a series of successive hikes beginning in the second quarter the Federal funds rate reaches 2% by year-end**
- 3. Heavy borrowing by the U.S. Treasury and some reluctance by foreign central banks to keep buying notes and bonds drives the yield on the 10-year Treasury above 5.5%. Banks loan more to corporations and individuals and pull away from the carry trade, thereby reducing demand for Treasuries. Obama says, "The suits are finally listening"**
- 4. In a roller coaster year the Standard and Poor's 500 rallies to 1300 in the first half and then runs out of steam and declines to 1000, ending where it started at 1115.10. Even though the economy is strong and earnings exceed expectations, rising interest rates and full valuations present a problem. Concern about longer term growth and obligations to reduce leverage at both the public and private level unsettle investors**
- 5. Because it is significantly undervalued on a purchasing power parity basis, the dollar rallies against the yen and the euro. It exceeds 100 on the yen and the euro drops below \$1.30 as the long slide of the greenback is interrupted. Longer term prospects remain uncertain**

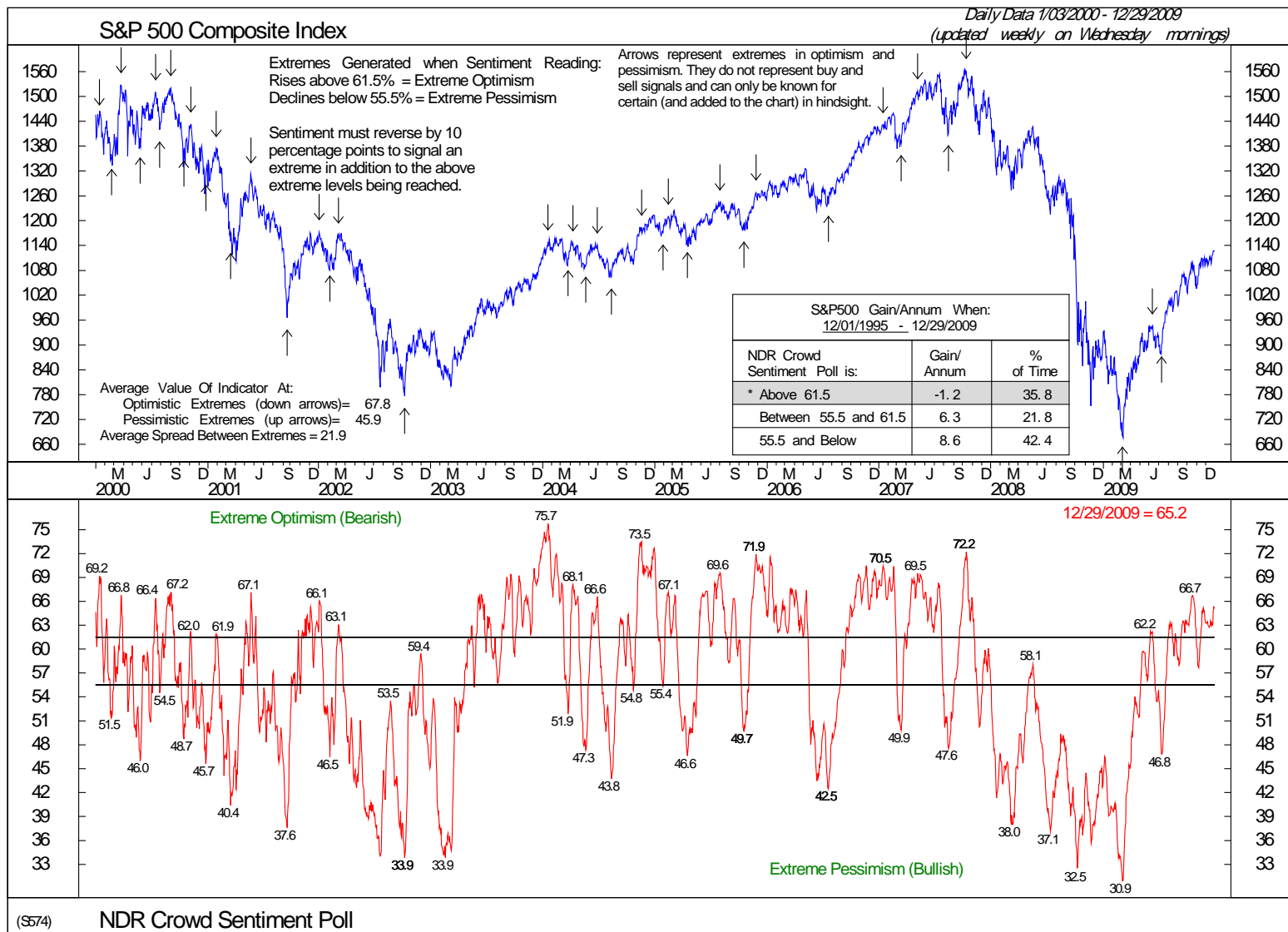
The Ten Surprises of 2010

- 6. Japan stands out as the best performing major industrialized market in the world as its currency weakens and its exports improve. Investors focus on the attractive valuations of dozens of medium sized companies in a market selling at one quarter of its 1989 high. The Nikkei 225 rises above 12,000**
- 7. Believing he must be a leader in climate control initiatives, President Obama endorses legislation favorable for nuclear power development. Arguing that going nuclear is essential for the environment, will create jobs and reduce costs, Congress passes bills providing loans and subsidies for new plants, the first since 1979. Coal accounts for about 50% of electrical power generation, and Obama wants to reduce that to 25% by 2020**
- 8. The improvement in the U.S. economy energizes the Obama administration. The White House undergoes some reorganization and regains its momentum. In the November Congressional election the Democrats only lose 20 seats, much less than expected**
- 9. When it finally passes, financial service legislation, like the health care bill, proves to be softer on the industry than originally feared. There is greater consumer protection, more transparency, tighter restriction of leverage and increased scrutiny of derivatives, but the regulatory changes for investment bankers and hedge funds are not onerous. Trading volume and merger activity increases; financial service stocks become exceptional performers in the U.S. market**
- 10. Civil unrest in Iran reaches a crescendo. Ayatollah Khamenei pushes out Mahmoud Ahmadinejad in favor of a more public relations adept leader. Economic improvement becomes the key issue and anti-Israel rhetoric subsides. Talks with the U.S. and Europe begin but the country remains a nuclear threat. Pakistan becomes the hotspot in the region because of the weak government there, anti-American sentiment, active terrorist groups and concerns about the security of the country's nuclear arsenal**

Surprises Not on the 2010 List

- **Gold**
- **Oil**
- **China**
- **Commercial Real Estate**
- **Tax policy**

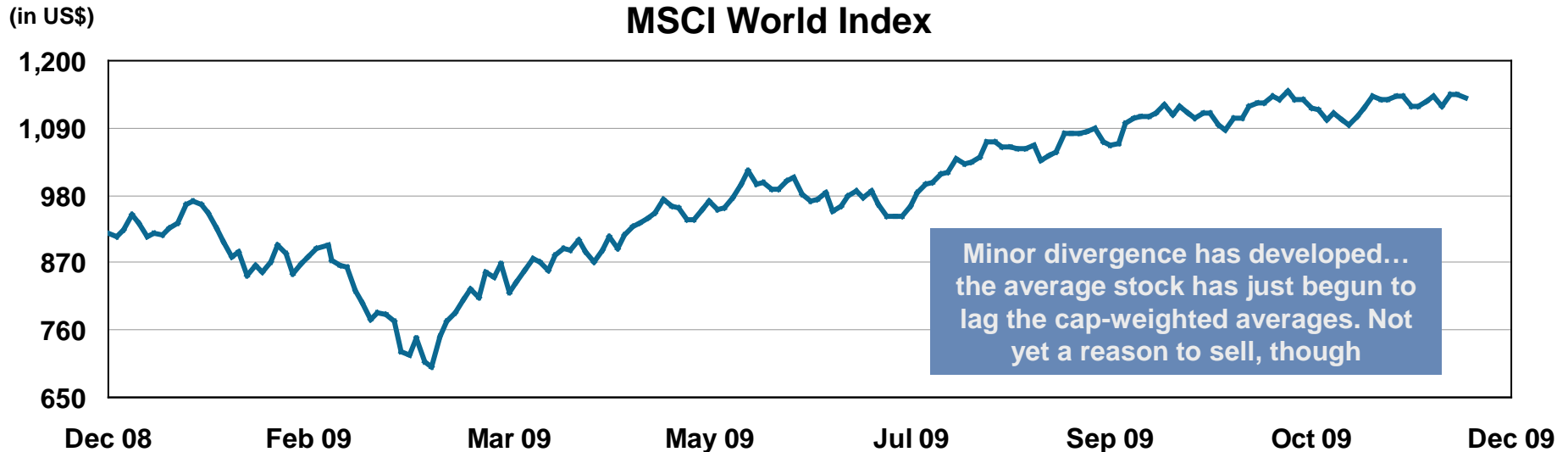
Crowd Sentiment Poll



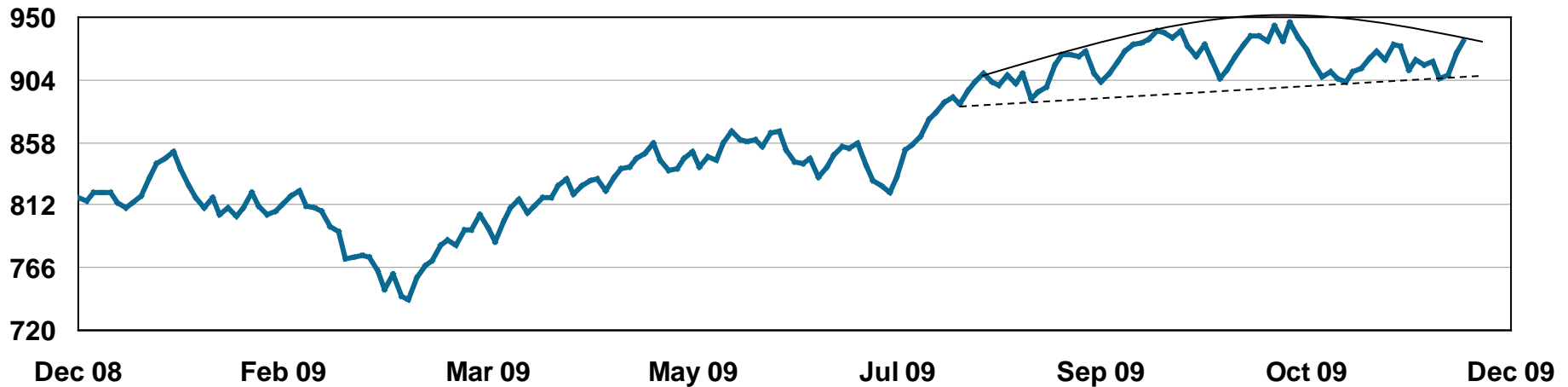
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Source: Ned Davis Research.

MSCI World Index (in USD)



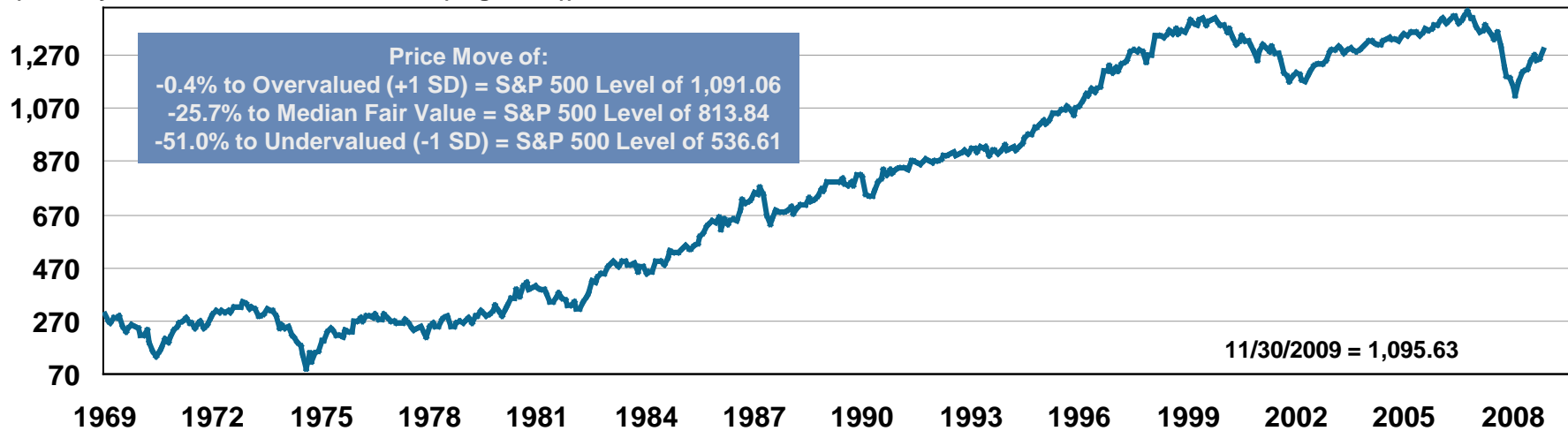
MSCI World Index Daily Advance / Decline Line



Source: The Leuthold Group.

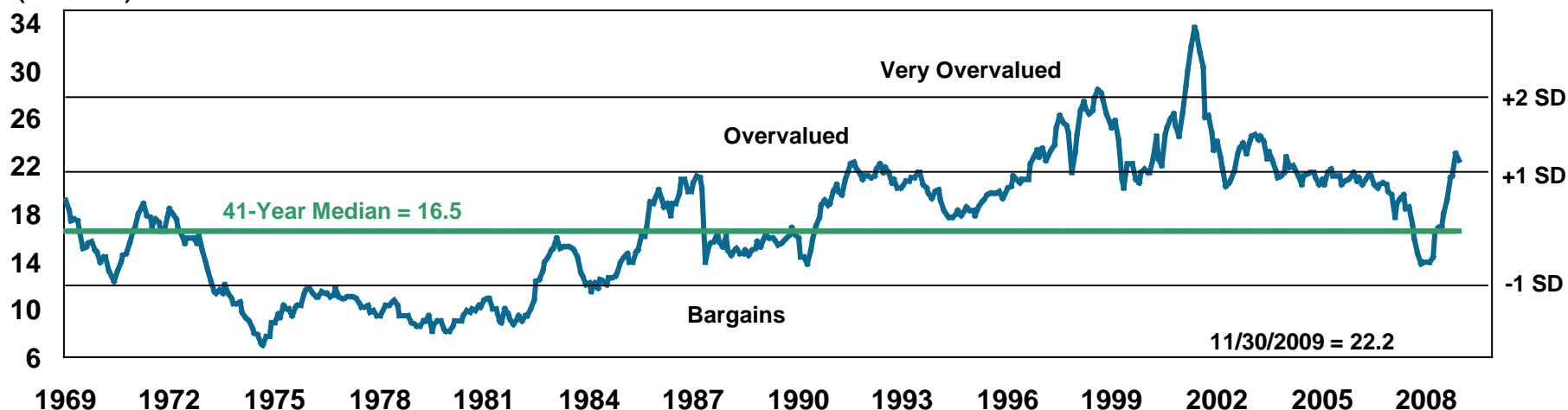
Standard & Poor's 500 Stock Index

(Monthly Data 12/31/1968 – 11/30/2009 (Log Scale))



S&P 500 Median Price / Earnings Ratio (NDR Calculation) with Historical Median

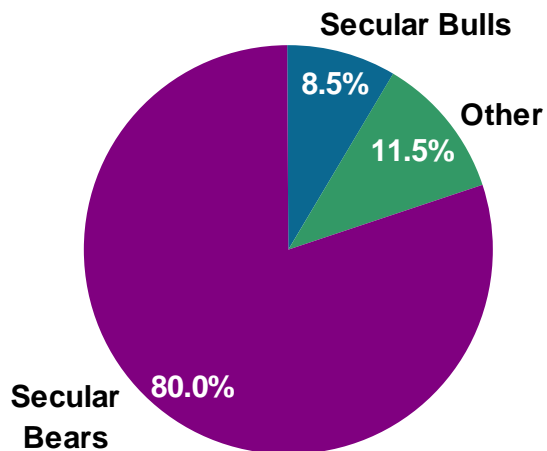
(Davis100)



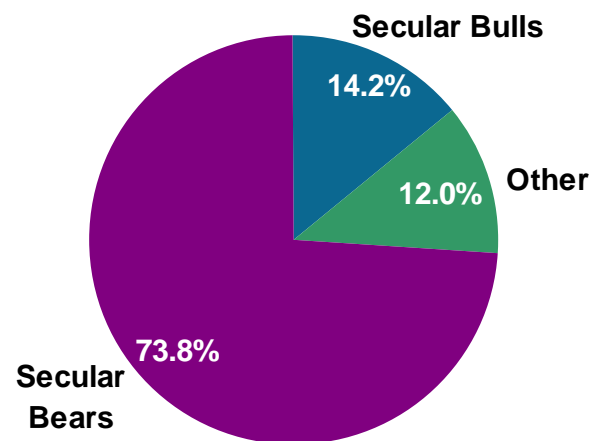
Source: Ned Davis Research.

World Market Cap as of 12/31/2003

World Market Cap as of 12/31/2003



World Market Cap as of 12/31/2008



Countries in Secular Bull Markets

	Market Cap as a % of World Market Cap in 2003	Market Cap as a % of World Market Cap in 2008	Point Change
China	0.36%	1.72%	1.36
Canada	2.54%	3.50%	0.96
Brazil	0.42%	1.22%	0.81
Taiwan	0.55%	1.03%	0.48
South Korea	0.83%	1.29%	0.46
Australia	2.05%	2.50%	0.45
India	0.26%	0.62%	0.36
Russia	0.22%	0.54%	0.32
Mexico	0.29%	0.49%	0.20
Hong Kong	0.65%	0.84%	0.19
Singapore	<u>0.33%</u>	<u>0.45%</u>	<u>0.12</u>
Total	8.49%	14.21%	5.72

Countries in Secular Bear Markets

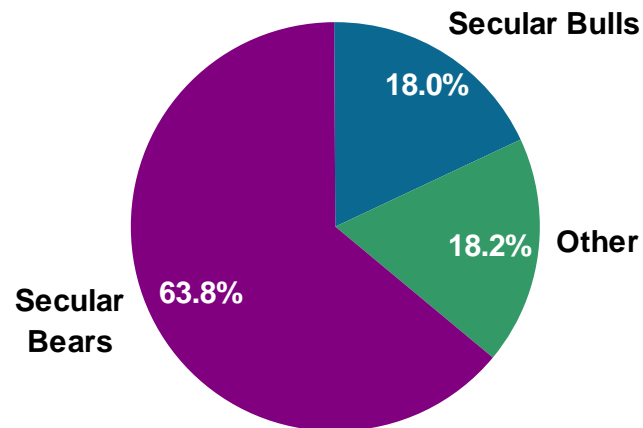
	Market Cap as a % of World Market Cap in 2003	Market Cap as a % of World Market Cap in 2008	Point Change
U.S.	52.47%	45.03%	(7.44)
U.K.	10.45%	8.35%	(2.10)
Italy	1.56%	1.54%	(0.02)
France	3.99%	4.58%	0.59
Germany	2.91%	3.67%	0.76
Japan	<u>8.64%</u>	<u>10.60%</u>	<u>1.96</u>
Total	80.02%	73.77%	(6.25)

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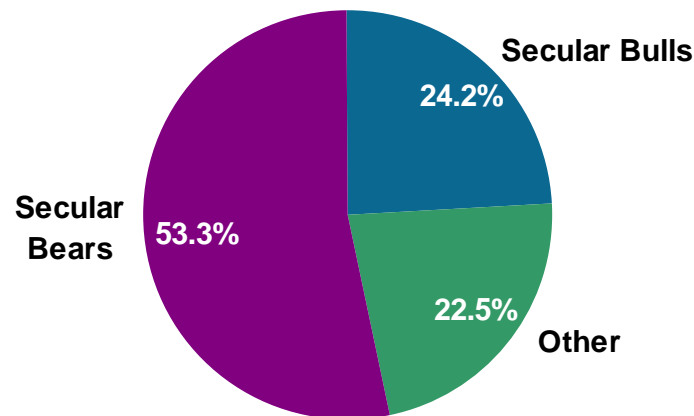
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World Nominal GDP as of 12/31/2003

World Nominal GDP as of 12/31/2003



World Nominal GDP as of 12/31/2008



Countries in Secular Bull Markets

	<u>GDP as a % of World GDP in 2003</u>	<u>GDP as a % of World GDP in 2008</u>	<u>Point Change</u>
China	4.57%	7.63%	3.06
Russia	1.21%	2.86%	1.65
Brazil	1.55%	2.76%	1.22
India	1.51%	1.96%	0.45
Australia	1.47%	1.74%	0.27
Canada	2.41%	2.61%	0.20
Singapore	0.26%	0.31%	0.06
Hong Kong	0.44%	0.37%	(0.07)
South Korea	1.78%	1.64%	(0.15)
Taiwan	0.86%	0.70%	(0.17)
Mexico	<u>1.95%</u>	<u>1.59%</u>	<u>(0.36)</u>
Total	18.00%	24.16%	6.16

Countries in Secular Bear Markets

	<u>GDP as a % of World GDP in 2003</u>	<u>GDP as a % of World GDP in 2008</u>	<u>Point Change</u>
U.S.	30.88%	24.94%	(5.94)
Japan	11.75%	8.49%	(3.26)
U.K.	5.17%	4.63%	(0.53)
Germany	6.80%	6.33%	(0.47)
Italy	4.19%	3.99%	(0.20)
France	<u>5.01%</u>	<u>4.95%</u>	<u>(0.06)</u>
Total	63.80%	53.33%	(10.46)

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Diminishing Returns from Debt-Financing by Decade

(12/31/1949 - 6/30/2009)

(\$ in billions)

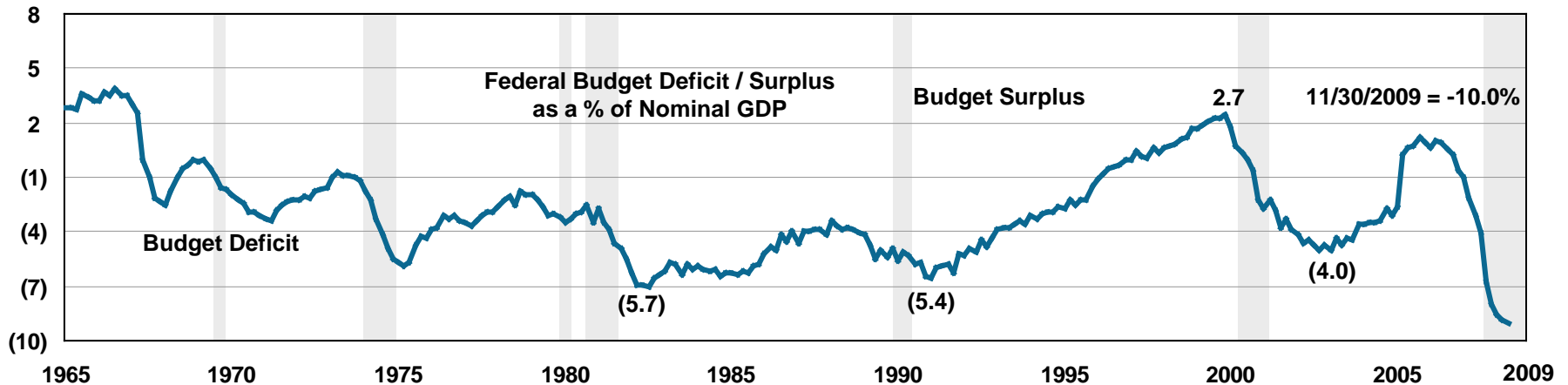
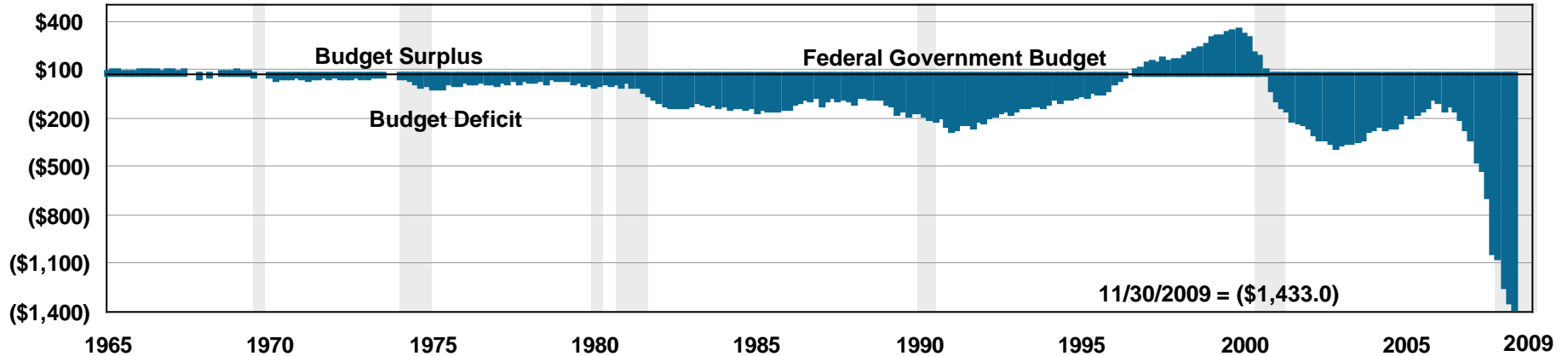
Diminishing Returns from Debt-Financing by Decade 12/31/1949-6/30/2009

<u>Debt Range</u>	<u>Decade Change in Debt (billions \$)</u>	<u>Decade Change in GDP (billions \$)</u>	<u>Debt/GDP</u>	<u>GDP/Debt</u>
12/31/1949-12/31/1959	337.6	248.0	1.36	0.73
12/31/1959-12/31/1969	752.1	491.3	1.53	0.65
12/31/1969-12/31/1979	2,785.2	1,654.9	1.69	0.59
12/31/1979-12/31/1989	8,562.8	2,922.3	2.93	0.34
12/31/1989-12/31/1999	12,550.0	4,026.0	3.12	0.32
12/31/1999-06/30/2009*	27,403.6	4,543.5	6.03	0.17

Source: Ned Davis Research.
(*) Most recent data available.

The Economy (The Index of Coincident Economic Indicators)

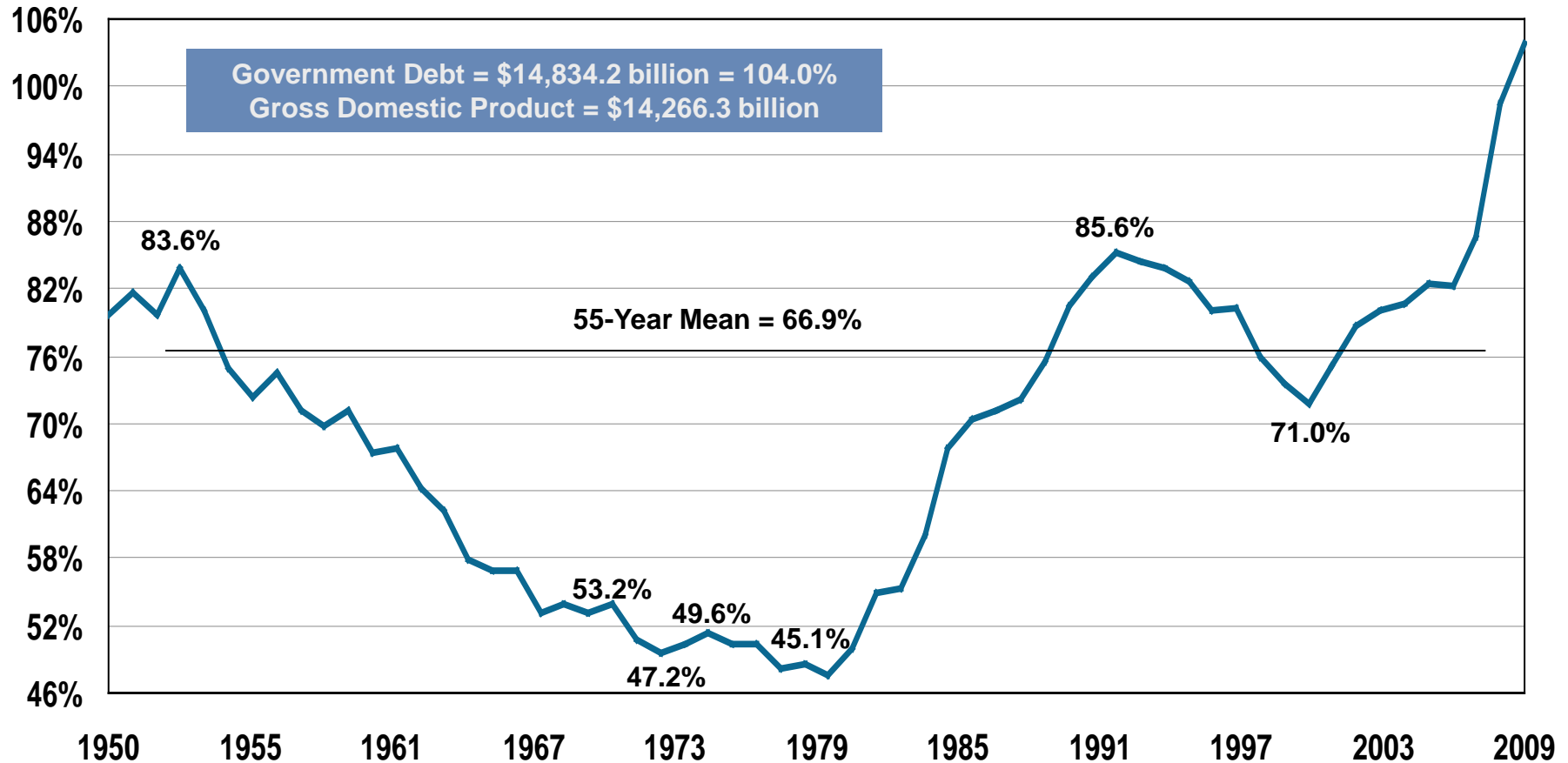
(12-Month Total – \$ in billions)



Source: Ned Davis Research.
National Bureau of Economic Recessions.

Government Debt (Federal, State, and Local) as % of GDP

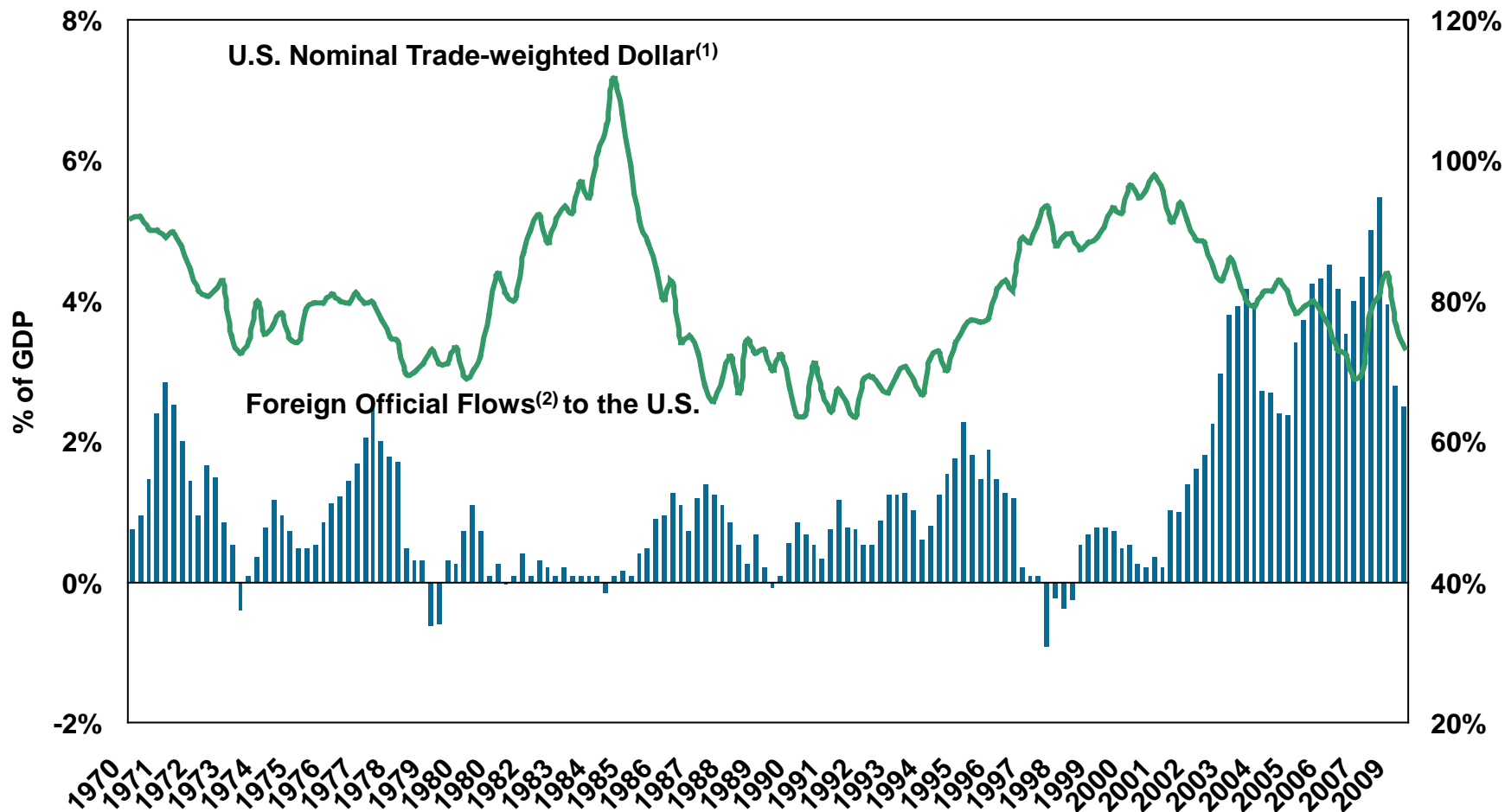
Quarterly Data 3/31/1952 – 9/30/2009



Data Subject to Revisions by
The Federal Reserve Board

Source: Ned Davis Research.

Foreign Central Banks

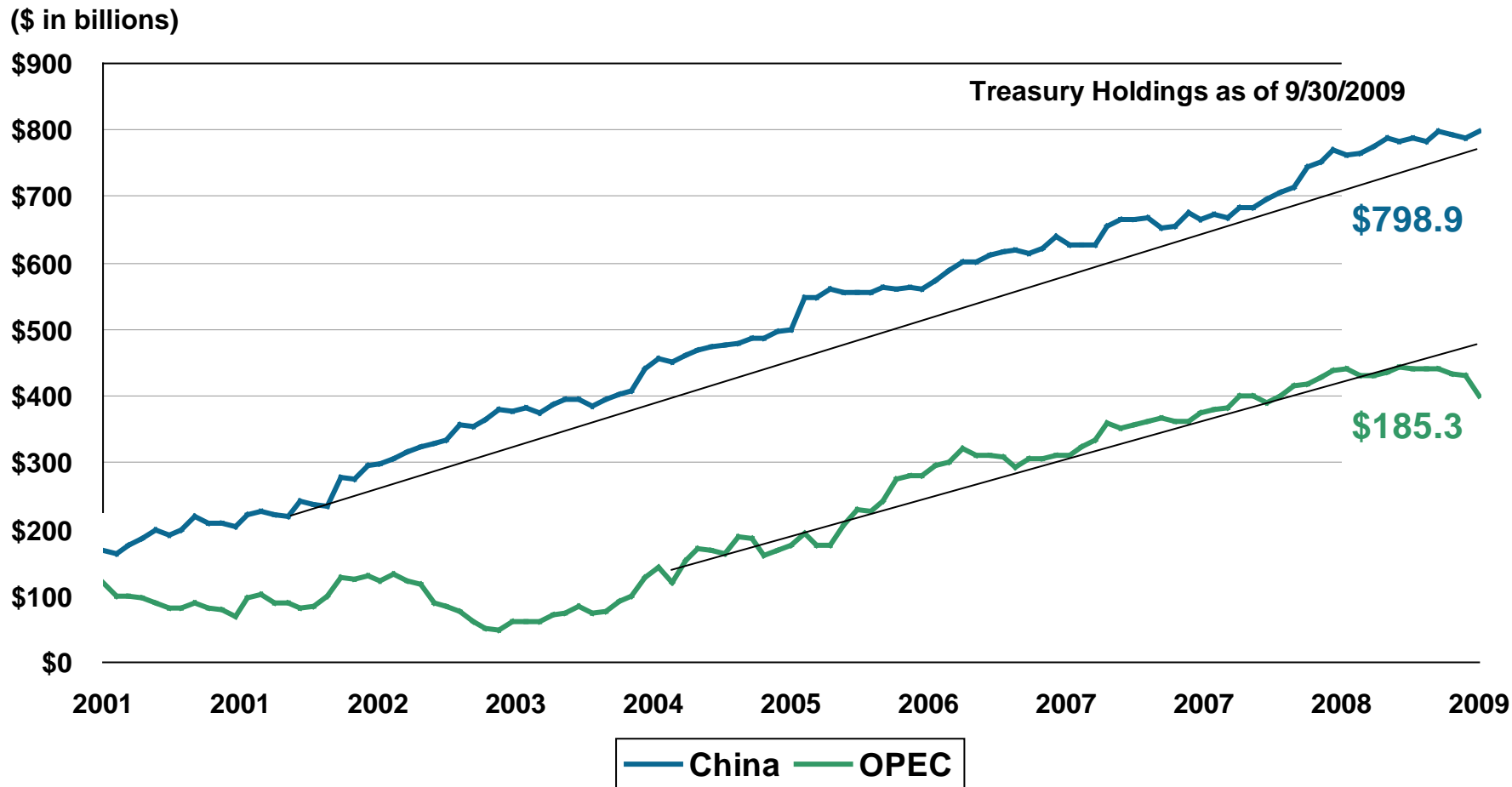


Note: Shaded regions reflect periods of heavy foreign official inflows.

(1) Source: J.P. Morgan Chase & Co, BCA Research.

(2) Central Banks and Monetary Authorities.

Dollar Watch – Two Foreign Holders of U.S. Treasury Securities



Source: Ned Davis Research.

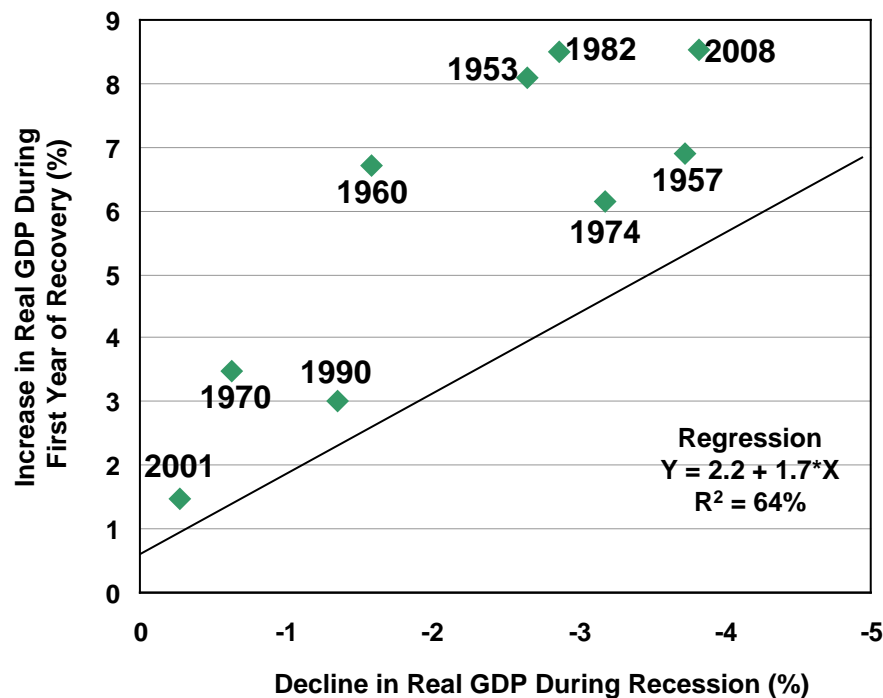
The United States Economy



Good News

History Suggests +4% Recovery Is Conservative

Recession	Real GDP		
	Peak-to-Trough Decline	First year Recovery	
Deep	1957	-3.7%	+6.9%
	1973	-3.1%	+6.1%
	1981	-2.9%	+8.5%
	2009	-3.9%	+8.6% ^e
Shallow	2001	-0.3%	+1.9%



Source: ISI Group.

Good News

By Component, It's Not Hard to Get +4.0% Real GDP

	2010:4Q Real GDP	
	4Q / 4Q	Cont. to GDP
Consumer Spending	+1.0%	0.7%
CapEx Eqp	+10.0%	1.0%
Housing	+10.0%	0.2%
Inventories	+\$196.0	1.5%
Trade	+\$140.0	1.0%
Federal Government	+6.0%	0.4%
State Government	-1.0%	-0.1%
CapEx Structures	-10.0%	-0.5%
Real GDP		4.2%

Source: ISI Group.

Bad News

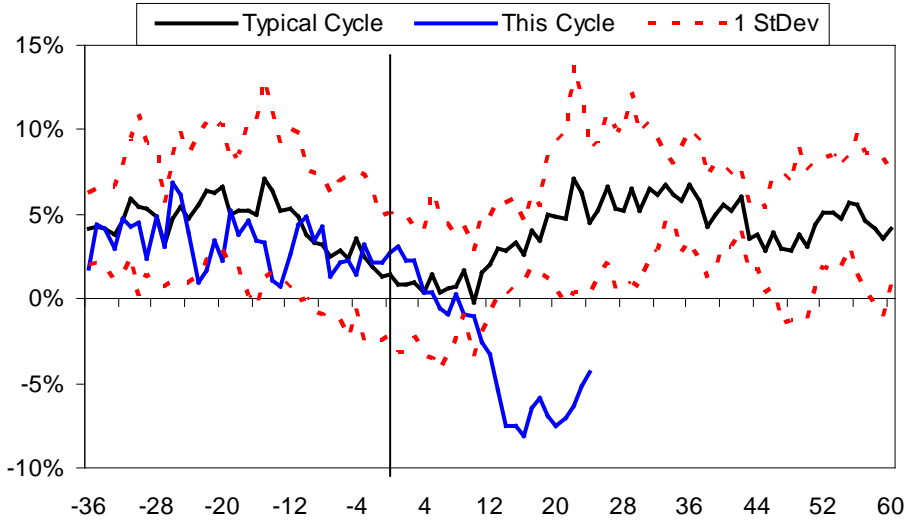
Recovery Off to a Slow Start

	Real GDP Q/Q % A.R.	
	1 st and 2 nd Quarter of Recovery	
	1 st	2 nd
1975	+3.1%	+6.9%
1983	+5.1%	+9.3%
1991	+2.7%	+1.7%
2002	+3.5%	+2.1%
2009	<u>+2.8% r</u>	+3.0%e

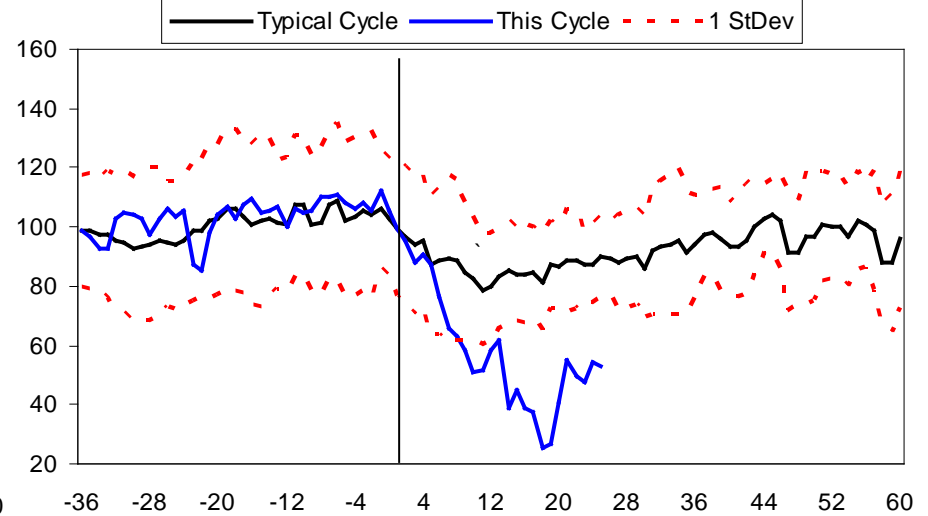
Source: ISI Group.
r = expected revision

Not a Normal Cycle

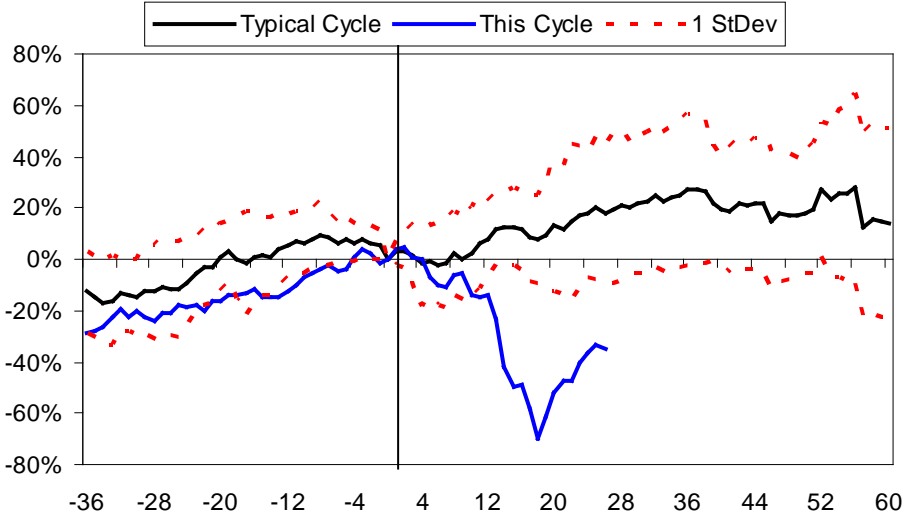
Real Retail Sales (YoY)



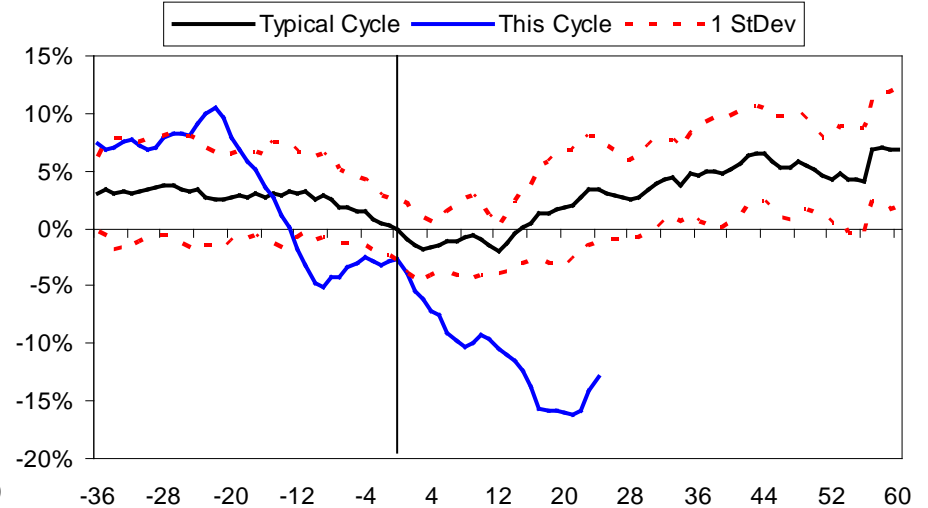
Consumer Confidence (Conf Board)



S&P 500 (ln)



Real Home Price Inflation (Home Prices YoY – CPI YoY)



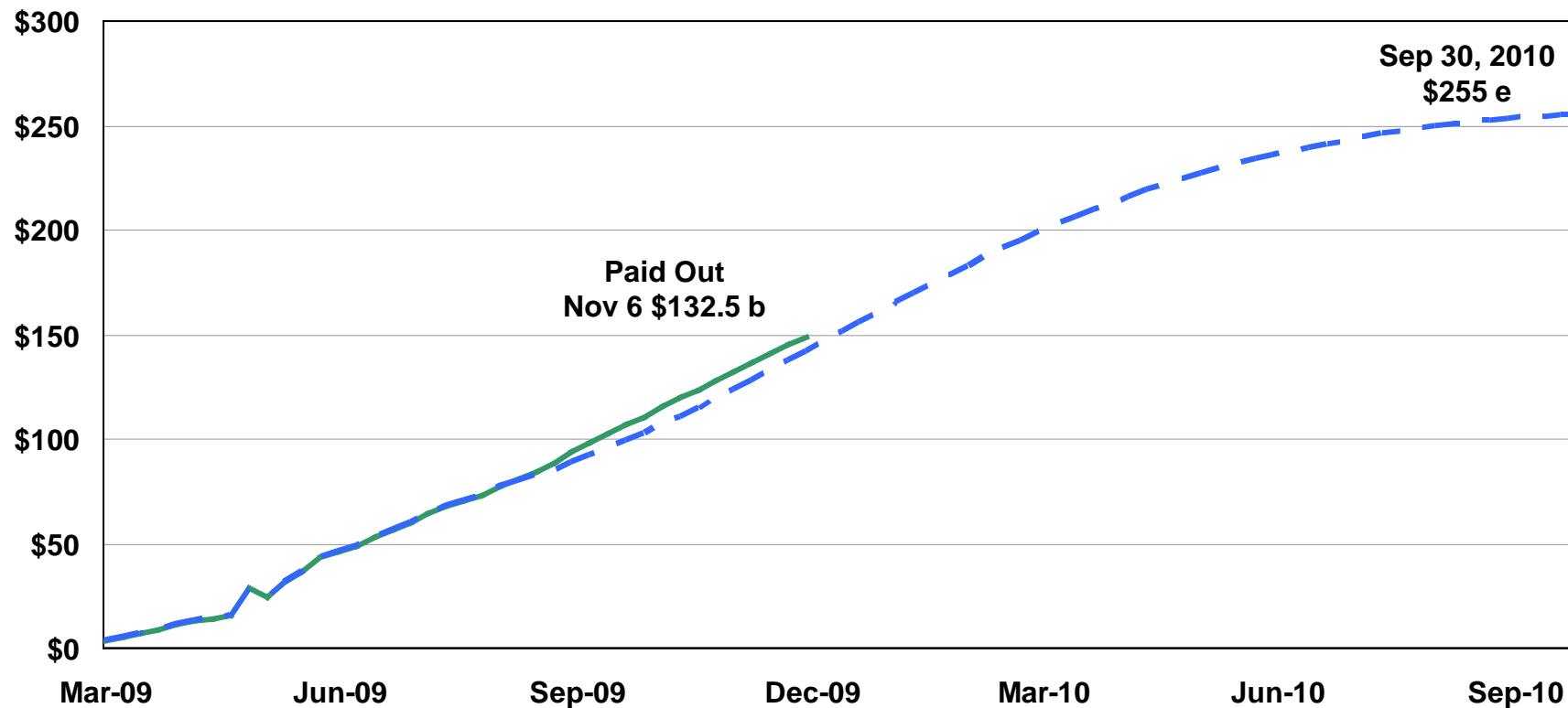
Source: Bridgewater

Good News

Lift to GDP from Spending Part of Stimulus

(\$ in billions)

Funds Distribution Reported By Week
(Total Stimulus Amount – \$787 Billion)



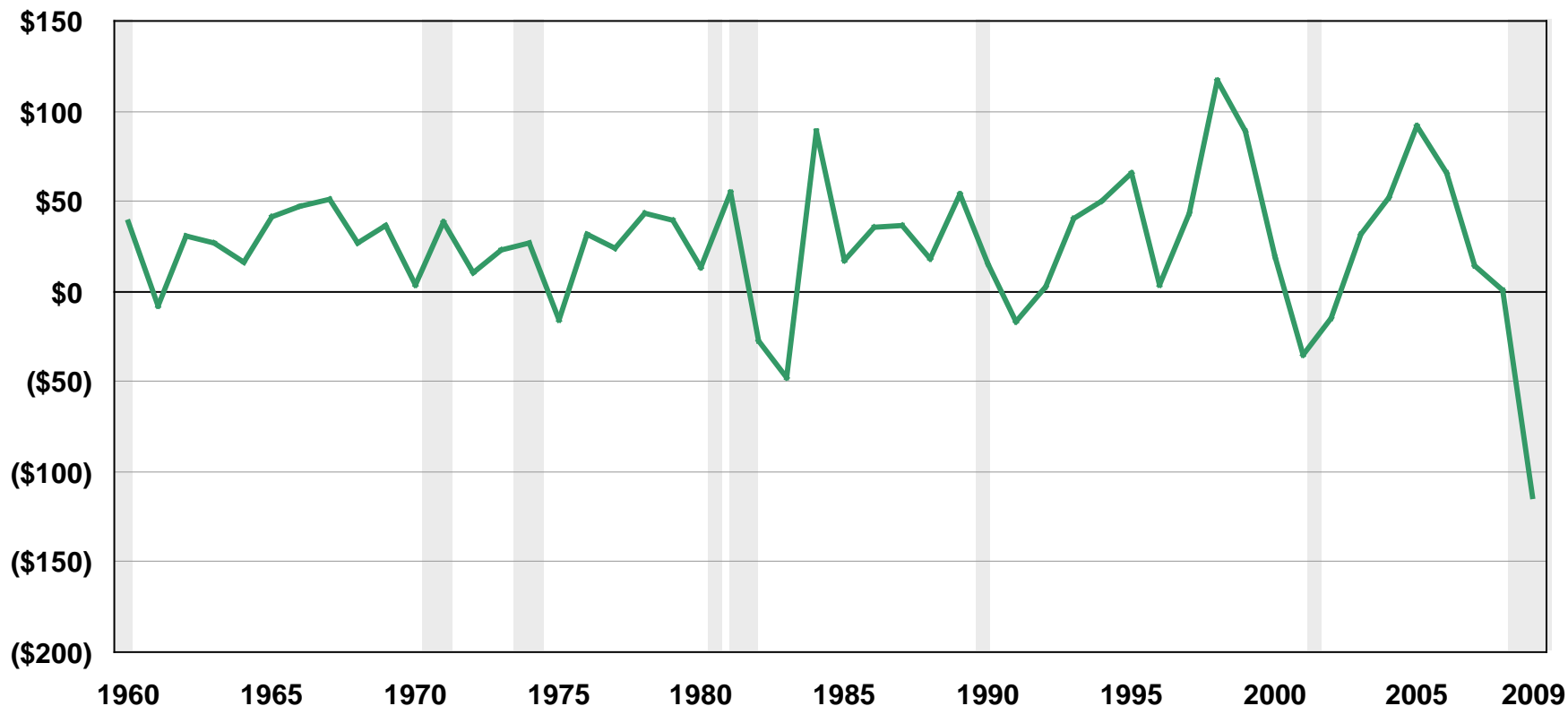
Source: ISI Group.

Good News

Inventories Still Plunging

U.S. Real Inventory Change

2009: 3Q $-\$130.8$



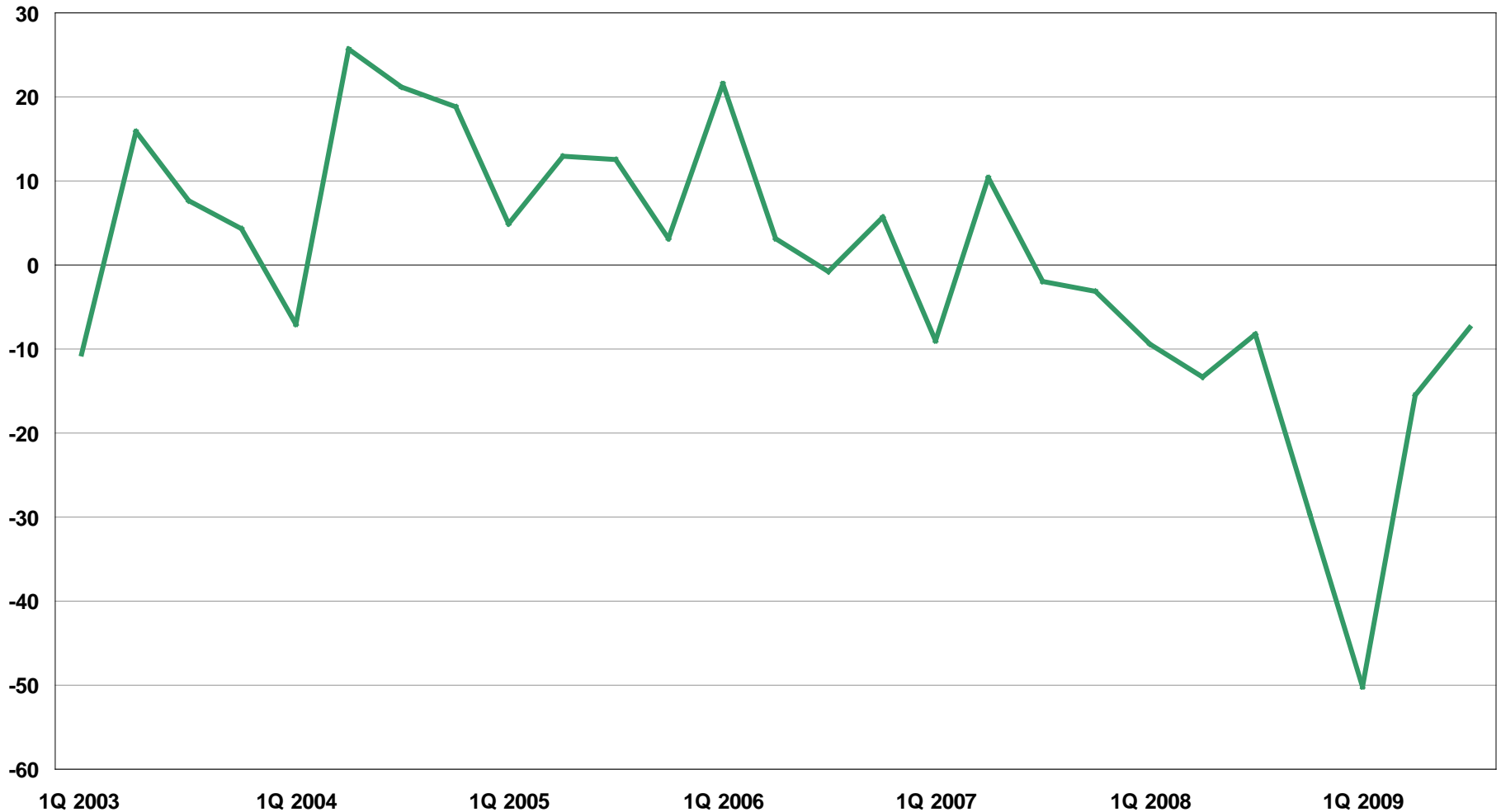
Source: ISI Group.

CapEx – Help for Industrial Machinery Shares

U.S. Nominal CapEx Eqp Ex Tech

Q/Q % Ch A.R.

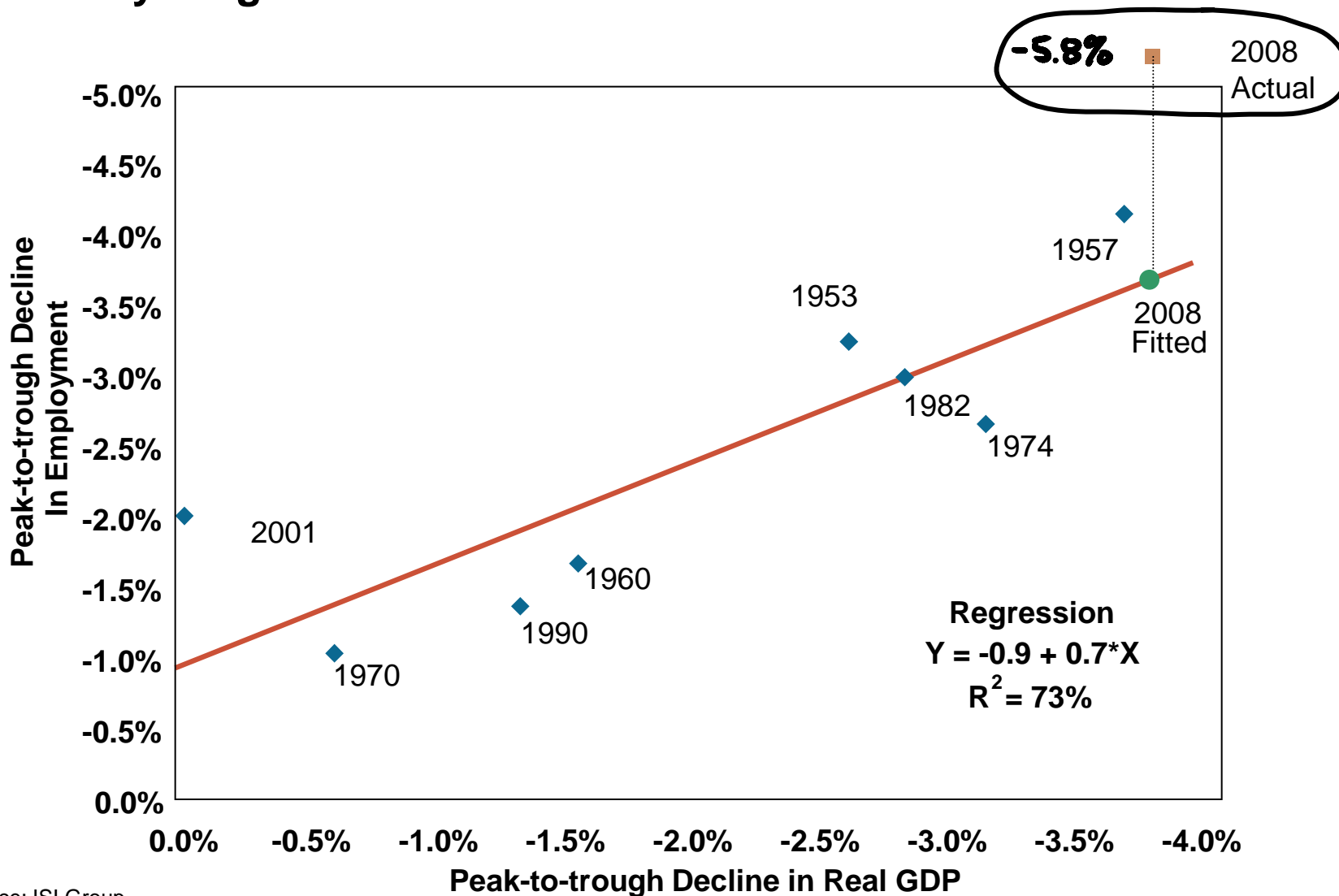
2009:3Q: - 10.0%



Source: ISI Group.

U.S. Employment

Unusually Large Job Cuts Relative to GDP

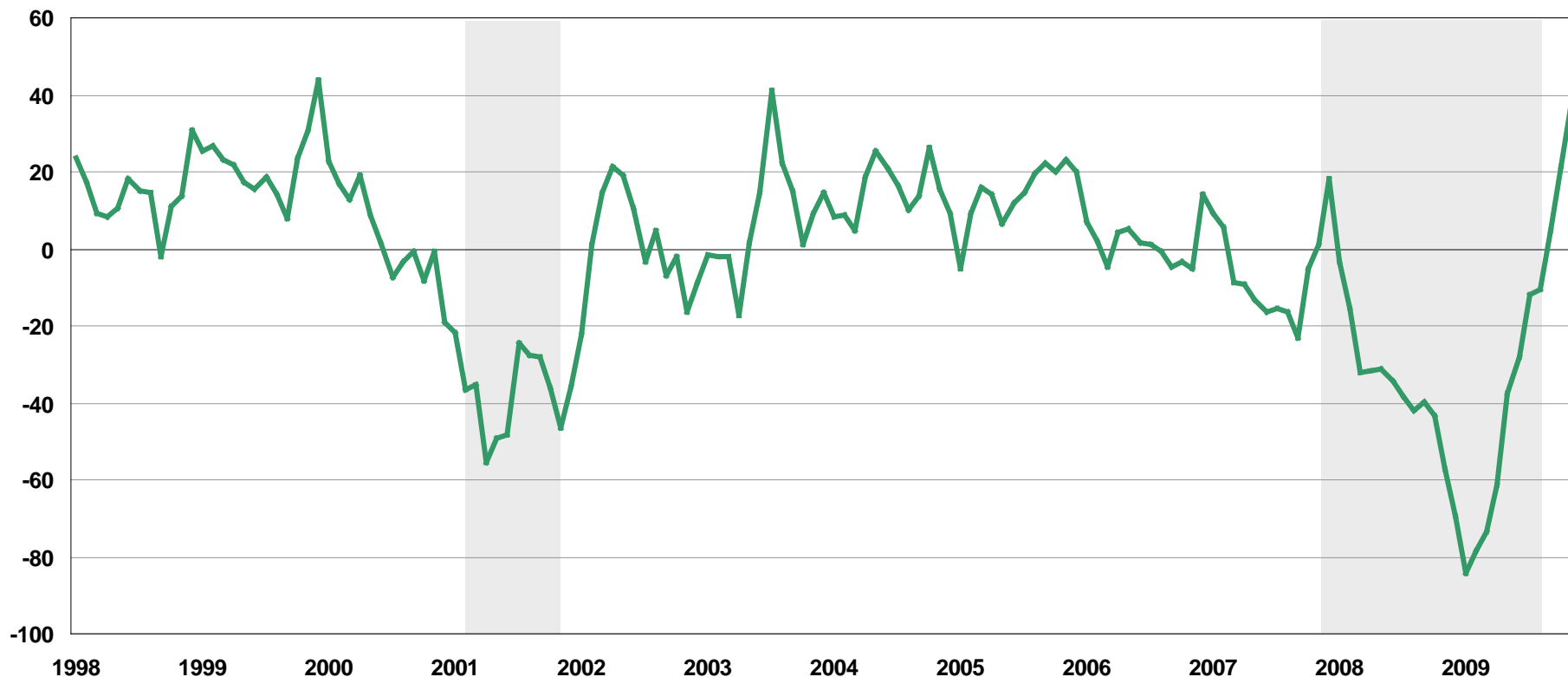


Source: ISI Group.

U.S. Employment

Likely to Increase Soon

U.S. Temp Employment
M/M Ch 3 Mo. Avg.
Nov 38



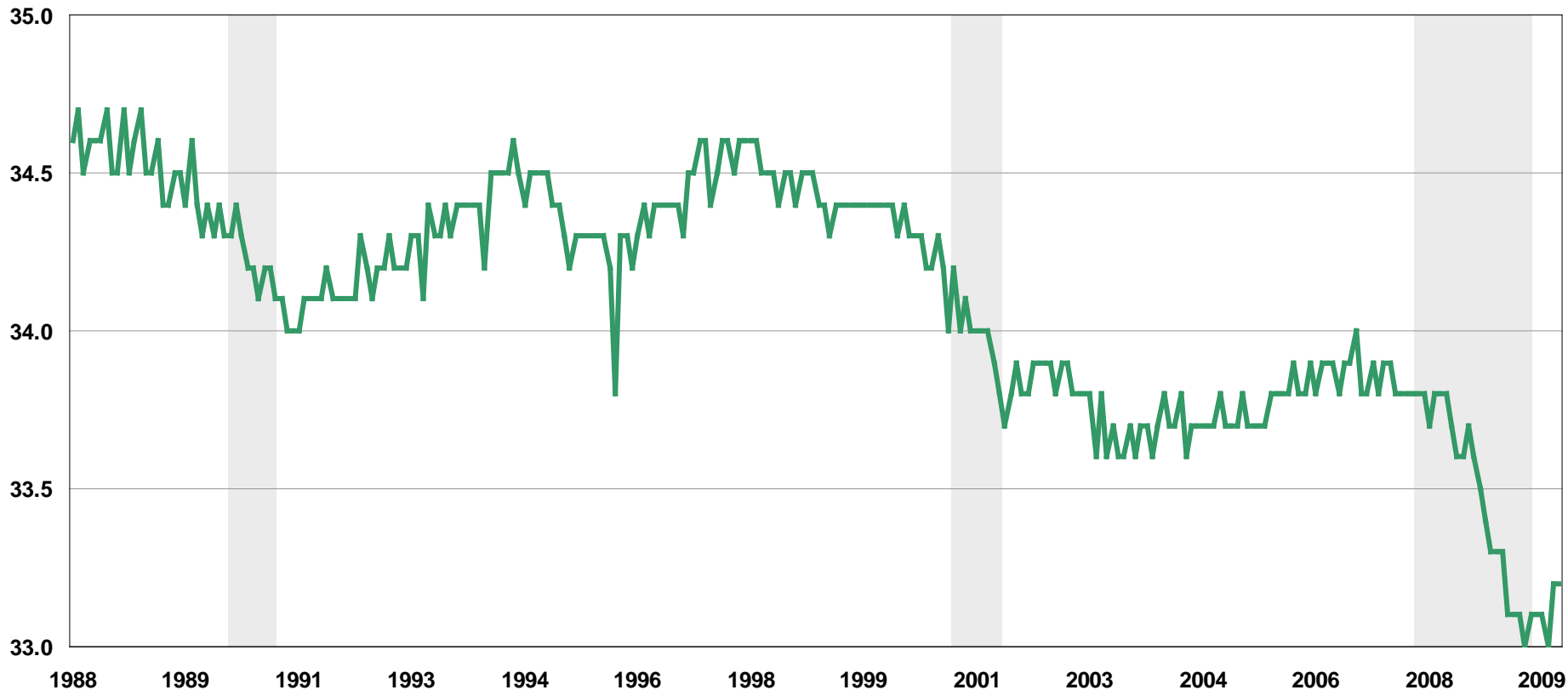
Source: ISI Group.

U.S. Employment

Likely to Increase Soon

Total Work Week

Nov 33.2

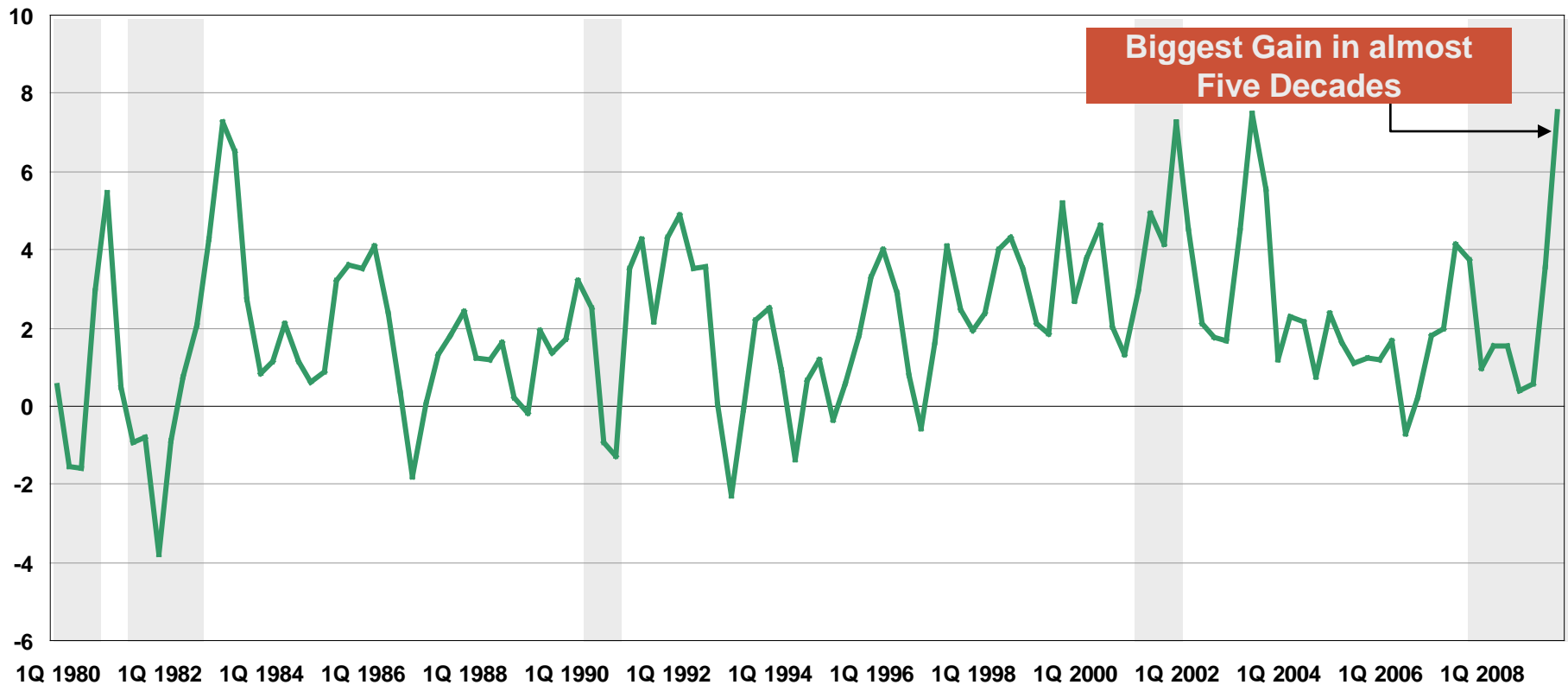


Source: ISI Group.

U.S. Profits

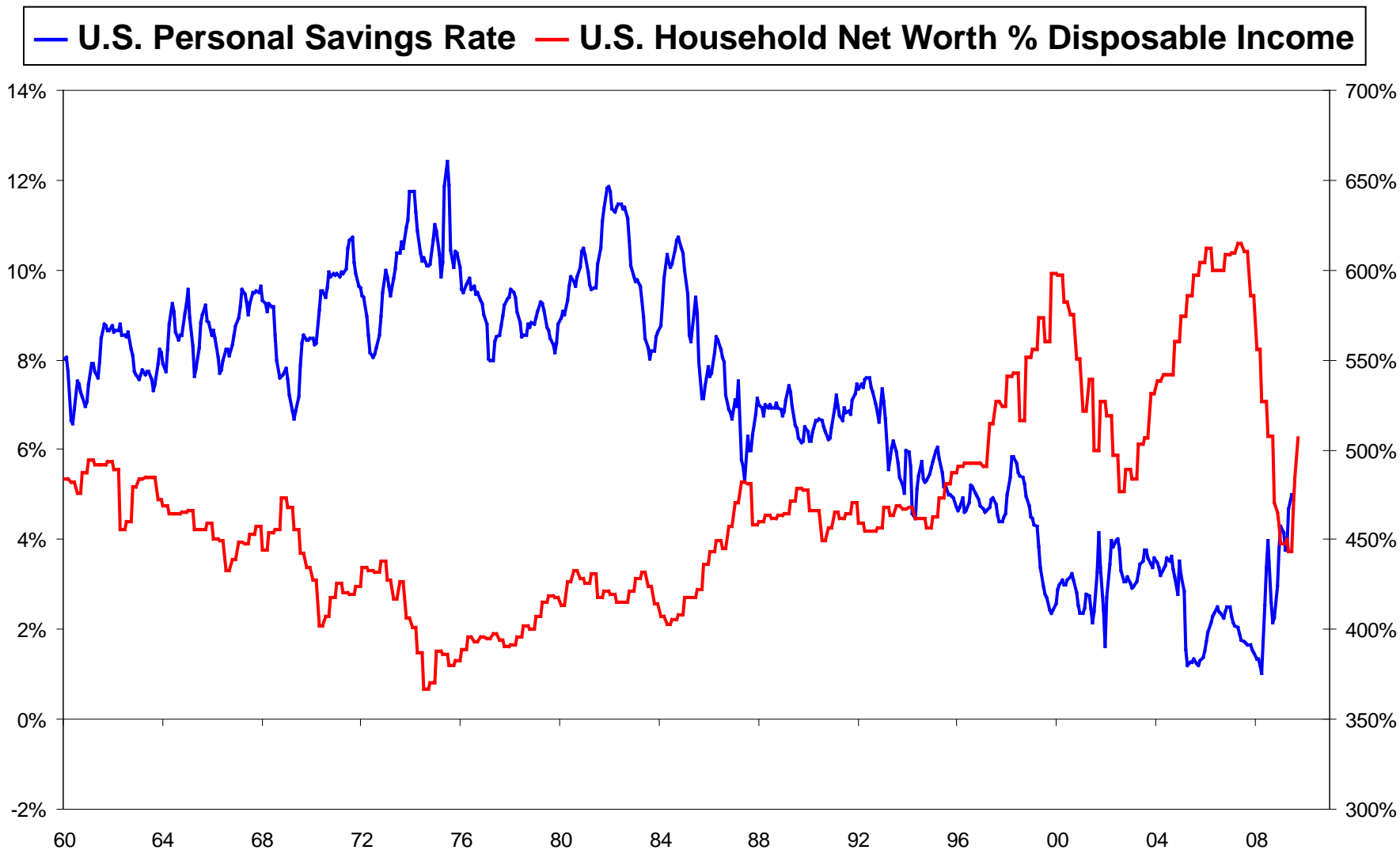
Another Blowout Quarter for Productivity

U.S. Productivity
2 Qtr. % Ch. A.R. 2009:3Q 8.2%



Source: ISI Group.

Increased Household Savings Reduces Spending

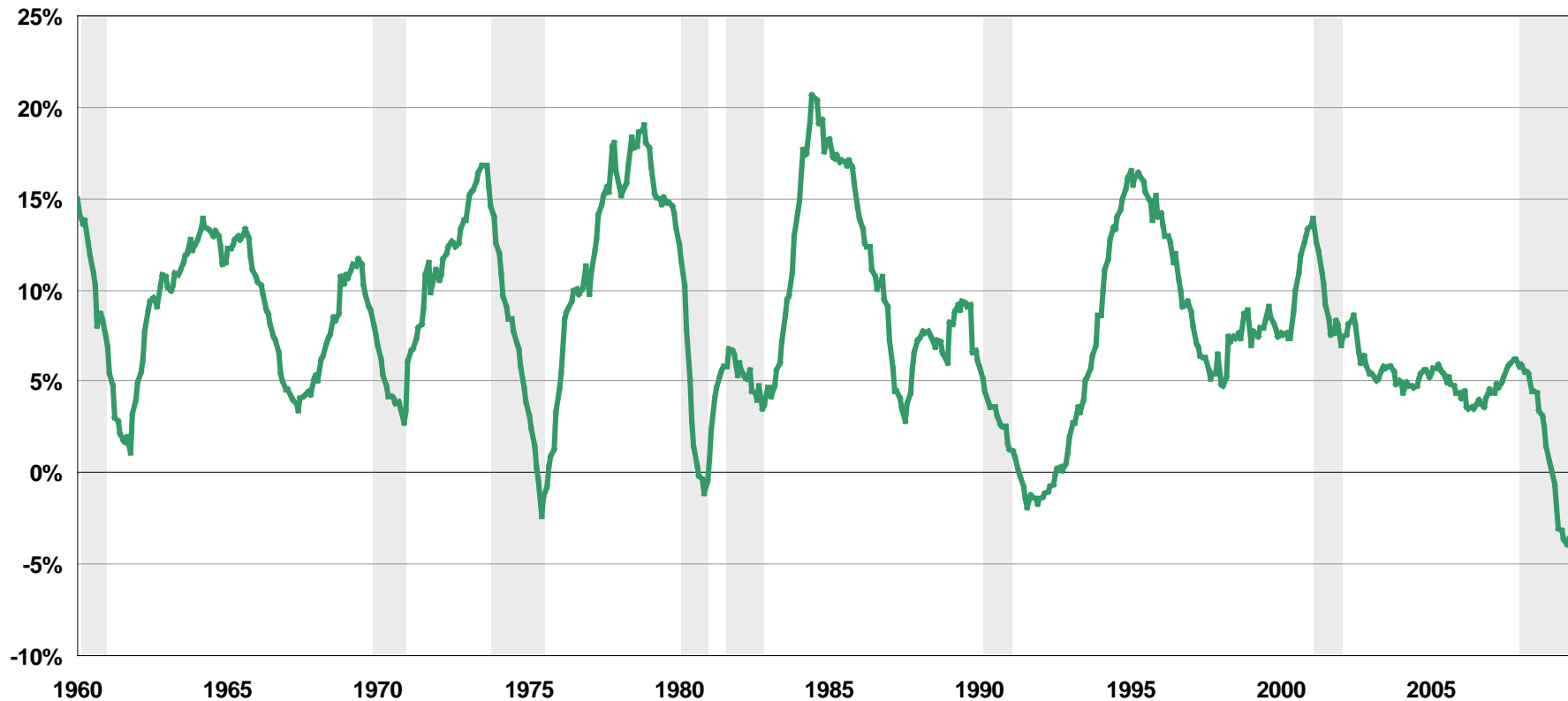


Source: Bridgewater

U.S. Consumer

CID Down a Record Amount Over the Past Six Months

U.S. Consumer Installment Debt
8 Mo. % Ch. A.R. Sep -6.3%

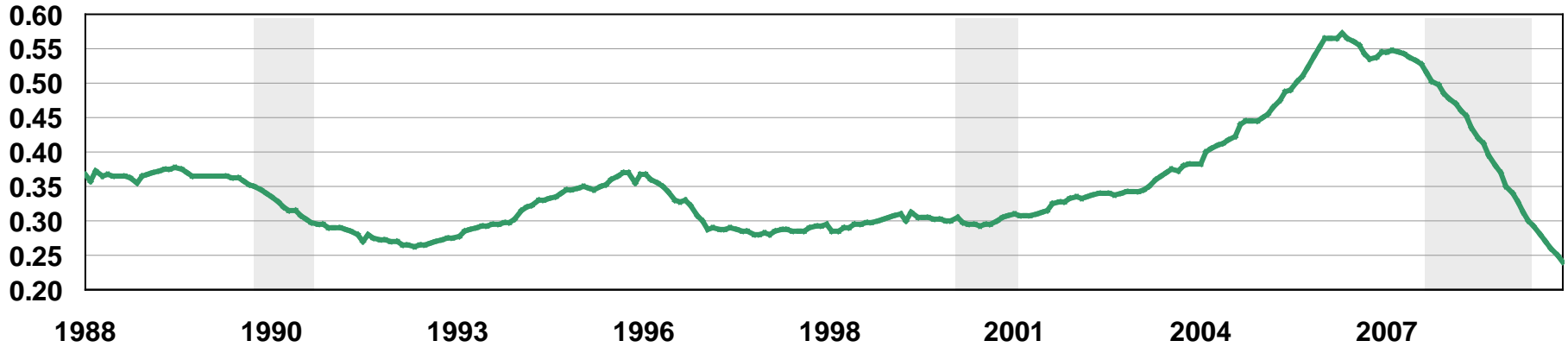


Source: ISI Group.

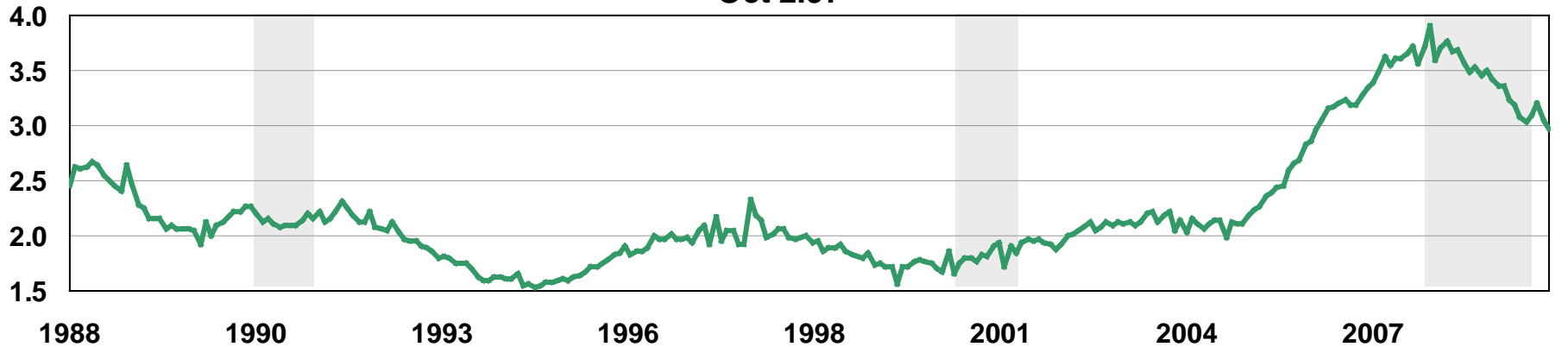
Housing

Inventory of New Houses for Sale at a 38-Year Low

U.S. New Houses for Sale
Oct 0.239



U.S. Existing Houses For Sale
Oct 2.97



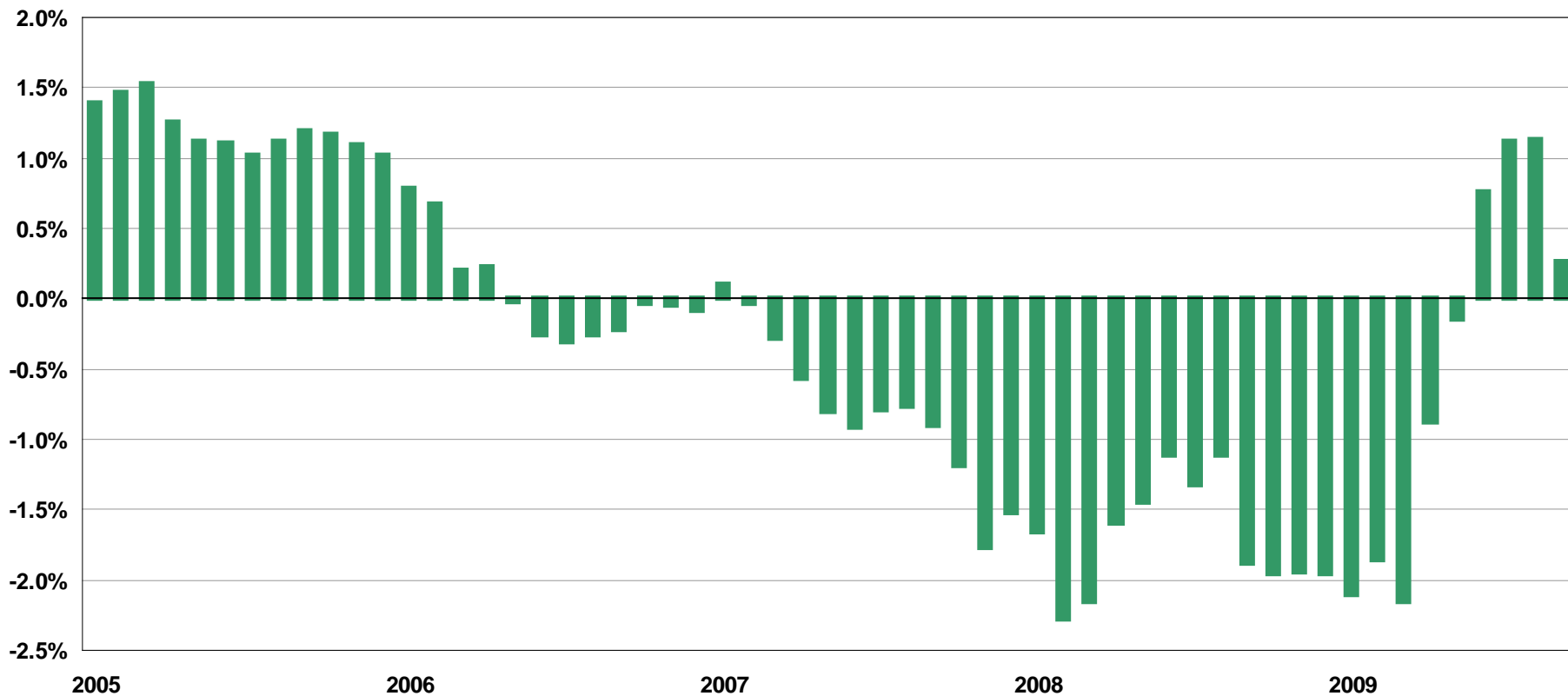
Source: ISI Group.

Housing

Prices Increasing

U.S. House Price Index (Case-Shiller)

SA M/M % Sep 0.3%

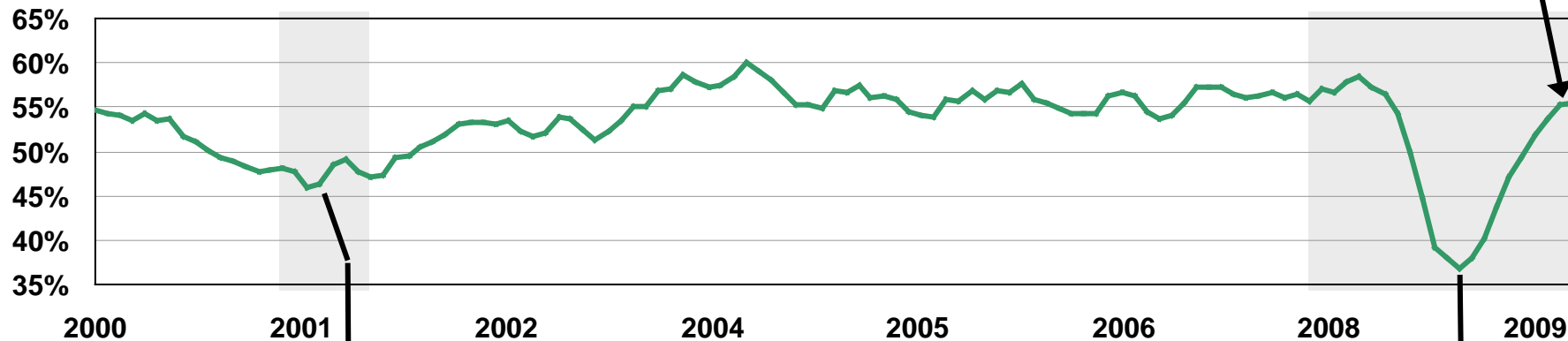


Source: ISI Group.

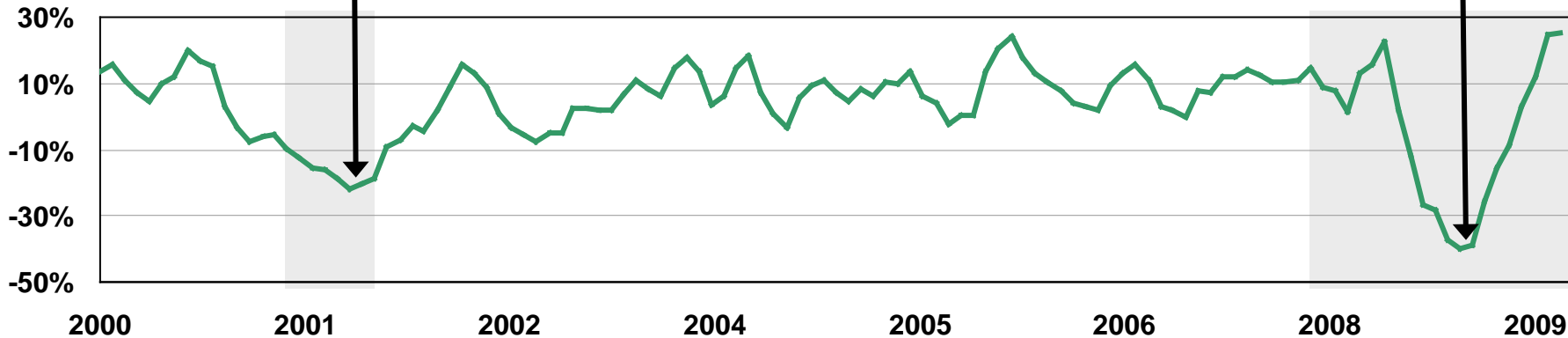
U.S. Manufacturing

Exports Increasing Significantly

U.S. Mfg PMI Export Orders
3 Mo. Avg. Nov: 55.5%



U.S. Real Goods Exports
3 Mo. Avg. 3 Mo. % A.R. Sep: 25.0%

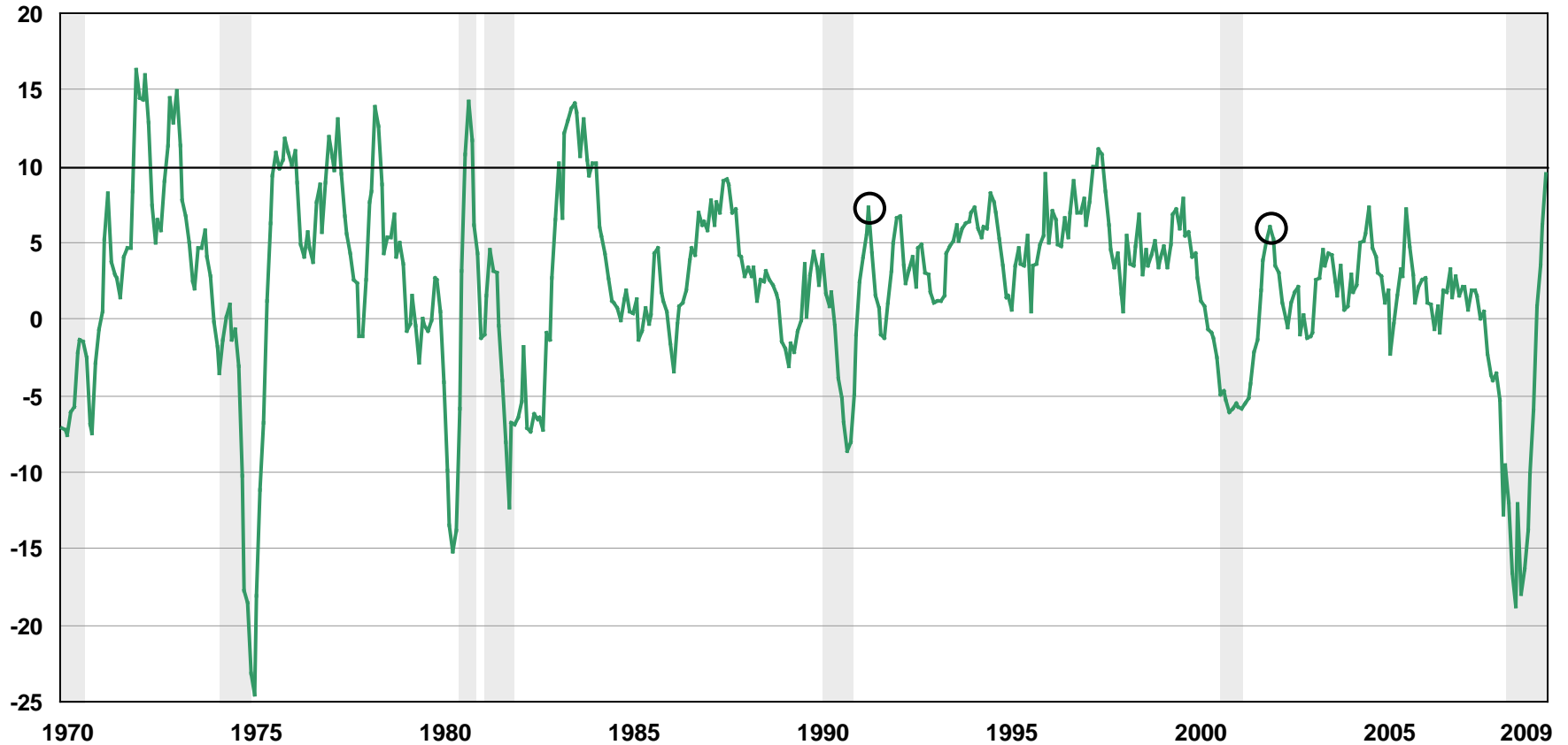


Source: ISI Group.

U.S. Manufacturing

Nov IP Probably +0.6% M/M

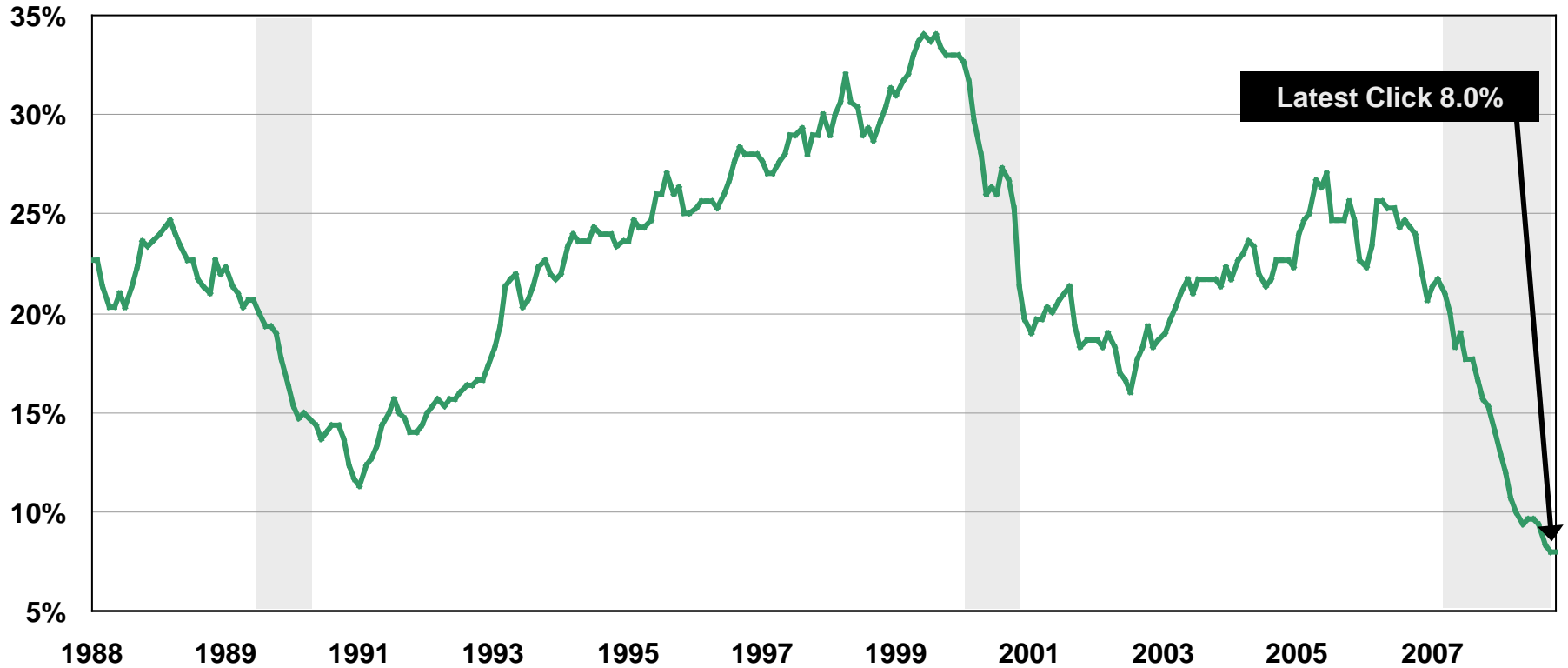
U.S. Industrial Production
5 Mo. % A.R. Nov 8.8% e



Source: ISI Group.

Small Business Not Hiring

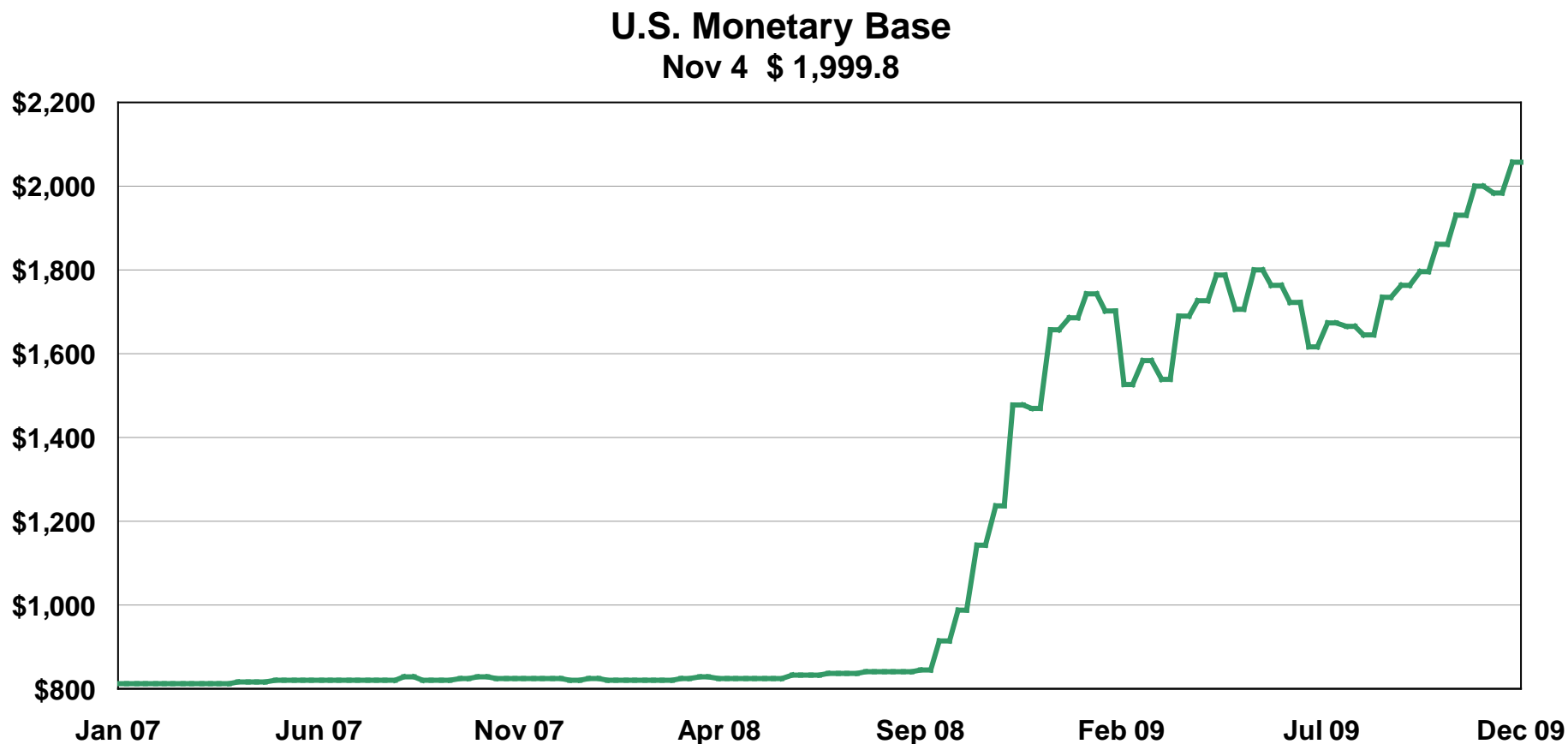
U.S. Small Business Trends (NFIB)
Job Openings 3 Mo. Avg. Nov 8.0%



Source: ISI Group.

Good News

Monetary Base Increasing at a +84.2% Annual Rate

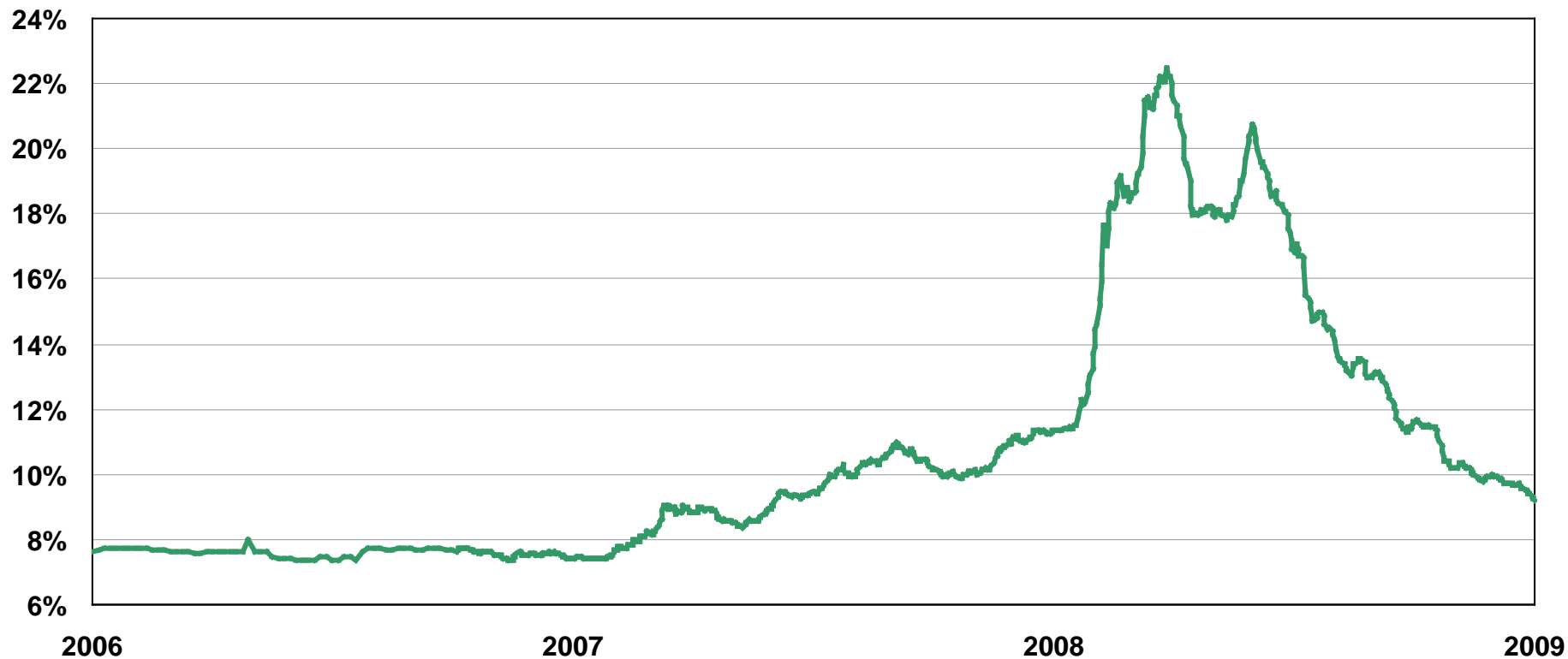


Source: ISI Group.

Money Moving Into Riskier Investments

Junk Bond Yields (Merrill Lynch)

Nov 13 9.82%



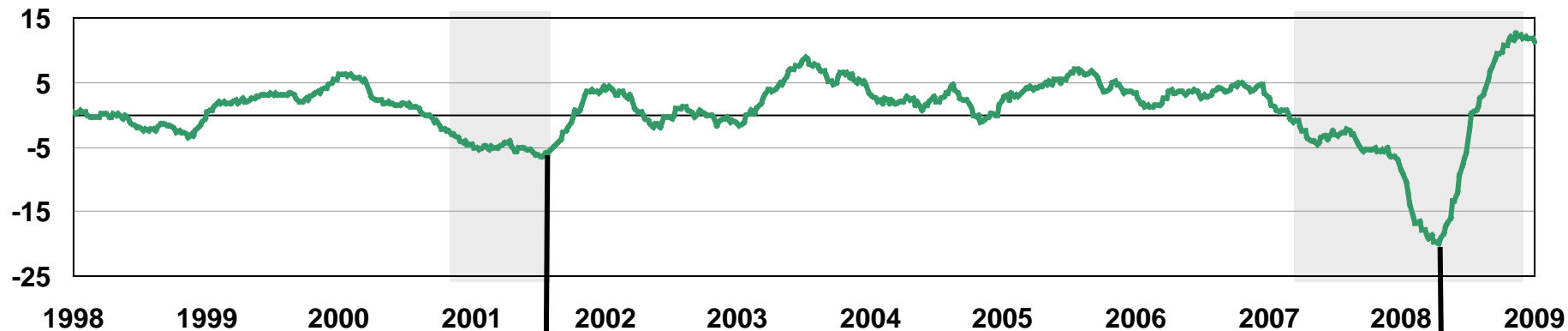
Source: ISI Group.

U.S. Profits

Profits-Led Recovery

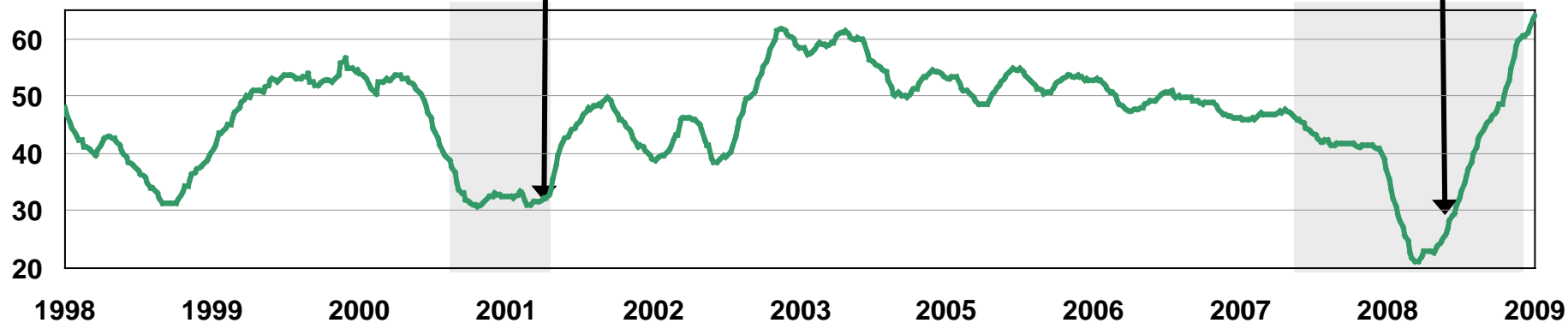
ISI Global Economic Diffusion Index

13 Wk. Avg. Dec 7 11.7



First Call Earnings Revisions Up

SA by ISI 13 Wk. Avg. Nov 27 62.5%



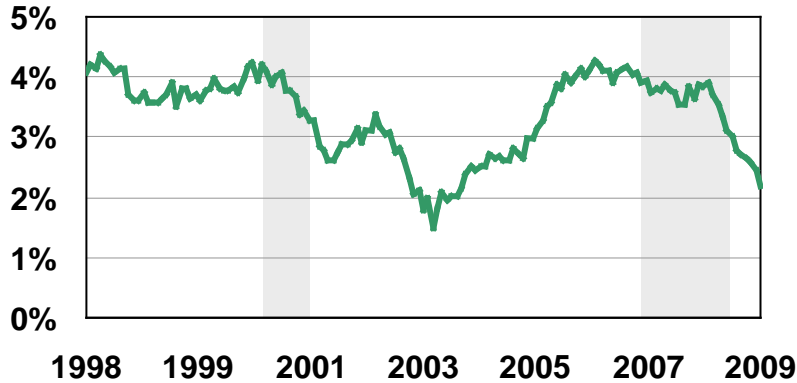
Source: ISI Group.

U.S. Inflation

Inflation Watch

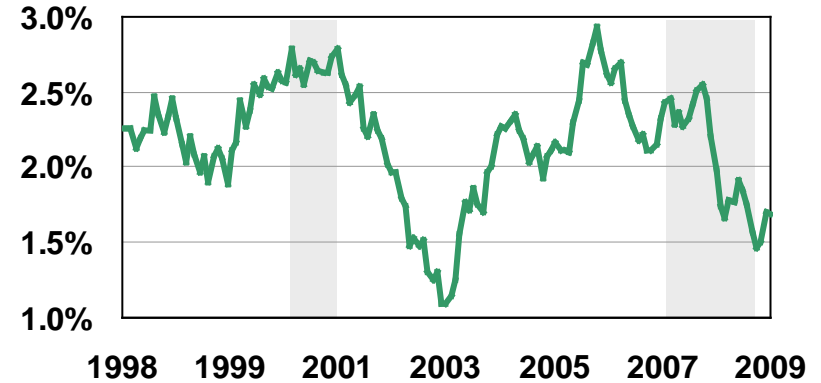
U.S. Average Hourly Earnings

Y/Y % Oct 2.4%



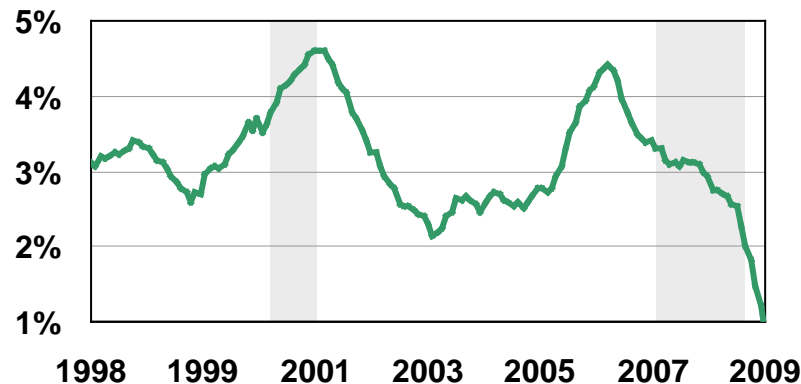
U.S. CPI Core

Y/Y % Sep 1.5%



U.S. CPI Total Rent Rent plus Owners' Equivalent Rent

Y/Y % Sep 1.4%



Source: ISI Group.

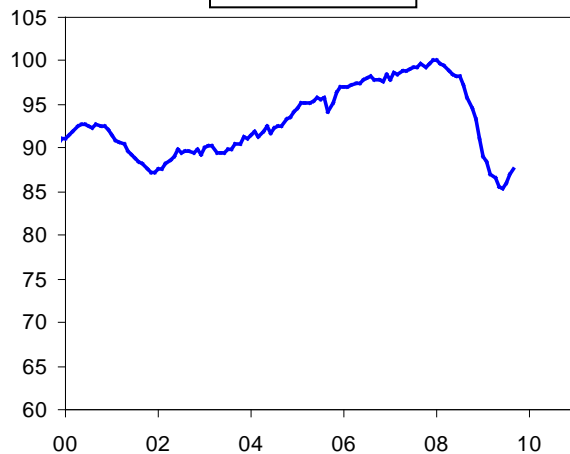
The Rest of the World



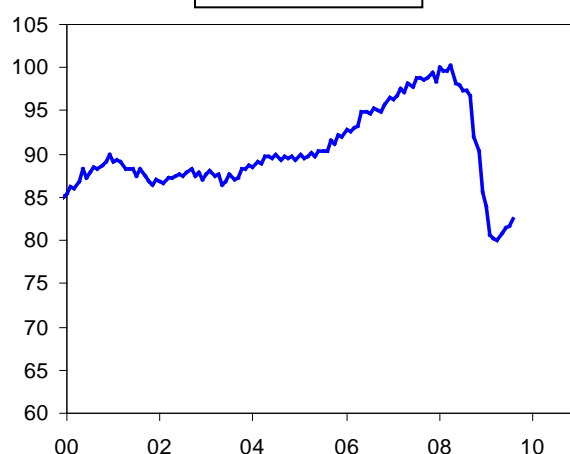
Conditions Have Diverged

Industrial Production Index

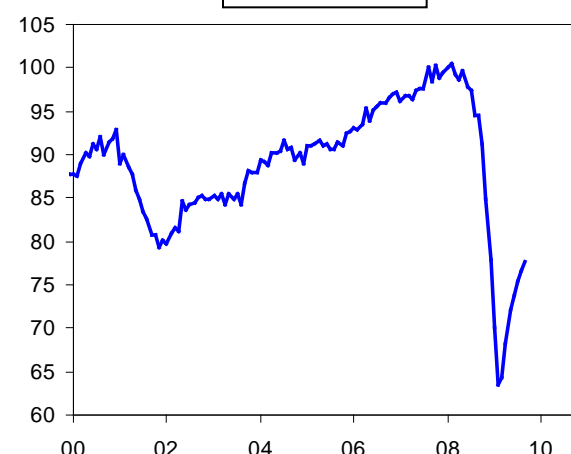
— U.S.A.



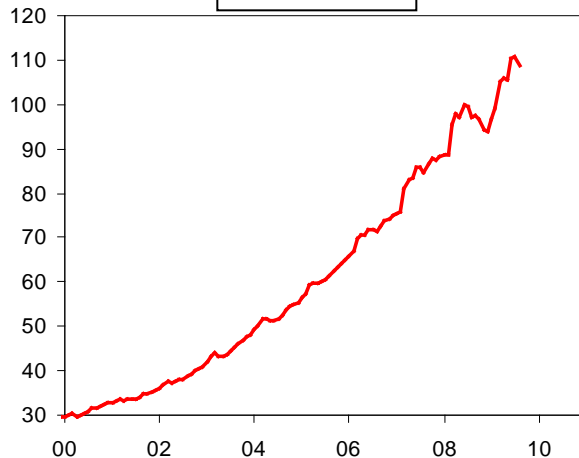
— Europe



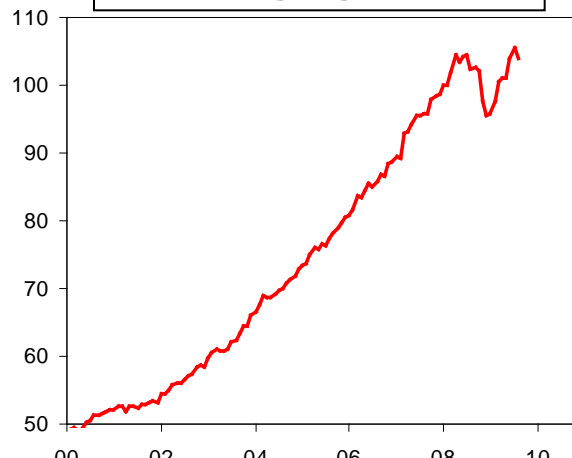
— Japan



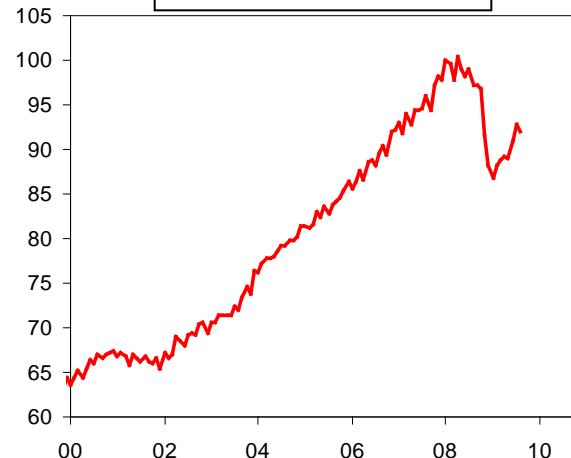
— China



— Emerging Markets



— EM ex-China

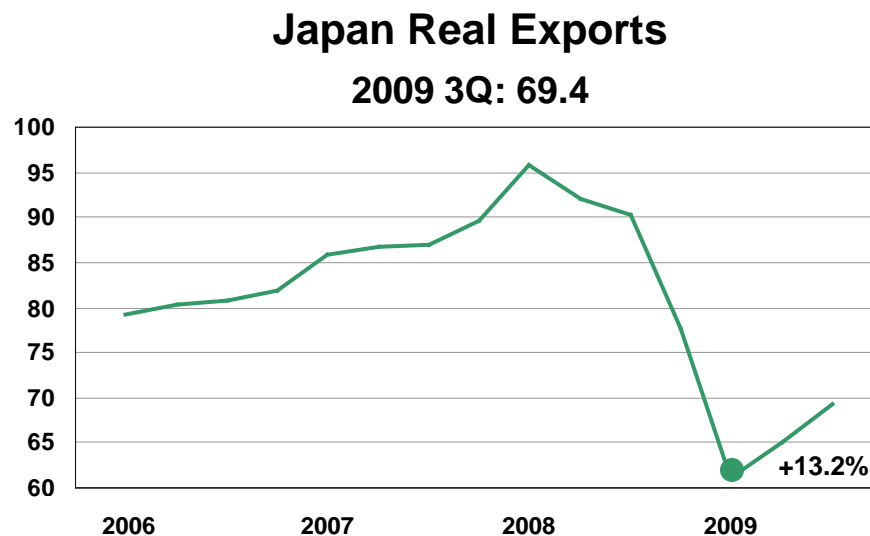


Source: Bridgewater.

Japan Real Exports

Nominal GDP Likely to Remain Weak

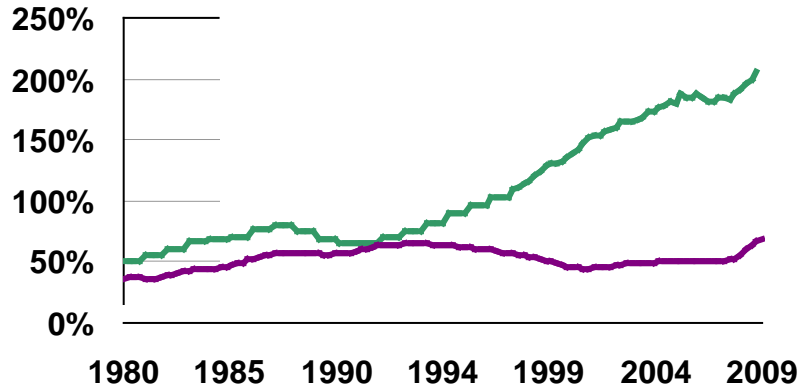
	Q/Q % A.R.		
	Real GDP	Price Deflator	Nominal GDP
2009 1Q	-12.2%	+2.4%	-10.1%
2Q	+2.7%	-4.2%	-1.6%
3Q	+4.8%	-4.8%	-0.3%



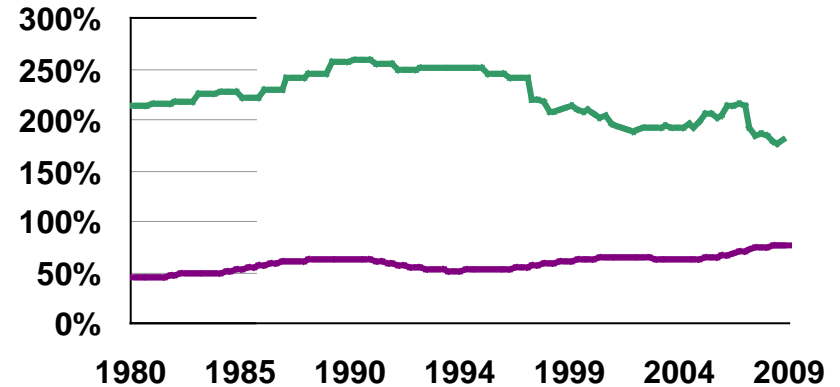
Source: ISI Group.

Japan

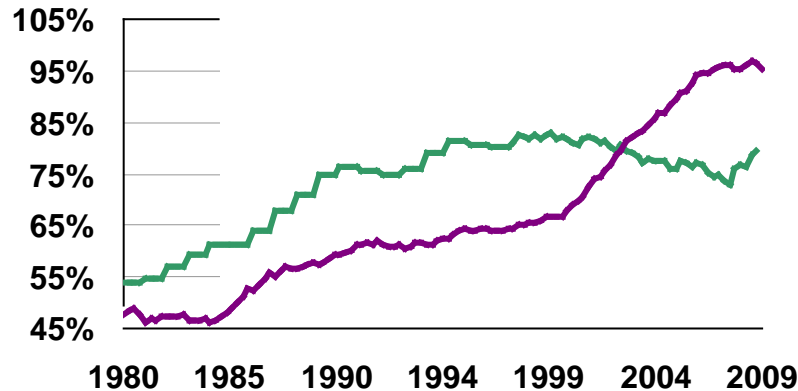
Government and Corporate Debt % GDP Much Higher than in the U.S.



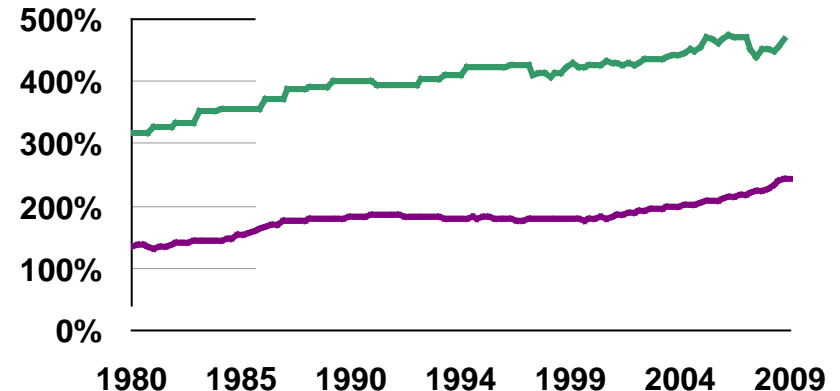
— JAPAN GOVT DEBT % GDP — U.S. GOVT DEBT % GDP
2009:2Q: 204.4% 2009:2Q: 67.0%



— JAPAN NONFIN CORPORATE DEBT % GDP — U.S. NONFIN DEBT % GDP
Debt Securities and Loans
2009:2Q: 178.3% 2009:2Q: 77.3%



— JAPAN CONSUMER DEBT % GDP — U.S. CONSUMER DEBT % GDP
2009:2Q: 78.6% 2009:2Q: 96.5%

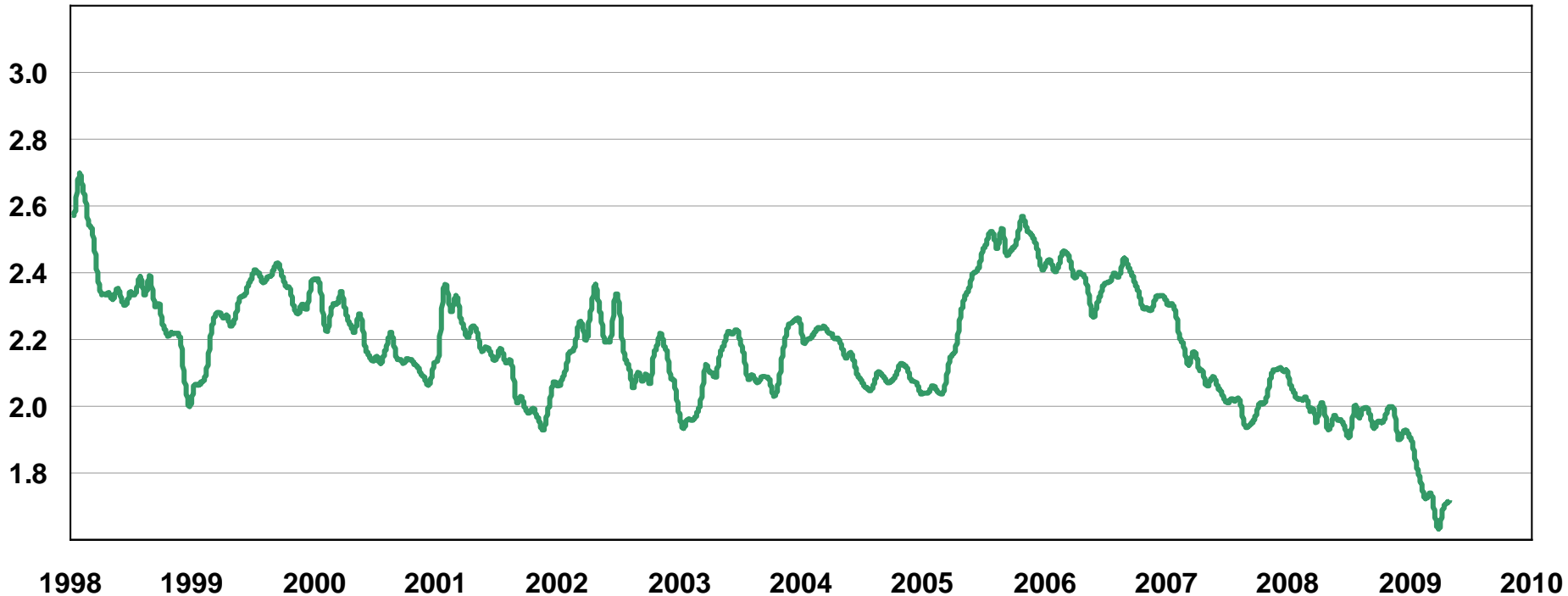


— JAPAN NONFIN TOTAL DEBT % GDP — U.S. TOTAL DEBT % GDP
2009:2Q: 461.3% 2009:2Q: 242.5%

Source: ISI Group.

Severe Underperformance From Japanese Equities

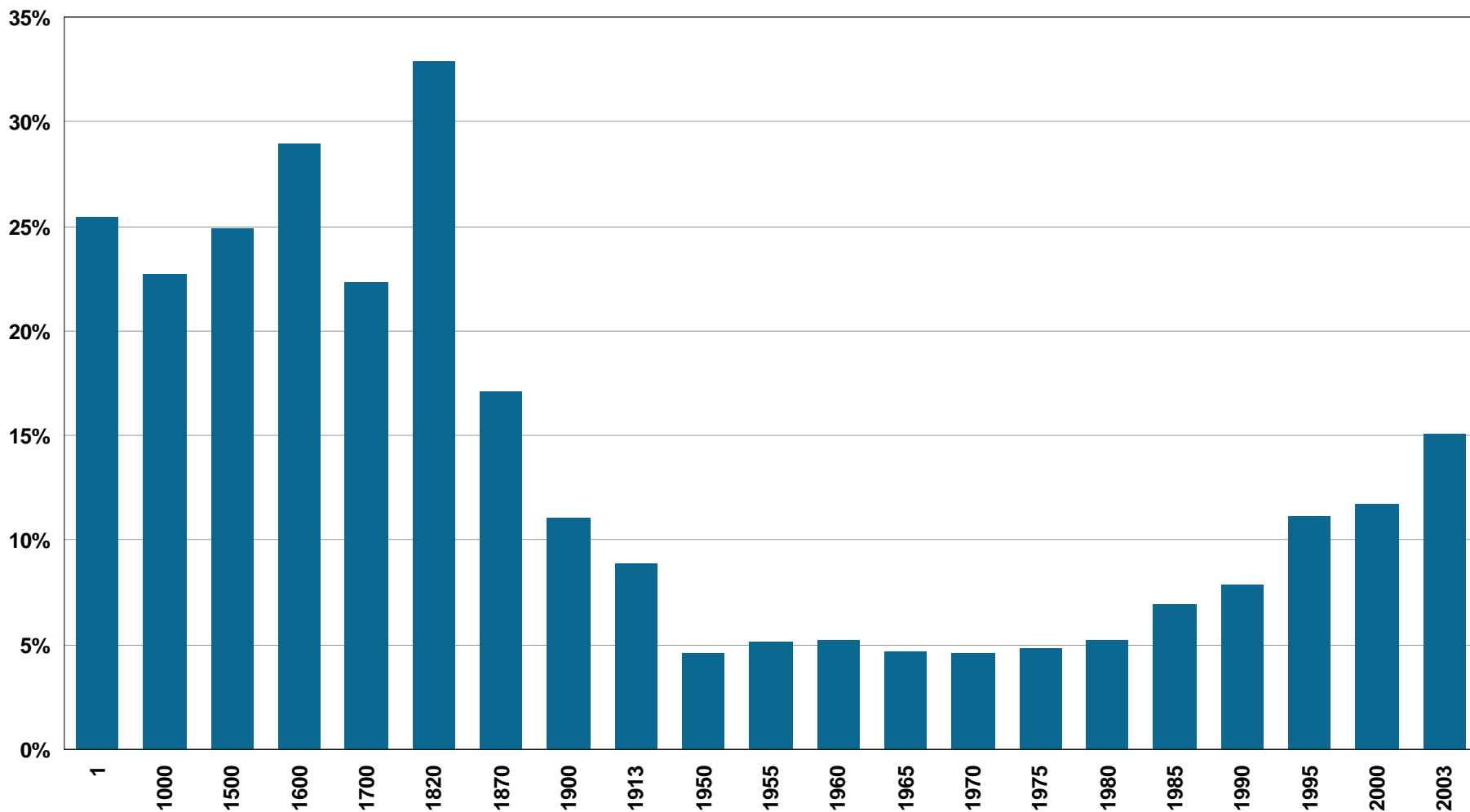
Japan MSCI Index Relative To World MSCI Index



Source: BCA Research 2009.

The 20th Century was a Growth Anomaly For China

% of World GDP

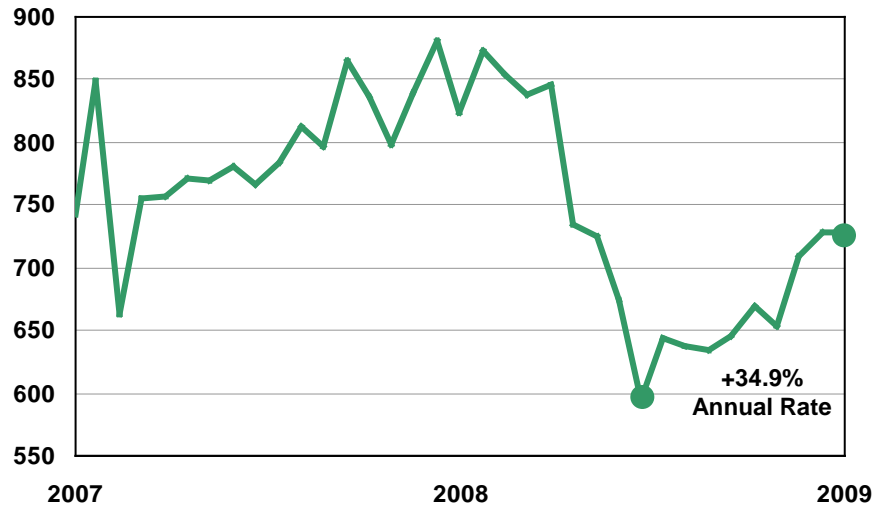


Source: Historical Statistics for the World Economy – Angus Maddison, J.P. Morgan Securities, Inc.

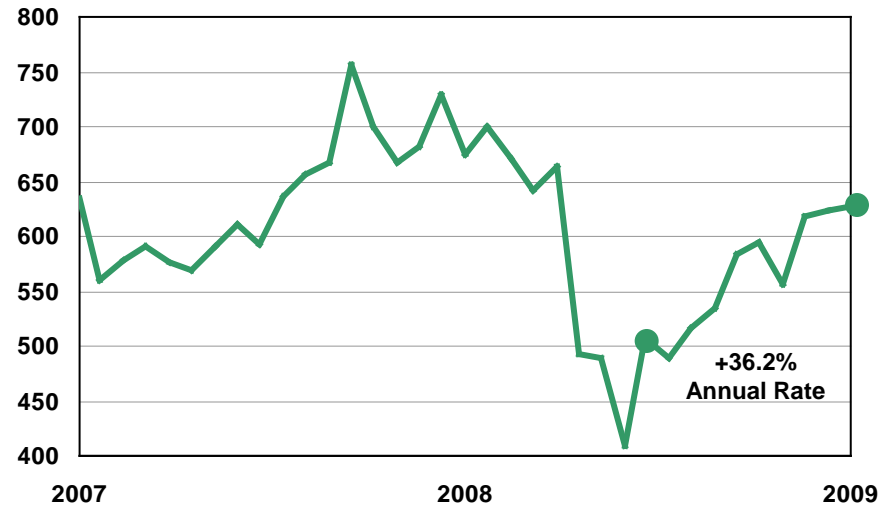
China

Another Package of Strong China Data

China Exports
S.A. by ISI, Oct 725.8

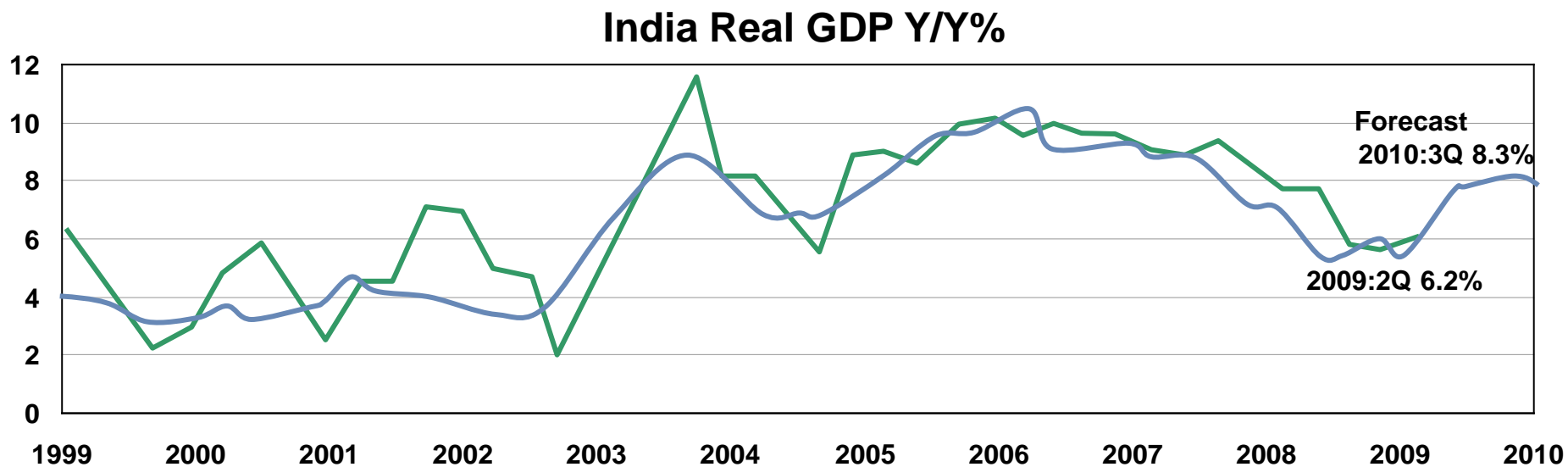


China Imports
S.A. by ISI, Oct 622.6



Source: ISI Group.

GDP Set to Reaccelerate



Source: ISI Group.

Brazil

GDP Set to Reaccelerate



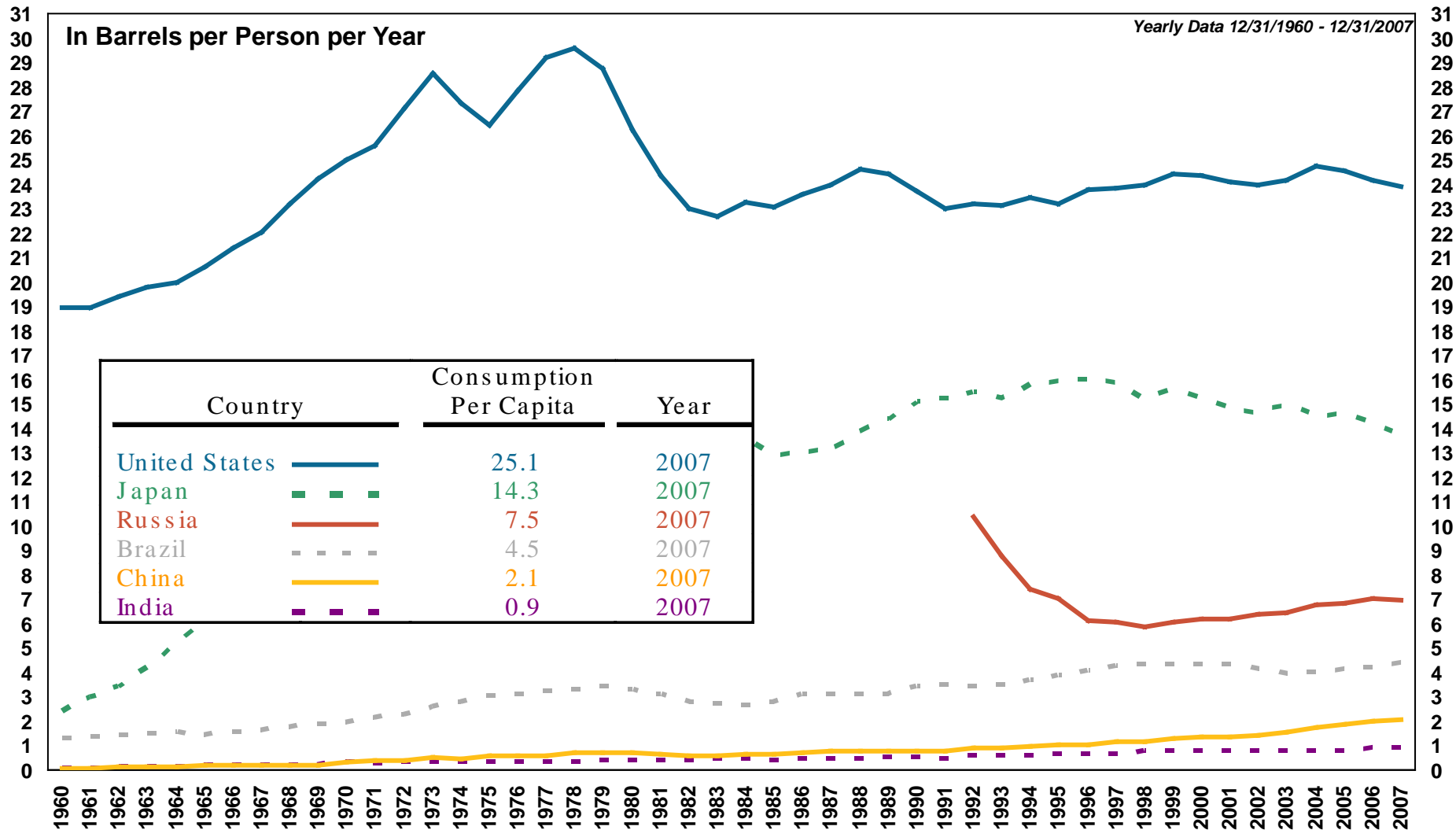
Source: ISI Group.

Some Thoughts About the Price of Oil



Long-Term Demand Drivers Are Still in Place

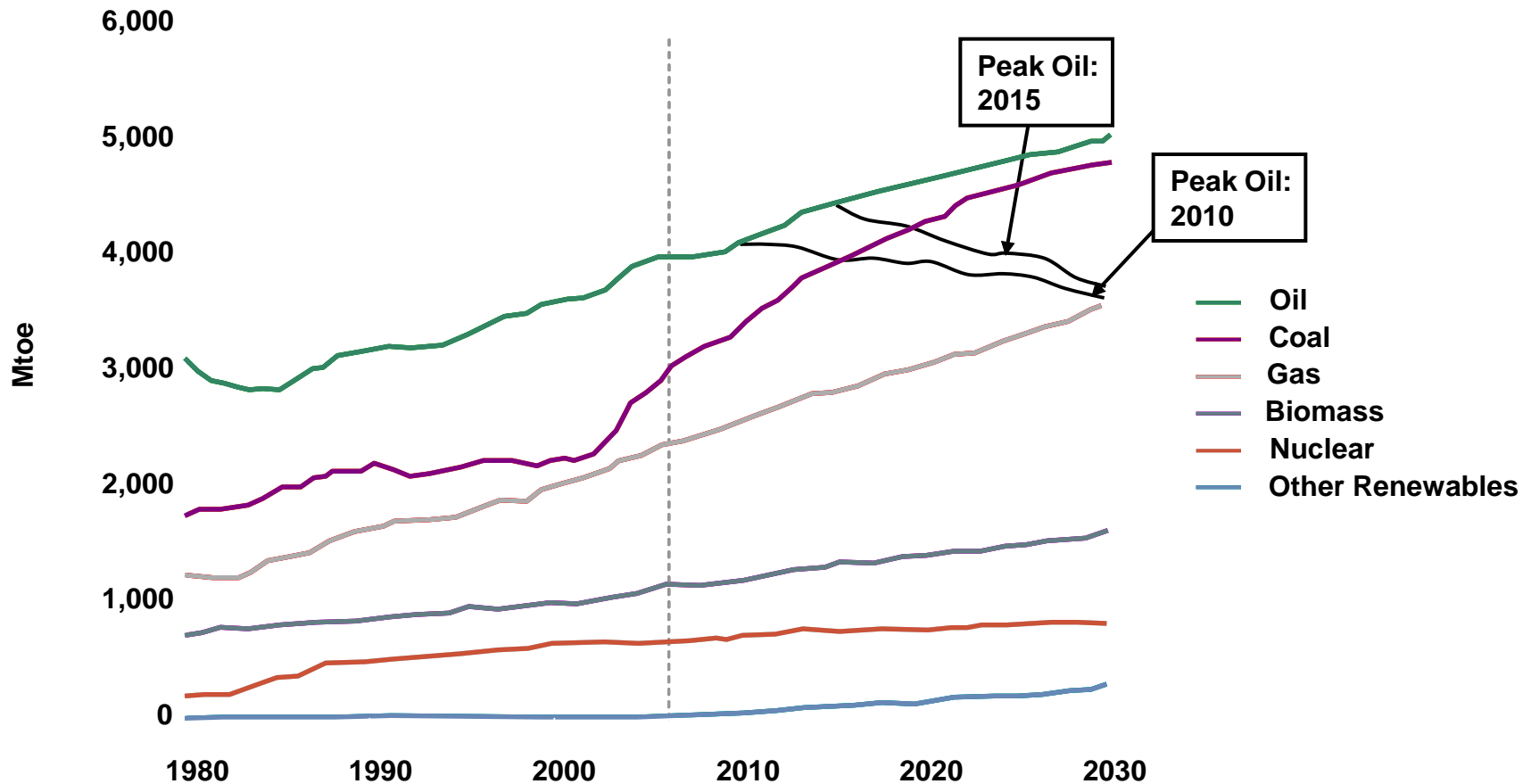
Petroleum Consumption per Capita for Selected Countries



Sources: Energy Information Administration and U.S. Census Bureau. Ned Davis Research.

Oil Supply / Demand Prospects

World Primary Energy Demand







World energy demand expands by 45% between now and 2030 – an average rate of increase of 1.6% per year – with coal accounting for more than a third of the overall rise

Source: IEA World Energy Outlook 2008. Bank of America Merrill Lynch.

Oil Supply / Demand Prospects

BRIC and Middle East Demand Outlook

(in Mmbl/d)

	2008 Demand	2030E Demand	Increase
 Brazil	2.4	3.6	+1.2
 Russia	2.9	3.9	+1.0
 India	3.1	7.3	+4.2
 China	7.9	17.0	+9.1
Middle East	<u>5.9</u>	<u>10.0</u>	<u>+4.1</u>
Total	<u>22.2</u>	<u>41.8</u>	<u>+19.6</u>

Conclusions:

- (1) Competition for oil supplies between emerging markets and mature countries is potentially a problem
- (2) The world needs and will actively seek out demand “Game Changers”

Source: IEA World Energy Outlook 2008. Bank of America Merrill Lynch.

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