Dave Hutchison, CERTIFIED FINANCIAL PLANNER™

1720 E Calle Santa Cruz
Phoenix Arizona 85022

HUTCHISON INVESTMENT ADVISORS
Registered Investment Advisor
Founded on a CPA Firm Background

E-mail:dave@davecfp.com
602-955-7500
Fax 602-955-1458

Market & Economic Update - January 2011 - Still a Buying Opportunity
Sharp Improvements in Economic Data – Diluted Market Response So Far

You would have to be a dyed-in-the-wool pessimist not to be encouraged by the recent spate of economic data.

Major indexes ended the first week of trading in the new year higher, making it the sixth straight week of gains.

In the first week the ISM Index showed that the manufacturing sector expanded for the 17th straight month. Factory Orders, Construction Spending, and the ISM Service Index all beat estimates.

Conflicting Jobs Reports

The 1/7/2011 government jobs initial estimates for December, based on household surveys was not as strong as the ADP report based on payroll data. While government job losses continued, the private sector increases resulted in 103,000 new jobs created in December.

The prior two months jobs estimates were revised upward 70,000. We added 1.3 million jobs in the private sector in 2010, with growth every month in the private sector. The 4th quarter 2010 had the most job growth in almost 4 years.

Morningstar says that if you adjust for working longer hours and somewhat higher income 1 million new jobs in 2010, is equivalent to closer to 3 million new jobs. However, we had four million job losses in each of the previous two years so we still have about 10% unemployment which also reflects population growth and new young people entering the job market.

Economists surveyed by CNNMoney forecast an average of 2.5 million jobs added this year, which would be the best one-year gain in hiring since the white-hot labor market of 1999.

The trend continues of private sector job growth vs the ongoing declines in government employment. As the stimulus to state and local government ends the loss of government jobs may accelerate.

Market Attitude Turning Positive

CNBC reports, there has been a change of market attitude and now pullbacks are seen as buying opportunities. However, volume remains weak and for the most part retail investors are still out of the market. They tend to come back in after they miss the large initial recovery gains in a market upswing. But the current upswing could last for years since market valuations are so low. Corporate earnings growth is expected to continue. Treasury bonds continue to have losses as interest rates slowing tick up, which is expected to continue.

Gold plunged as optimism about the global economy dims the metal's appeal as a safe haven when stocks are so undervalued vs. the long running gold bubble with no fundamental basis.

GDP Nearing Pre-Recession Level **(As are corporate profits but market has lagged)**

Norman Fosback, editor of Fosback's Fund Forecaster, says, "The Great Recession has now been completely overcome: The United States economy (total inflation adjusted GDP) is today back to where it stood at its peak prior to the Great Recession of 2008-2009...or a few weeks away." The GDP data is released a few months after the end of each quarter, but projecting from the 9/30 GDP data it appears we are now near a new high.

You'd think that the complete recovery from the worst economic downturn since the Great Depression would be big news. But it hasn't been widely picked up by the mainstream press. We continue to have extraordinary pessimism enveloping the consumer investing population. That has played a big role in holding the stock market back from even bigger gains in recent months. There are signs that institutional "smart money" is slowly starting to move out of bonds and into equities. But the potential amount of funds that is out of the market is still huge. The smaller retail investor is still missing in the market recovery.

Even though the economy is now back to pre-recession levels, the major stock-market averages are not even close as the market remains under valued - a good buying opportunity. As a result of investors extraordinary pessimism, still in fear, gripped by financial post-traumatic stress left over from the 2008 crisis, the bull market will likely last longer than it otherwise would have if investors had more quickly jumped on the bullish bandwagon.

Fund Flows & Outlook

Domestic equity mutual funds sputtered into the end of 2010 with 33 straight weeks of net outflows even though global equity funds recently have seen net inflows, according to TrimTabs market research.

Despite a 12 percent gain in the S&P500[1], fund investors in 2010 were putting most of their money into bonds, which until December were seeing inflows of $25 billion a month. Fund flows are generally seen as the best gauge of where retail and institutional investors are putting their money, while individual stocks and ETF's are more often the playground of short-term traders.

The trend lately has been for money to come out of bond funds. The belief is that the flow out of fixed income will lead more investors into U.S. equities

CNBC.com 12/29/2010: "Predictions for the year ahead have the S&P 500 gaining anywhere from 10 to 20 percent, with much of that predicated on accommodative monetary policy from the U.S. government and a continuing recovery for the U.S. economy. "The U.S. investor has poured so much money into bond funds that the trend is bound to change. The funds that flow out of bonds are going to go in a high proportion right into U.S. large-caps."

Recovery is Mostly Global[2]

CNBC "Closing Bell" reports: Crude oil continues to soar in price anticipating the global recovery and increasing oil demand in improving economies. The Kuwait Oil Minister said the stronger world economies can handle $100/brl oil.

The global economies (ex parts of Europe and Japan) should see stronger recoveries (estimated 5.5% average global GDP growth in 2011), that can absorb higher interest rates. Consensus is to avoid bonds (other than some emerging market debt and carefully selected high yield) and overweight stocks.

In a CNBC panel all agreed on stronger growth globally, but differ on foreign vs. U.S. opportunities. One view is that with a stronger U.S. economy and higher interest rates, the dollar will remain strong which hurts foreign earnings in $US. The other view is the dollar will weaken again due to the high level of U.S. debt, which helps foreign earnings.

China increased interest rates slow inflation - may have ideal situation with lower inflation but may still have GDP growth of close to 10%. The Asian strength isn't just in China - but also in South Korea, Singapore, and "all the Asian economies that are absolutely booming." The U.S. will be stronger but it's the emerging markets that will be the leaders in global growth. U.S. companies that sell to emerging markets may be especially timely since U.S. unemployment will hold back the U.S. from even stronger growth in 2011. "Even though our demand picks up it is going to be dwarfed by what is going on outside the U.S." (Bob Froehlich's view)

Another view (Ron Insana CNBC's senior analyst) is that the U.S. consumer now is so strong, plus the huge stimulus package just passed, that there is "more strength to the economy than many people realize…I like emerging market debt...But I still think the U.S. is the place to be for next year."

Trading volume has been extremely low leaving the market mostly to short term traders not long term investors.

2010 Market Swings

In early 2010 the economy was starting to recovery at a faster pace and estimates were for about 4% GDP growth for the year. But that turned out to be a mirage after the European debt crisis, the Flash Crash mostly with ETFs (which I have never recommended), and the popularity of "Dr Doom" and other pessimists that resulted in a "doom and gloom" outlook and fears of a "double dip recession." resulting in large market losses

By 2011 those fears proved to be unjustified. Even with lagging employment gains, the ongoing housing crisis the consumer and business started spending again. As Morningstar points out, "The consumer has been exceptionally strong here the last two quarters, and I think that's what's really got everything rocking and rolling again. They seem to have a greater willingness to spend, and they've got some of the income to do that, too; the income numbers have been getting better."

Inflation has remained low - too low - for the Feds target of 2% resulting in the "Quantitative Easing" policy to crowd out the Treasury market to divert record amounts of cash to more productive uses in the economy.

U.S. debt levels currently are a non issue with huge demand for U.S. debt far exceeding the amount of new debt available. The TARP profits and repayments have reduced Treasury borrowings below initial estimates. Long-term the debt will need to be dealt with - a stronger recovery will help the most, since tax revenues are increased without an increase in tax rates.

Housing Crisis Continues

The housing foreclosure crisis continues and while painful it affects a small percentage of the population. The problem is the banks are doing all they can to foreclose instead of doing mortgage modifications for those that should qualify. The bank "servicers" rarely own the loans and make far more money on foreclosures than on the modification incentives.

For most U.S. mortgages the taxpayer takes the huge foreclosures losses (via the GSE's) or investor mortgage pools. Banks are making billions in profits by mostly ignoring the Treasury directives for the various modification programs. Banks lose documents repeatedly sent in by homeowners even when sent by Congressional Offices, Since the Treasury programs are not laws, but created as part ot TARP, there is little that can be done to force banks to follow their participation agreements. Many lawsuits, including class actions, have been filed against the major banks for fraud, and violation of state consumer laws.

Morningstar's 2011 Outlook

Robert Johnson director of Economic Research with Morningstar summed up the 2011 outlook "Quarter-End Insights" 12/28/10. Highlights:

"I believe the economy is now at a tipping point, about to move into a stronger, more sustainable recovery. Until the third quarter of 2010, consumer spending had been increasing at a steady but anemic 2% pace, which was not enough to really get the virtuous cycle going with gusto. The cycle was slowed due to remarkable productivity gains during the recession and consumers propensity to spend a lot of their extra dollars on foreign goods. However, things began to change in the third quarter of 2010 as consumer spending accelerated to almost 3%, and early reports suggest it could accelerate to as much 4% in the fourth quarter driven by the strongest holiday season since 2005. Recent trade data suggest that more of those dollars are being spent on U.S. products as well."

"A lot of firms probably could limp along at 2% consumption growth without having to hire a lot of new people, given a typical 1% productivity increase and the fact that some of that demand was satisfied by overseas factories. However, with 3% to 4% growth, better hiring rates are in the cards. Higher employment levels and higher asset prices, combined with a substantial (though largely unrecognized) improvement in consumer financial positions and lower payroll taxes should continue to drive the consumer forward in 2011."

"I believe that continued growth in emerging markets, a stronger U.S. economy, and rising commodity prices will drive inflation up by 2% or more, versus about 1% in 2010. A stronger U.S economy combined with modestly higher U.S. interest rates in 2011 are also the backdrop for a stable to modestly stronger dollar, despite some legitimate questions about very liberal U.S. fiscal and monetary policies. The stronger economy will also be responsible for higher interest rates in 2011(and bond losses), despite the Fed's best efforts to keep rates down."

"Emerging markets are another common theme for both 2010 and 2011. Whether its factory capital equipment or fast food, emerging markets remain key growth areas as those countries boast growth rates that are two or three times higher than those found in developed economies. A growing middle class further cements the opportunity in these markets."

Summary – *Although markets will continue to have short term corrections based on daily events, some have called the current equity market the timeliest in perhaps a generation for potential gains over the next few years.*

Although the outlook is good, there are market risks. I recommend alternative opportunities without stock or most bond market exposure for more cautious investing, as well as more aggressive recovery opportunities. Most U.S. bonds have high interest risk since they decline in value when interest rates return to more historical norms.

My Approach - I do not recommend “dumb” index funds[1] or ETF’s where you are tossing your dart at companies. I recommend managers with long track records of outperformance (Alpha in Modern Portfolio Theory) vs. risk taken (Beta) among other important factors.

As there are always market risks, I recommend participate yet protect as much as possible strategies depending on individual investor objectives, investment time frame and risk tolerance.

I continue to be proactive, suggesting changes as warranted, to take charge of investment opportunities – in other words to avoid becoming a victim of static allocations, models or just index investing.

“Participate yet Protect"- Most of our clients need reasonable growth to fund 20-30 years of active, healthy retirement and need some protection strategies from large market losses. A 65-year-old American couple has a 50% chance that one of them will live at least 27 years to age 92 (Source: On Wall Street, SOA).

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Prudent diversified investment recommendations and low fees

We suggest “Participate yet Protect" investment strategies

Customized & personalized for your individual objectives and risk tolerance

We Take Your Financial Future Seriously

[1]Investors cannot directly invest in indices. Past performance does not guarantee future results.

[2]Additional risks are associated with international investing (especially in developing countries), such as currency fluctuations, political and economic stability, and differences in accounting standards