

2010

OUTLOOK



By Bob Landaas

# INVESTORS FACE A NEW NORMAL

One year ago in this magazine I wrote that stocks were near their bottom. Two months later, the equity markets began their comeback. The S&P 500 index is now up 62 percent from the lows of last spring. As the economy emerges from the longest and deepest recession in more than 70 years, investors face a deep divide among economists and market strategists.



# ON BALANCE

■ we have those who argue for a “V” shaped recovery, a severe downturn followed by a strong upturn in economic activity. The other group has coined the term “new normal,” a change in the economy that will bring much slower growth and significantly lower asset returns. The implications for investors are enormous.

For now, the “V” shaped crowd seems to have the upper hand. After four quarters of contraction, the economy grew at a 2.8 percent annual rate in the third quarter of 2009. This higher-than-expected growth brought huge returns in the equity and fixed income markets. Unfortunately, much of the economic growth came from government stimulus and incentives such as Cash for Clunkers and the first-time home buyers tax credit.

With the economy still weak, I wonder about the health of the “patient” once we remove the life support of government intervention. Historically, deep recessions tend to be followed by steep recoveries. However, studies show that recessions caused by a credit crisis tend to recover at much slower rates.

The “new normal” group says the United States is in for a prolonged period of below-average growth and that recent growth is not sustainable. The

“new normal” crowd argues that we are unlikely to return to accelerating use of leverage and financial innovation that, when pushed to extremes, helped create the financial crisis. This new era of deleveraging, along with re-regulation, will serve to limit economic growth and corporate profits.

While it’s difficult to forecast during periods of economic disruption, I believe the economy will experience anemic growth for the foreseeable future. Massive fiscal and monetary stimulus stabilized the economy and allowed it to grow in the second half of 2009. Reductions in government stimulus mean that today’s good news is temporary. The inventory rebuilding cycle has also helped the economy, but it won’t be enough to sustain current levels of growth.

Deleveraging has had a profound effect on financial institutions, and we are only halfway through the process of unwinding debt. This will serve as an added drag on growth. Banks are still rehabilitating their balance sheets and, as a result, have restricted their lending. This will not change until losses in residential and commercial real estate are better quantified, which will take time.

Traditional asset allocation models based on modern portfolio theory need to change to more forward-looking allocation models based on changes to the economic landscape. Low federal funds rates have helped to push asset prices higher. This monetary stimulus will eventually end. When the Federal Reserve System tightens rates this year, it will also serve as a headwind for the economy. As a result, there may be more chance of downside risk than upside potential for many asset classes.

We can imagine numerous investment themes based on our outlook of slower growth. This environment will clearly favor high-quality, yield-oriented stocks rather than those focused on growth. Lower-quality stocks led the markets higher in 2009. This is common in recoveries, as those stocks that are punished the most in the downturn recover first.

Low-quality securities tend to flame out within the first year of recovery with the baton passing to the higher-quality blue chips. Large-company stocks remain cheaper than their historic averages and on a relative basis are more attractive than small-company stocks.





# A MAJOR INVESTMENT THEME

at my firm is our intense focus on international equities and fixed income. Dollar weakness should continue primarily as a result of our large budget and current account deficits. This trend favors unhedged foreign stock funds and non-dollar denominated bonds.

The best ways to protect your portfolio from a falling dollar are foreign stocks, foreign bonds, and commodities. Big American companies that earn much of their revenue outside of the U.S. may do better as the dollar drops. Companies that repatriate their earnings back to U.S. dollars increase profits for U.S. shareholders.

Diversification outside the U.S. will likely benefit U.S. investors. The balance of economic power will continue to shift toward developing economies. While the global economy remains far from healthy, emerging economies

have seen industrial production and retail sales rebound much quicker than the U.S. Investors tend to benefit not only from dollar weakness, but also from stronger growth outside the U.S., particularly in India, China and Brazil.

Fixed-income investors should favor shorter-term maturities and durations. The near-term deflation risks caused by the financial crisis will gradually give way to inflation risks. As the Fed continues to pump money into the system by keeping the overnight rate at almost zero, investors have been forced out further on the yield curve. Investors are not being adequately compensated in intermediate- and long-term maturities for the inflation risks that lie just beneath the surface.

Historically, the U.S. has spent about 3 percent of gross domestic

product stimulating the economy during recessions. The government is on its way to spending almost 19 percent of GDP responding to this current crisis. In my opinion, it is very unlikely that inflation will remain low for very long.

In managing several billion dollars on a daily basis, I struggle with cyclical trends and longer-term secular trends in our economy and markets. The era of declining interest rates, excessive use of leveraging, and lax regulation is clearly behind us. Investors will need to learn new skills to prosper in this altered landscape.



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