

CCR Wealth Management Portfolio Strategy & Outlook; 2009

REVIEW: Dow Jones: 8742.46 S&P 500: 909.73 as of January 9

Looking back at our 2008 “Outlook” from last January, we would be tempted to congratulate ourselves on the nearly clairvoyant forecasts regarding the demise of the global banking sector and its impact on the broader markets, as well as our suspicion of all but the safest credit instruments in the bond market (i.e. Treasuries)—*were we not so off-mark with respect to the degree of impact these and other issues ultimately had.* We also offer a mea-culpa on our outlook for steadily higher commodity prices in 2008—but more on that later.

The investment year of 2008 has found itself a place in history that has already been exhaustively analyzed. Suffice it to say, it’s a year most investors are eager to leave behind. As we turn our attention to the year ahead, we note that calendars artificially demark time and events for easier parsing in the future—but the clock continues to tick, economically speaking, and most issues that riled the markets 4 months ago remain unresolved. In short, we’re not “out of the woods” yet.

OUTLOOK:

- Today, while it may be difficult to absorb the wealth destruction of the past 52 weeks, we note that the S&P 500 is actually up 20.90% from its November 2008 low. The Dow is up 15.76%, and the Nasdaq Composite is up 22.86% from November.

These moves off the low in November are entirely consistent with our oft-communicated historical review of bear markets.

We do not take current market levels for granted—and anticipate retreats from these levels—though we would be surprised to see any new lows put in place.

We believe investors would be wise to begin any advised strategic allocation adjustments to their portfolios in this environment.

- The equity and bond markets have advanced for the last two months despite increasingly gloomy economic news and hard data, illustrating the fact that the correlation between the markets and the news is lower than most people think.

Looking ahead however, there are numerous potential news-worthy developments which could have market-moving economic impacts, and will likely feed a choppy market (with numerous “false rallies”) in the quarters ahead:

Unresolved Issues:

- Hope and Change; clearly a successful campaign theme—but the devil will be in the details beginning January 20. The ultimate *adopted* draft of the Obama administration’s approach to the current economic woes will have significant impact on both equity and credit markets, as well as the US currency. Indeed, politicians of all stripes were complicit in creating the current mess—and their involvement in trying to get us out of it will have far-reaching consequences—many of them unintended. We expect market reactions in any event.
- The Housing Market; The “first Domino” in the origin of the credit mess, the US housing market implosion has spun off numerous tangential catastrophes which will likely require their own individual remedies.

While banks, car companies and unemployment may be stealing the headlines today—we cite the importance of housing data by mid 2009 as potentially a make or break for *any* market recovery later this year. Consensus (which has served investors particularly ill last year) suggests improving housing data by Q3, 2009 as a predicate to any economic improvement elsewhere. While this housing data may simply take the form of *less-dire indications* (rather than outright signs of recovery)—*no improvement* by the end of the summer could signal that all extraordinary attempts made by the Fed and Treasury to-date have been for naught—and set off a new round of despair among investors globally.

- The Big Three; While the Captains of Industry, such as they are today (both captains *and* industry)--line up hat-in-hand for a piece of the taxpayer’s largesse, there’s a certain *schadenfreude* some might feel in watching the auto industry executives, in particular, squirm in front of Congress.

Chrysler and GM have already received installments on the \$25 billion the industry originally requested last month—though it is entirely unclear how this, or even the entire amount—“advances the ball” in their becoming viable manufacturing entities. Indeed, it is our impression that the cash-burn rate of these companies will have them back for more cash in a matter of weeks.

The prospect of failure, then, remains quite real—and the impact on US unemployment would likely be a vicious negative feedback-loop for the US, and therefore global economy. We watch this saga with particular interest.

This is only a partial list of issues requiring resolution, of course, but in CCR WM's estimation, they are of the greatest moment.

- *The Federal TARP bailout authorizes \$700 billion in new Federal “emergency” spending. At this writing, the new administration’s “Economic Stimulus” proposal calls for an additional \$800 billion (first draft—Congress has yet to attach special projects and provisions!), and we think conservatively we can round up this total to \$2 trillion to reflect, well, politics & politicians. Add to this, of course, the guarantee extended to cover roughly three quarters of the liabilities of US banks—and voila! A credit crisis that began because of too much debt is seemingly solved with future deficits (approaching 7% of GDP) as far as the eye can see!*

Here, we'll return to the topic of commodities: A year ago we wrote: “*Investors need to embrace current high commodity prices as a long-term reality*”. Mea-culpa. Commodity prices did indeed spike though the first half of the year—far beyond our most drastic inflation expectations. However, this surge was due in large part to speculation—and fueled by much of the same over-use of leverage that exposed the weaknesses in the housing and consequently the financial sectors. They've since fallen well below year-ago levels.

CCR Wealth management feels past is prologue here. Against the backdrop outlined above, the US has flooded (or promised to flood) the global marketplace with Dollars to make good on commitments made thus-far for the TARP and other obligations. This, of course, will cheapen the dollar—though it remains to be seen whether this weakness will be most expressed against other major currencies. Our view is that, absent any monetary discipline (and with no fiscal discipline likely in the new Congress), the weak dollar will manifest itself most prevalently against hard assets—commodities.

Historically, gold has been a lousy long-term hedge against inflation. The 1980 inflation adjusted peak for gold was around \$2,145 per ounce. However, gold has typically spiked *with* inflation—and other crises--as investors seek the “currency of last resort” when the Dollar's strength is battered.

Oil has nose-dived from \$147/barrel to around \$40/barrel in less than 7 months. While we had no confidence that \$147 reflected economic reality, we are equally

skeptical of its current price range. Oil is an important hard-asset, traded globally in US Dollars, and has been subject to wild swings of the pendulum. Additionally, oil is uniquely sensitive to supply constraints and geo-political tensions. We believe the truth lies somewhere in the middle—which could mean substantial upside from current prices.

Oil and gold will likely display the most sensitivity to a spike in inflation. We caution, however, that inflation will likely not manifest until there is some indication of market/economic stabilization. We are prepared to see these assets trade in a range-bound manner for many months. In addition, we remind our clients that commodities in general can be very volatile (see 2008)—and attention should be paid to what allocation percentage they make up in a portfolio. (via index funds or ETF's)

Portfolio Strategy, January 2009

Equities: Most CCR Wealth Management portfolio models currently favor US, Large Cap equities. We anticipate choppy, “range-bound” major equity indexes for much of the year—with the *possibility* of more recovery later in the year (pending constructive developments in the housing and employment picture).

We see little obvious benefit to emphasizing value or growth investment styles currently, although this may change and we will make adjustments accordingly.

We remain underweight in US small and Mid Cap companies, favoring Large Cap relative stability in this economy. However, we note business-cycle upswings tend to manifest in smaller company stocks first, so we of course will be looking for relative strength in the small and mid cap indices to make any adjustments to this weighting. For now, we are mostly concerned with the outsize-effect the credit crunch has on smaller companies vs. their blue-chip counterparts.

Non-US: Non-US equities remain a key component to all our investment models. However, approximately six month ago we reduced what had been a long-standing overweight emphasis in non-US, developed market equities (as measured by the MSCI EAFE index). Today, we continue to prefer an emphasis on domestic vs. international equities.

The rest of the developed world grapples with their own credit and economic crises—some of it directly tied to the US markets (global credit and banking trade), and some of it decidedly home-grown. For the time being, we prefer the devil we know.

Emerging Markets: We retain our 5% exposure to emerging economy markets—but note that this investment category is likely to become increasingly fragmented between those economies which “learned their lesson” from the currency and debt debacle of the late 1990’s (i.e. China), and those that didn’t (i.e. Latin America).

On this basis, China appears attractive relative to broader emerging market indices, where exposure to Latin America is significant.

Fixed Income: A year ago we wrote: “*We recommend caution in the bond market...Added to this concern lingering credit issues—and perhaps new ones (Credit Default Swaps) make it very important to know what your bond fund(s) may be holding.*”

Many high-quality bond funds with long-standing, superior track records were brought low by the 2008 credit market melt-down. We can only reiterate this advice for 2009.

Cash/Money Market: Cash is a legitimate asset class in the current market—and we recommend a good supply of it (raising it when choppy markets rise). While we do not support “deflationary” theories, cash is obviously the best asset in periods when asset prices are under assault.

Looking ahead—we need to note the corollary to our expectations regarding inflation: Large cash positions in an inflationary environment are not recommended.

Bonds: CCR Wealth Management continues to prefer high-quality, short term instruments (i.e. 1-3 year treasuries) as the foundation of a bond portfolio.

The TIPS (Treasury Inflation Protected Securities) market seems to us to be discounting the likelihood of future inflation, so while TIPS make sense from a diversification perspective, we caution on overweighting this government bond class.

Municipal Bonds have recently been singled out by many commentators as displaying attractive value. CCR Wealth Management believes this is true on a *state by state basis*. Consensus seems to *expect* federal handouts are imminent; we prefer to be somewhat more skeptical. We believe fiscal pain for state and local governments will get worse before it gets better.

After a drubbing in 2008, the corporate high-grade bond market has fragmented—and may fragment further. Government intervention has rendered the bonds of some companies that were on the verge of bankruptcy just months ago relatively



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“attractive” overnight—given the implied federal backing this debt seems to enjoy now. But the recession carries on—and we advocate scrutiny and a decided bias to highest credit quality in the corporate bond market.

Non-Correlated Assets:

As previously stated, our preference in this area is the hard-asset commodities of oil and gold (via index funds and ETFs). We reiterate patience and low near-term expectations.

The scandal and headlines set off by the gross impropriety of Bernard Madoff has understandably raised many questions. We feel it is important for us to reiterate that all assets managed by CCR Wealth Management are custodied by Pershing, LLC (a wholly owned unit of Bank of New York).

The views are those of CCR Wealth Management and should not be construed as investment advice. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. Additional risks are associated with international investing such as, political and economic stability, difference in accounting standards and currency fluctuation. Investors cannot directly invest in indices. Past performance does not guarantee future results.

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