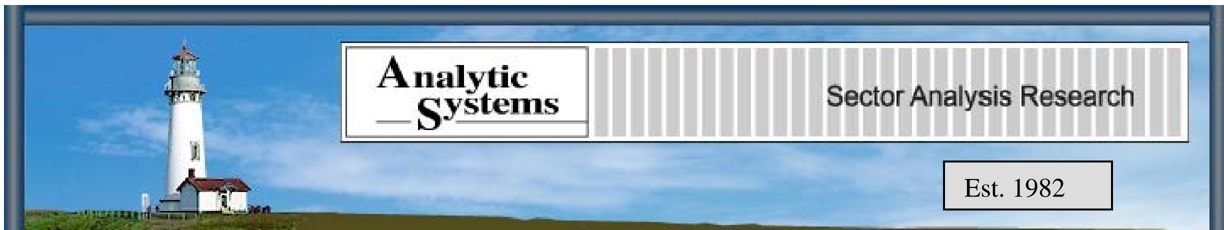


Here Comes the Fed February 19, 2010

Investment Strategy

Analytic Systems Corporation refined a model based on computer studies of the historical behavior of thousands of stocks and hundreds of economic time series to identify which variables and factors have the greatest impact on stock returns. The model developed in 1982 holds that past economic relationships have application to the future trends. This month's Sector Analysis Research has identified the specific industry groups which appear to be in a favorable position based on the current economic climate.

Equities:

Telecom and Health Care are well positioned based on the current economic environment. An overweight among S&P groups is advised in Industrials and Health Care. Market weights are advised in Consumer Staples, Energy, Financials, Information Technology, Materials and Utilities. Underweighted is Consumer Discretionary. There were no changes this month.

Fixed Income:

Our view on long bonds based on current macroeconomic trends is neutral. We would rate the current duration environment as a 5 the same as last month. Our duration is scaled from 1 to 10, with 1 representing a maximum position in Long Treasuries and 10 representing a maximum position in short term debt.

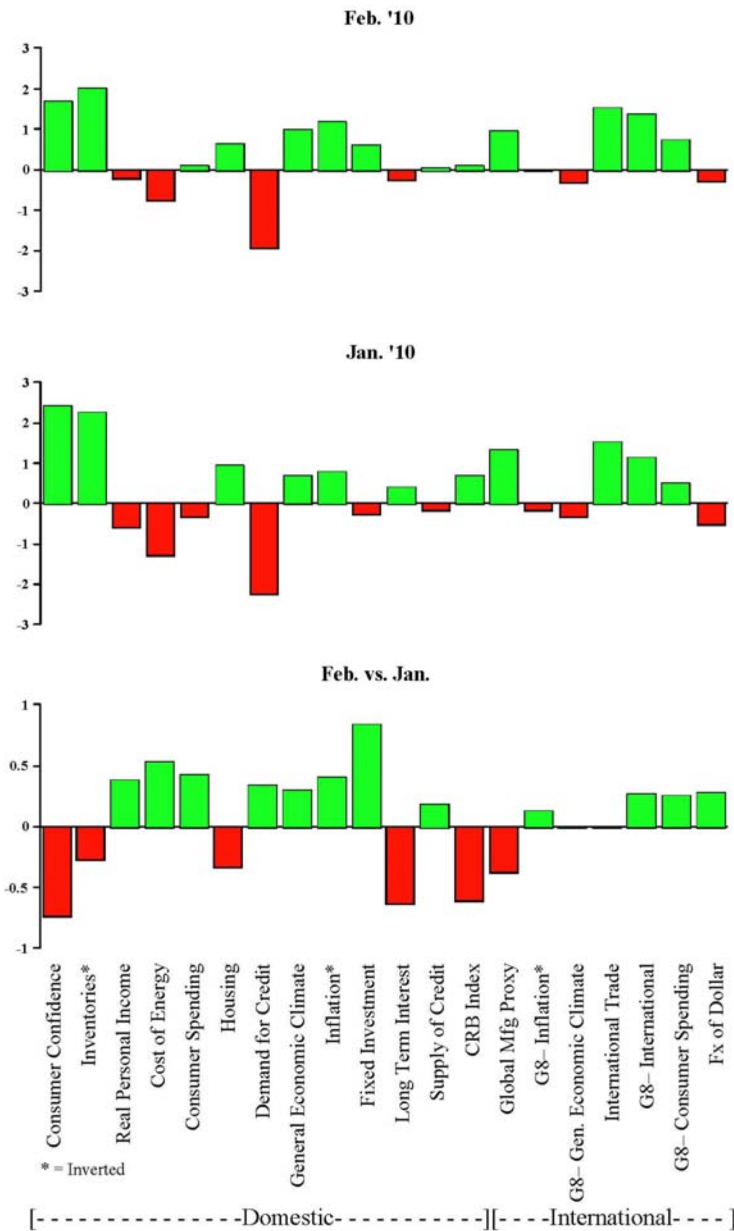
Hedge Funds:

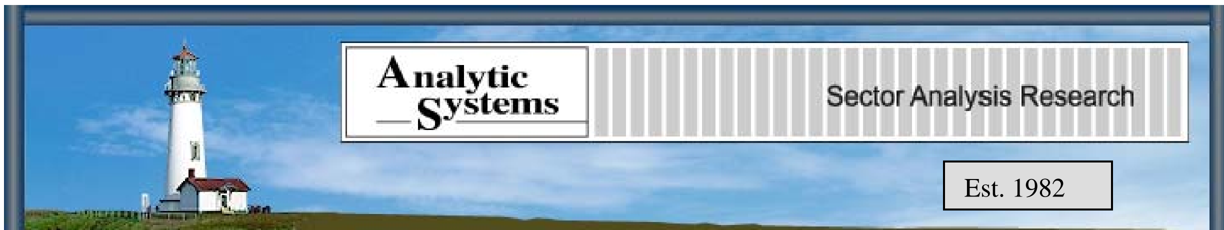
We are long Industrials and Health Care. After a very strong year with ASC's advising a bias toward risk since Dec. 08, the ASC model began suggesting in November '09 that one should gradually begin to opt for more safety in equities, fixed income and alternative investments. Part of that approach would be to pull back from emerging markets, high yield fixed income securities and be long the US dollar (in particular against the Euro).

Fact Forward Inferences:

Analytic Systems' approach to forecasting is fact-based, rooted in recent economic history and mathematically driven—incorporating new realities. The top bar graph on the following page shows the velocity (first derivative) of key areas of the US and G8 economies for February 2010, the middle shows the velocity for January 2010 and the bottom bar chart shows the acceleration or deceleration (second derivative) in trends that occurred in February 2010.

The following charts show fact based trends in ASC Economic factors as of February 2010 as compared to January 2010 and changes expressed in standard deviations around the norm, hereinafter referred to as "units."





The model highlights the units that rose in February 2010	
Fixed Investment	0.84
Cost of Energy *	0.53
Consumption US	0.42
US Inflation *	0.40
The model highlights the units that fell in February 2010	
Init. Unemploy. Claims *	0.73
Long Rates *	0.62
CRB Index	0.60
Global Mfg.	0.37
Housing	0.33

Analytic Systems Factor indicators of future activity suggest that the current strength in the US economy may not be sustainable. The recent pay down in consumer installment credit moderated to $1.7 billion, down from a restated $21.8 billion in the previous month. Retail sales results firmed up somewhat soft, up .5 %, .6% ex autos. The latest results on retail sales were encouraging, additional months of firming appear to be necessary to provide for sustained growth in the US economy. The overall latest score was 108.3 as compared to a restated 106.9 in January 2010.

Of the three scenarios we outlined several months ago, that of a sustained recovery and low inflation, a “w” with the current strength turning to weakness or a tsunami in which the Fed overstays and inflation picks up, last month’s data suggested that the odds of a “w” improved slightly. Consumers are not behaving as they usually do in the early stages of an economic recovery. Job creation by small to medium sized firms remains weak. The odds of tsunami decreased with signs of moderation in the economic recovery and a somewhat stronger US dollar.

We are now experiencing a spurt of growth owing to a lessening of inventory liquidations in Q4 ’09 and Q1 ’10. The question that still remains is what happens afterwards. With the consumer still deleveraging from concerns about jobs, one out of six doesn’t have a job, and almost one out of 4 owes more on his house than it is worth, there is cause for concern.

Our previous thesis that job growth is likely to be less robust than normal because of tight credit for small to medium businesses, which typically are the primary sources of jobs is still holding up. Last month there was a loss of 20,000 jobs instead of gains that

some economic services had foreseen. The job growth from newly hired census workers is not likely to provide sustained improvement. What is really scary are the large numbers of unemployed who have given up on finding a job and have stopped looking. Economists seem to treat these long-term unemployed as no longer existing once they drop out of the government's unemployment results. The NFIB index which is a survey of optimism of small to medium businesses rose slightly last month from 88 to 89.3.

ASC industry group rankings were once again slightly more defensive last month with continued high rank of Utilities such as Regional Phones, Consumer Non-Discretionary (foods), and Hospital Supply which are ranked at 6th, 11th and 5th respectively. Electronics and Technology slipped to rank 7th and 8th respectively. Economic sensitive industry groups such as Rails and Trucking are ranked at 37th and 41st. Defensive industry groups have been perking up in ASC's rankings since November 2009. ASC's two over weights, Health Care and Industrials, are off to a good start so far.

Government officials are trying to stimulate the US economy until it returns to normal. With the loss of goods producing jobs (from over 30% of the total in the 1970's to less than 14% recently) and other effects of globalization, one might ask what is normal. In the last cycle, growth was achieved by high levels of debt aided by soaring residential real estate prices. Excluding the increase in debt, growth was minimal. As the private sector deleverages and globalization is in full force, the US economy may be able to grow only at 2 – 2.5%, which is in line with those who have been discussing a "new normal". At that rate of growth the unemployment rate is likely to stay quite high for a protracted period of time. Not only is a high unemployment rate politically unacceptable, a low growth doesn't allow the US to outgrow its increasing debt burden. While politically difficult the US needs to retrench and cut back entitlement spending. There is not enough room to cut spending in a meaningful way unless entitlements such as Social Security, Medicare and Medicaid are included. The private sector has adjusted to the forces of globalization, foregoing wage increases and become more productive, whereas the public sector has become bloated, inefficient and overpaid on a relative basis.

Never before has the outlook for budget deficits been so large for so long with the exception of World War II. Financing those deficits over the next five years appears to be beyond the scope of anything that has ever been accomplished. Recently forays into longer maturities of Treasuries have been met by relatively poor receptions. What does that say about the ability of the US government to finance a rising debt obligation when the economy resumes more normal growth and inflation displaces current fears of deflation?

Conditions in Greece and other weaker Euro zone countries are likely to worsen from the lagged effects of a strong Euro that is making their economies lees competitive with China and the US. The only practical way to lower deficits as a percentage of GDP is for the economy to out grow the deficit. To reduce deficit percentages during a period of

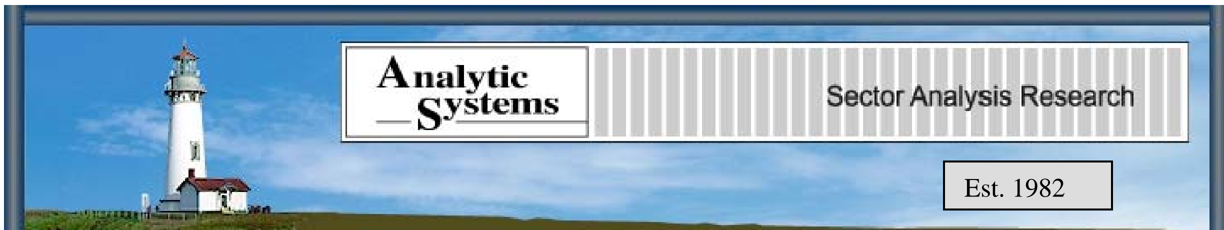
slow growth that is likely over the next few years would appear to be nearly impossible, in particular since Greece needs to lower its percentage from around 13% to 3%.

Since there are problems among the three developed world currencies of US, Japan and Europe and each one's debt as a percentage of GDP are rising, perhaps one should examine which country is likely to lose the race to the bottom. As we discussed in previous reports, the US economy appears to be more dynamic allowing for creative destruction up until the recent "too big to fail mantra". Europe is saddled with the problems of having one currency without a political union as is being shown with the current dilemma of the inability of weak counties to devalue their currencies to remain competitive. Japan has been slow to admit failure and slower to respond in a meaningful way. The US government has become dysfunctional with the Republicans opting for the easy fix of cutting taxes and Democrat opting for increased spending resulting in a dismal outlook for the US budget deficit. There is a ray of hope as numerous Congressmen, many long time incumbents, have recently announced that they are not going to run for reelection. There could be a bloodless revolution in American politics over the next several elections.

States that are in dire straits such as California and New Jersey are likely to find that conditions worsening in 2011 when the aid from the Federal government runs out. The recovery in the US economy is unlikely to materially improve the finances of the troubled states. Reductions in employment and reduced spending are likely to be a damper on the US well after the fiscal stimulus runs out. After the second quarter of 2010, the effects of the stimulus will have a diminished effect.

While the Federal Reserve has begun to talk about its exit strategy, the ASC model is showing that we have tight credit. When the Fed stops buying mortgages in March '10, spreads are likely to widen, dampening the prospects for a continued recovery in housing. Long term rates are likely to rise even with a slow growth US economy as the prospect of deflation recedes and the prospect of renewed inflation rises. With the low duration of debt being sold by the Treasury to finance the stimulus and the trade imbalance, the government debt calendar is going to increase sharply. While the US has been in the sweet spot with heavy demand for Treasury offerings because of deflation fears, a dose of inflation and possible stagflation could spoil the appetites for what is likely to remain very heavy demand by government officials to finance the stimulus and roll over short term debt that was sold in 2009.

US investors face the prospect of significantly higher bond yields over the intermediate term. In addition, inflation is unlikely to stay as low as TIP spreads are indicated at 2.30% on the 10 Treasury. In this environment finding what is safe is not easy. As we have stated in the past, blue chip stocks with a good dividend yield that is comfortably being earned should provide a relatively safe haven in a world in which inflation returns. To provide for a hedge against a weaker US dollar longer term, one should have a healthy allocation of foreign dividend paying equities.



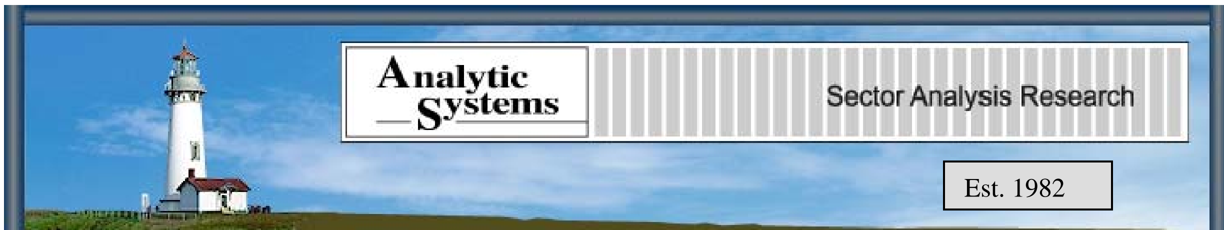
Portfolio Manager Comments:

Market volatility has picked up noticeably in the past few weeks. The VIX has been bouncing about in a range of approximately 20 to 30. On several trading days it rose or fell by 3 to 5 points. The message contained in this action is pretty simple, investors are confused. They are confronted on almost a daily basis with developments and information that turn their lack of conviction into wild swings in optimism and pessimism. They are struggling to incorporate several important domestic and international economic problems into an appropriate investment strategy. There's just one problem; the data is so slippery that conclusions worthy of the basis for investing real money are almost impossible to formulate.

It's times like these when the ASC model is helpful. Let's look at what it's telling us. The five highest and lowest ranked groups offer some insight. The five lowest ranked groups are: Rails, Steel, Aerospace, Processing and Trucking. The five highest ranked groups are: Computer Service, Telecom, Appliances, Housing and Hospital Supply. We think that the foregoing indicates that market action in these groups, good or bad, is signaling a change in leadership. Market action is telling us that the leadership groups whose positive earnings outlook were based upon the belief that the US was experiencing a V shaped recovery in which earnings would recover faster than expected and which might result in a bout of inflation if policy makers were not timely in their withdrawal of excess liquidity from the economy. Also implicit in their strategy was confidence that Europe and China would lead the US out of recession and into the next growth cycle. However, investors appear to be questioning the assumptions that previously convinced them to buy these groups. In recent weeks the certainty surrounding the economic well being of Europe and China has been undermined. We have spent a lot of time discussing our concerns regarding investor complacency when it comes to the risks we see in many areas from real estate to the bond market and now it seems others are beginning to react as well.

During the recent correction, the groups that were hit the hardest were commodity related and energy. If we expand the population of groups we are considering to include the bottom half of ASC's rankings we see more evidence that the investment environment is changing or perhaps has changed to the point where the groups that made up the market leadership for the past six months have started to give ground: Energy is 29th, Chemicals are 31st, Retailing is 32nd, Coal is 34th, Papers are 35th. Investors appear to no longer be willing to bet that we will see a V shaped recovery or that liquidity can be withdrawn without mishaps occurring.

Where might we find the new leadership? Looking again at the top half of the group rankings we see the likes of Electronics, Technology, Natural Gas, Commercial Banks and Hospital Management. The ASC Model is placing more value on consistent growth and dividends of companies that are not so dependant on a normal economic rebound. Investors want companies that can prosper in a 'New Normal' economy.



We also would like to comment on the dilemma facing investors who are looking for yield in a world where the 90 day T-Bill yield is barely positive. The last time the yield on Treasuries was as low as it is today was the early '40's after the depression. By 1982 the yield on the 30 year Treasury was approaching 15% and bank CD's were yielding over 20%. Here's the lesson to be learned: investors always extend maturities and settle for lower quality at turning points in the bond market as they reach for yield. It's happening right now. Shell shocked investors have pulled billions out of stocks in the past year to buy bonds at 70 year low yields.

Some have justified buying bonds because they believe that inflation will not be a problem for many years, they are forgetting that there are several economic and political developments that can cause interest rates to rise. We have just seen a couple of excellent examples of sovereign debt risk that resulted in large interest rate increases in Dubai and Greece. Holders of those countries' bonds are licking their wounds. Locking up capital for a 3% or 4% yield at this juncture seems to exhibit a faith in governmental restraint that is charming but perhaps not very wise. We would suggest that a better road to income would be blue-chip equities with dividend yields in the 3% to 5% range. We believe that you'll be better served particularly if inflation is not dead, as the fortunes of corporate equities are better in times of inflation compared to corporate debt. During the Weimar Republic in Germany in the late 1920's, as inflation skyrocketed, high quality stocks held their value while bonds were decimated.

In the February 16th, 2010 issue of the 'Wall St. Journal' there's an interesting tidbit that exemplifies the danger of run-away inflation. Thomas Hoenig, president of the Kansas City Fed, recounts the story about his 85 year old neighbor who gave him a 500,000 German mark note when he assumed his new position to remind him of his duty to protect the value of the currency. The old man told him that the note would have bought a house in 1921 and by 1923 it wouldn't buy a loaf of bread. Hoenig says that note is framed and hangs in his office to this day.

For information on Analytic Systems Corporation's methodology and samples of past reports please visit our web site http://www.asc-sector.com.

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Analytic Systems Corp. 740 Broad Cove Rd. P O Box 496 Hopkinton, NH 03229. 603-746-6443 Email ascsector@comcast.net