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Serving Your Personal Investment Needs Since 2003

Friday, December 30, 2011

YEAR 2012 AND BEYOND – A FORECAST FOR THE FUTURE

On a fairly regular basis, I review my analytical data and make forward looking predictions as to economic growth and stock market pricing forecasts. On a less regular basis, I go "way back" in my data history (1970's) and look for changing trends and how my data anticipated those trends. Below is the result of that "long" backward look at that data. I have included some of my observations in order to give some insight to our thought processes when we make a buy or sell stock market recommendation.

- Volatility has been the story of the last 4 years, and how, since late 2008, it has been so debilitating from an investor's point of view.
- Most retail investors have been put to the "sidelines" by this volatility.
- The only remaining buy-and-hold investments have been focused inside retirement accounts.
- Retirees have suffered the most psychologically.
- The best stock market indicator – predictor - over the past seven years has been the Velocity of Money (GDP/M2)
- The problem with Velocity of Money is its late reporting schedule: quarterly, late in following month after quarter-end.
- The best stock market indicator, for the past 15 years, has been the cross of the 34 MA* and the 10 MA*
- Steep changes in the 10 MA* indicate that a market change will happen in the not-to-distant future.
- At the end of a steep move in the 10 MA, the change steps get smaller.
- Why has M-2 grown so strongly since mid 2011?
- Only at the middle of the sharp M-2 rise, did M-1 have a sharp increase.
- M-1 is directly related to Fed activity thru the Monetary Base.
- M-2 may have seen a strong inflow of money from European banks.
- The Fed has been very active in the monetary marketplace since yr. 2000, causing confusion when reading the monetary numbers as they relate to economic forecasting.
- Year over year, GDP is growing at a rate of over 4% since Q2, 2010. For the last two quarters the growth rate has slipped below 4% somewhat (3.77% and 3.91%)
- Since Q1, 2011, M-2 has been growing faster than GDP (5.1%, 6.8%, 9.9%)
- We can surmise that this growth in M-2 is not-actively-invested money, but is a currency trade to protect capital previously held in Eurodollars; alternatively, it is money removed from European banks for fear of bank failure.
- When this money moves back to Eurodollars, the Velocity of Money will change to positive growth, very rapidly.
- To anticipate volatile changes in market prices, we need to modify the makeup of our investment portfolios – increase and decrease the percent of equities – as the market gets oversold or overbought.
- This means more work for the investment manager – to buy and to sell.
- The involvement of the Fed in manipulating monetary aggregates, impacts the economy and the stock market.
- Interesting productivity increases have influenced the Fed's decision making process.
- Higher productivity should increase the Velocity of Money (GDP/M2).

*34MA – 34 day moving average

*10MA – 10 month, end of month, moving average

Recommendation:

After considering the data, and projecting forward a risk profile designed to forecast the coming year, I think that it is time to recommend a process for reinvesting in growth - to begin moving money out of fixed income (where we have moved it in order to preserve our capital). By this, I am suggesting that we begin putting money back to work using an incremental process – perhaps 10%, more or less at each entry level – and buying when the market moves downward to an oversold condition. Alternatively, should the market go up rather strongly and initiate our model's "buy" recommendation, then we would not need the incremental process, and can move all of the money we have reserved for equities investment, back into our mutual fund investment allocation. In general terms, we expect that once the market begins to move upward, a relatively slow upward bull market will continue, for perhaps as long as 8-10 years, gathering momentum as the individual sovereign entities recover from this severe recession and begin to contribute positive growth to the global economy.

Analysis:

One question that you should obviously ask, relates to the term "risk profile" forecast. What does this mean?

There are three areas of highest risk to the global economy. There are many grains of sand in the "risk" pile of sand, and no one knows what may cause a global economic collapse, assuming one occurs. I prefer to dwell on the three inclusive areas of greatest concern, and deal with these - making the assumption that the lesser failure points will input into these most serious problem areas.

1. The potential for economic collapse in Europe, sovereign debt restructuring, and the destruction of liquidity within the global banking system.
2. Failure of the Japanese government to stem the growth of government debt. Increasing interest rates on its debt will create a calamitous cash flow failure.
3. Political stalemate in Washington, D.C. that prevents (a) achieving a balanced budget, (b) shrinking the size of government contribution to GDP, and (c) restructuring Social Security and Medicare.

When considering the future, these three make up the greatest concern!

Numbers one (1) and three (3) can be resolved. Number two (2) probably cannot be resolved. Japan will likely enter a severe recession sometime in the future, bringing about a devaluation of the Yen.

How will European countries, and the European Union, resolve these issues and survive, without economic and functional collapse and dissolution?

Answer: We are already seeing general movement toward a solution by the members of the EU. The issues are difficult, but the commitment to preserve the Union is so strong that it seems very likely that the members will come together to make the compromises necessary. The difficulties focus on defining those compromises; those decisions are yet to be agreed to. In order to preserve the European banking system, it is necessary to provide the European Central Bank the authority to create liquidity within the system. Governments in the EU are shrinking their budgets and working toward shrinking their debt. These are all necessary steps along the way. It is likely to be several years before we are able to say that the EU is stable and growing. In the meantime, there will be a lot of uncertainty about the eventual outcome.

**Why do I think that our Legislature will be able to regain control of government expenditures, balance the budget, shrink government expenditures, and restructure Social Security and Medicare?
GOOD QUESTION!!**

Answer: Sometimes you just have to operate under the presumption that, when there are no other alternatives, even **our** politicians will finally do what they know they must! The US economy is strong and gaining momentum. In spite of what is happening in Washington, D.C., private investment is growing, productivity increases, and entrepreneurial creativity is making the future look better than the news media perceives.

NOTE: THERE IS NO ACTION TO BE TAKEN AT THIS TIME. HOWEVER, BE PREPARED TO RECEIVE AN ADVISORY, SOMETIME IN THE NEAR FUTURE, RECOMMENDING SPECIFIC ACTION TO BUY EQUITIES.

US Government Spending as Percent of GDP

http://www.usgovernmentsspending.com/spending_chart_1903_2010USp_13s1li017980_659cs_F0t_US_Governmen_t_Spending_As_Percent_Of_GDP

Sincerely,

Dick Brackett
High Desert Investment Advisors

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