2010 – The Year of the "Increase"

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I expect these increases in 2010:

- Taxes will increase
- Debt levels will increase
- Interest Rates will increase
- Economic headwinds will increase
- Commercial vacancies will increase
- The size of our Government will increase
- Eventually, downside momentum will increase too.

The increase in taxes and interest rates will put a halt to hopes of sustained recovery, but a sustained recovery was out of the question anyway. We cannot expect higher highs soon unless we think liquidity levels get back to their 2005-2007 levels. I think not. A number of contributing factors, none more important than the Investment Rate, support my point.

Using an analysis akin to what I incorporated into my 2009 economic analysis, titled "A Return to Parity," I use the Investment Rate to compare current and future projected demand levels for investments in the United States. With that, I have reached conclusions, which shape the next 6-12 months of Economic and Market conditions. The repercussions of these conclusions on the Global Economy are significant.

When conducting this review, as always, my effort was to 'Keep It Simple.' KISS is an integral component to all of my economic analysis. Cluttered econometric variable equations leave too much room for error, and are often flawed or distorted by the Economist who created the model. As we know, most economic models can be used to argue for or against the same point.

The Investment Rate is different, because it is a guiding hand that proves future conditions. It is simple, and easy to use. Unless the Market and the economy stop following the Investment Rate (The IR has been a leading indicator since 1900), the economic conditions will worsen, and the Market will fall. In fact, as 2010 comes to an end, the declines are likely to get very aggressive again.

Begin with a graph of the Investment Rate. I have provided two of them here.

Figure 1.1 The Investment Rate since 1900

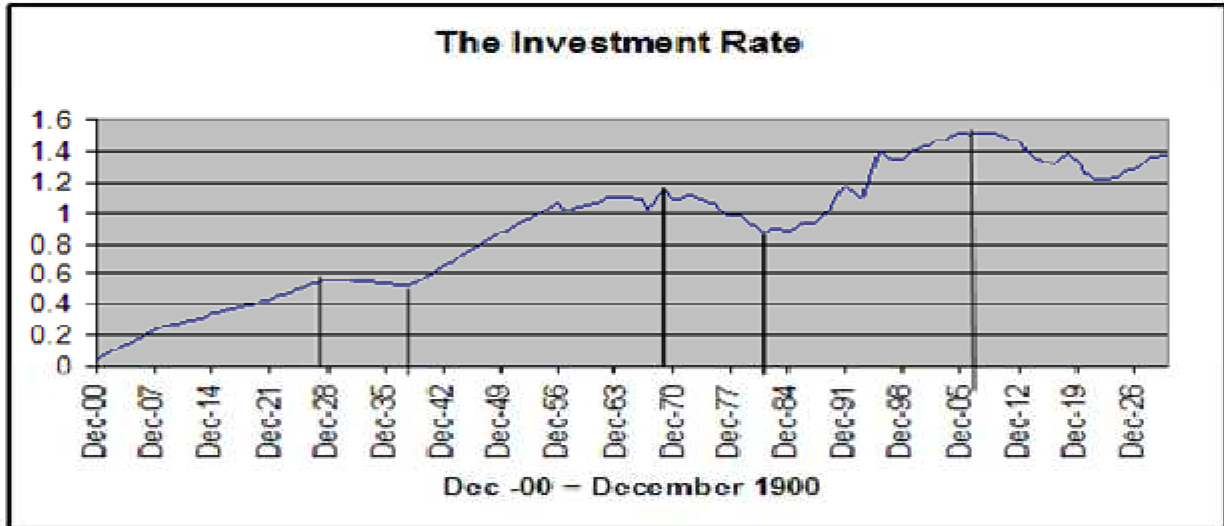


Figure 1.2 The Investment Rate – A closer look

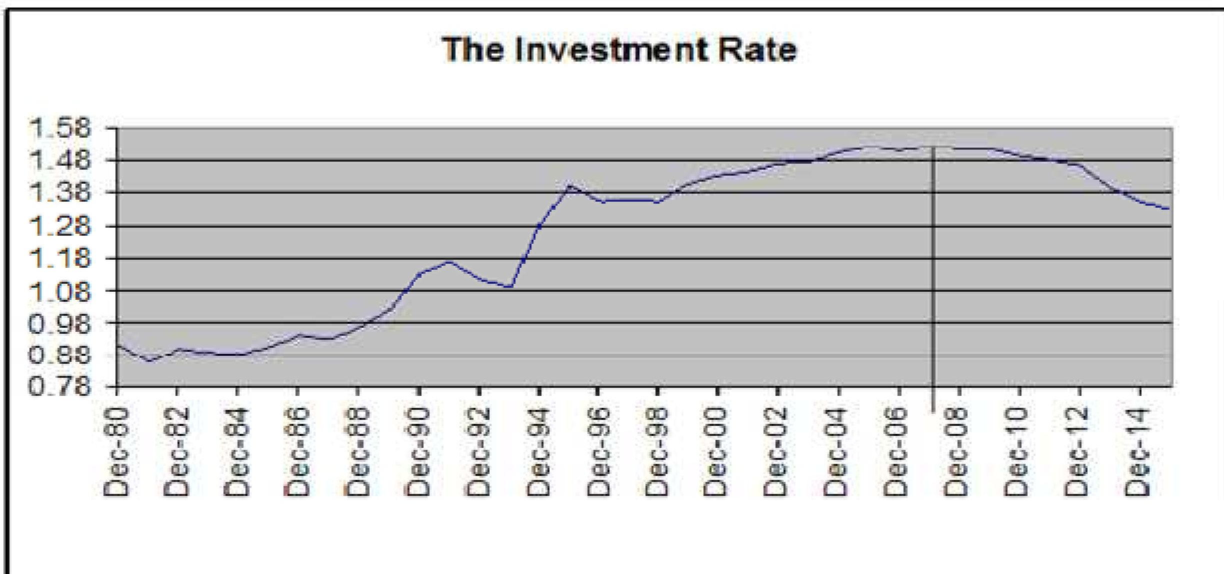


Figure 1.1 and Figure 1.2 are representative of The Investment Rate. The dates are end of year, December closing. Figure 1.2 is merely a snapshot of the IR between 1980 and 2015. Figure 1.1 is all-inclusive. Combined, the two images allow us to first evaluate the long-term trends, and then the short-term implications of the rate of change in demand, as provided by The Investment Rate.

At the onset, we are less concerned with short-term fluctuations in the Investment Rate, unless those are part of a recent shift in cyclical trend. The IR spans 130 years, so it is a measure of long-term cycles. With focus, we can use it to measure short-term cycles as well, but we need to start with long term observations and work our way down. Therefore, our first look is at figure 1.1, and the takeaway is obvious. The Market has already entered the third major down period in US History. The IR predicted the Great Depression and Stagflation Periods too, and this time in economic history is the same as those. That is not because the economy looks the same, but because the Investment Rate says so.

Clearly, there has been a fundamental shift in the US Economy. This is supported by recent conditions. However, the tail does not wag the dog. The recent conditions are not causing the Investment Rate to slope lower. Instead, the Investment Rate is proving a material shift in demand for investments, and that lessened demand is causing the economy to weaken. This is something we expected and were prepared for well in advance, going into 2007.

The Investment Rate also tells us the duration of the weakness. From December 2007, the duration is 16 years. In simple terms, the weakness has only just begun. Based on this data, we are two years into a 16-year down cycle. That does not mean the market will head lower the whole time. Instead, it means the rate of change in the amount of new money available to be invested in the United States will decline every year on average through the 16-year span.

Usually, an ultimate bottom comes somewhere in the middle of a down cycle like this. The middle, in this case, would be somewhere near 2015. That may be actionable then, but it is far away.

More important to us now are the conditions that lie immediately ahead. The broad strokes have been painted, and we know the weakness will continue. However, we also know that the market never goes straight down. The 2009 recovery is an excellent case in point. This was also predefined by our shorter – term Investment Rate analysis, "Return to Parity," which was issued at the end of 2008. We were ready for the 2009 increases thanks to that report, and profited nicely from them. Will 2010 be another 2009? The answer is no.

Even though economic conditions will change, our results do not need to. In 2010, the Economy and the Stock Market will hit a brick wall. The economy will flounder in the first few months, and then a more sustained decline will begin. This will not be the same as 2008 either.

Uniquely, 2008 was a sharp knee jerk reaction, and 2009 was a V-shaped recovery. Knee jerk reactions are often met with bounce-backs. The declines in 2010 will not be like that. They will not be knee jerk, because there will not be any surprises. Instead, when they start they will be slow, monotonous, and unyielding. After the first quarter, we should start to see signs of economic weakness again. Expect 10% undulations from the Market through the first half of the year. In the beginning, the Market will probably face resistance. Resistance may already be defined, or close to it. Once defined, this resistance level could hold all year.

This time, the wealth that is lost will not be recovered quickly. On that note, it will not dissolve overnight either. Instead, buy and hold investors will lose it slowly. By the time the panic sets in, it will be too late. That is usually our buy signal of course.

That will be the theme for the first half of 2010, most likely. The Economy will ebb and flow, and so will the Market. A neutral channel will prevail across the broad markets, and a no-growth environment will exist. Once that factors into current multiples, contraction should occur.

Figure 1.2 supports much of this. That image shows a gradual decline in the Investment Rate after 2007, and until about 2010. Then, the slope of the IR becomes clearly negative, and then gets even more negative after 2012. The result of my general conclusion is supported by this. The Investment Rate tells us that persistent weakness should exist, and it warns us that the economy and stock market will become weaker as 2010 comes to an end.

Until then, I expect some investors to be hopeful, I expect the Market to offer excellent trading opportunities, and I expect a nervousness to set in. Much of that nervousness will come from the subtopics I listed at the beginning. Those helped me title this analysis, so we will go through them.

I listed seven subtopics at the beginning of this 2010 review.

- Taxes will increase:

In 2010, as the New Year begins I expect to hear concrete debates about raising taxes. That means income taxes and capital gains taxes. I expect taxes to increase for everyone except the very poor. I expect the middle class to pay more, small businesses to pay more, and the rich to pay substantially more than they do now.

The most obvious reason could be US Debt, but immediate tax increases will do nothing to take down the debt. I am lumping Social Security (Social Security will become a burden in 2012) and Medicare into this equation. That references the Healthcare issues on the table as 2009 ended. The only way the US can afford to refund the Social Security and Medicare programs is to raise taxes. In my opinion, Healthcare reform has plenty to do with those bankrupt programs. I expect the US to pass the buck, and collect the funds for ongoing Medicare programs or alternatives from new taxes or costs that weigh heavily on small businesses.

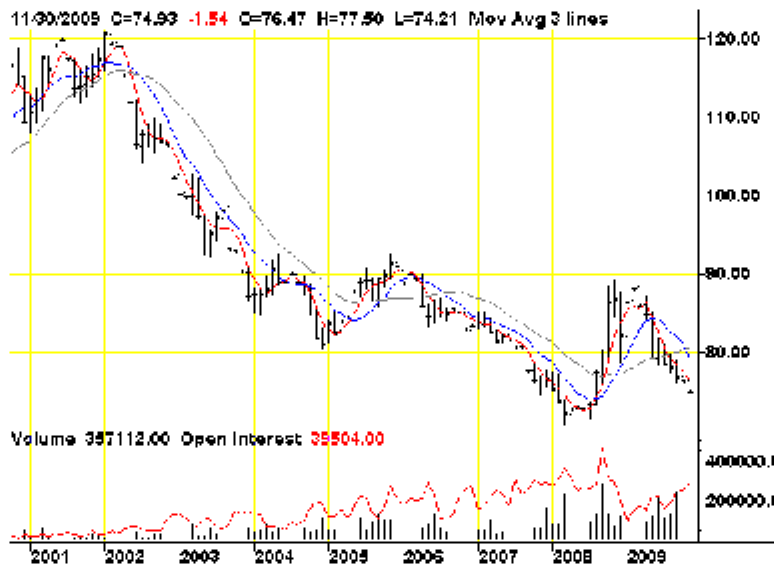
This is one of many reasons taxes will increase. The second is that the Obama administration needs to fund its spending programs. Higher taxes have nothing to do with bringing down the debt; they are simply designed to offset the escalating debt levels.

If higher taxes were designed to reduce US Debt levels, they could be acceptable for a short while. However, taxes are increasing at the same time debt levels are skyrocketing, and that is a problem. This creates a lose – lose - lose scenario where US taxpayers lose, the economy loses, and anyone holding dollars loses too.

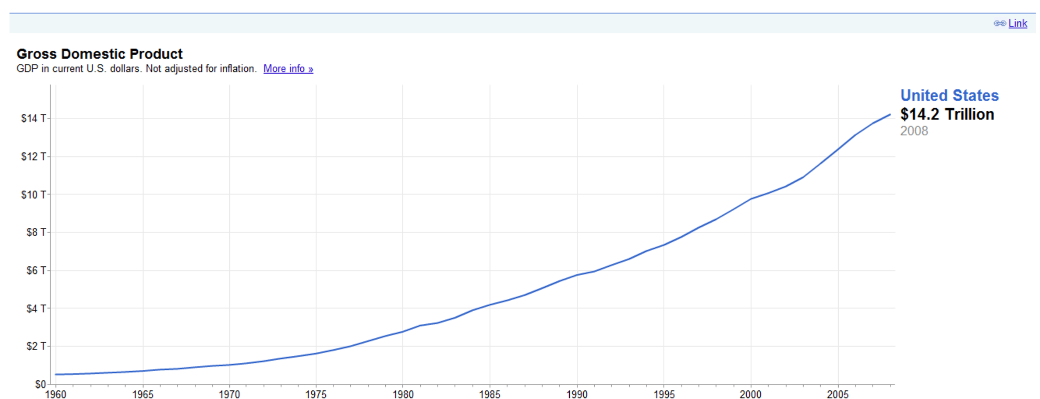
- Debt levels will increase

The debt levels of the United States will continue to increase. Spending will not subside, and fiscal responsibility will not exist. I define fiscal responsibility as a balanced budget. The Obama administration has no plans of balancing the budget during his term. In fact, debt levels are expected to swell instead. If one were to treat the Dollar as a stock representing the United States, the debt levels would become a very serious concern. The administration does not see it this way, but since 2002, the rest of the world has. This chart represents the declining dollar since 2002.

Figure 1.3. The Value of the Dollar



According to an AP article on December 10, the Obama administration does not project less than $739 Billion in annual deficits for the next decade. That equates to over $9 Trillion, which would increase the current stated deficit by 75%. When we add in unfunded liabilities, the debt situation comes into a much clearer picture. My 2007 estimates suggested 4-5 times GDP. I have recently heard analysts claim 8 times GDP. Look at the GDP figure below to understand just how serious this issue is.



Obviously, GDP is not representative of tax revenues. According to Wikipedia, the US collects 28.2% of GDP in tax revenues. Using the figure above, the US receives roughly $4 Trillion in tax revenues. From that, roughly, $400 Billion goes to interest payments on outstanding debts, and that will only increase going forward. This will be happening in the face of a declining Investment Rate, and that spells trouble.

Rationalizing the increasing debt levels, the Obama administration is expecting a strong recovery in the next year or so, but they are not going to get it. Not only that, but it will get weaker. The Obama administration will get the opposite of what they are expecting, and the Investment Rate offers proof.

If the Healthcare proposals work to eliminate Medicare, Medicare Advantage, or whatever else we have been paying into for years, at least some of the hidden deficit will be resolved, but the current deficit numbers do not include that anyway, so it would not be seen on paper.

The political debate looms. Any payments we have made into a Medicare program will have essentially been wasted. Obama needs to keep Medicare, just to save face, but the new proposals will change the landscape of that program completely, moving the ongoing responsibilities to existing taxpayers and away from the Government. Again, this adds to higher burdens, especially on small businesses.

- Interest Rates will increase

This is the looming issue. It is not a matter of if, but when. Surprising to some, the FOMC does not control interest rates. Interest Rates are set in the open market by supply and demand, and associated risk factors. The FOMC can control lending rates between banks, to incentivize them to lend more or less, and that influences interest rates, but they do not control rates in the open market.

As of 12.17.09, the Treasury Auctions had already been showing signs of weakness. The Bid – Cover ratios were worsening for longer maturities, and potential buyers of US Treasuries were requiring a higher yield. I expect this pattern to continue. Regardless of what the FOMC decides, Interest Rates will move higher.

However, I also expect the FOMC to increase rates formally; otherwise, they will not be able to fund the revolving debt levels of the country because foreign investors will not buy Treasury Bonds. They have lost 38% by holding dollars since 2002 already, and many have had enough.

In addition, when interest rates go up, they have an immediately negative impact on the economy, where cuts often take time to make a difference. This is a touchy issue. I have already offered a detailed report about it. In early December 2009, I offered this report. Please take the time to read it.

Higher Rates and Dollar Stability:

http://www.stocktradersdaily.com/reports/dollar%2012.2.09.pdf

- Economic headwinds will increase

There are a number of economic headwinds to look forward to, but none is more important than Taxes and Interest Rates. We have already discussed those. I will offer a few more here.

The employment situation is also important. The jobs picture will not change meaningfully in 2010, with one exception. The number of unemployed over 26 weeks will increase closer to the unemployment rate. I do not expect significant hiring, outside of Government subsidized programs. More likely, I expect stability in the first half of 2010, and then weakness in the job market as the year progresses. Without significant hiring, more people will remain unemployed for longer.

In addition, the Government will need to unwind its intervention at some point, and that means they will stop creating jobs aggressively. In fact, we can conclude that the jobs creation programs will eventually turn into job sustainability programs. For example, if 100,000 jobs were created this year with Government funding, the same Government support will be required next year to keep those jobs alive. If the Government wants to increase the number of jobs, they will need to increase the funding beyond the prior year and grow from there over time. They cannot do this forever, but they seem to be trying. Soon, that will hit a wall. We all know this is coming too.

When they start to unwind, when the growth of their intervention stops, or when they disclose the method and timing of the unwinding, I expect that to be a significant headwind. This may not come until 2011 or 2012, but it is coming. Obama hopes to start unwinding when the economy begins to strengthen again. Unfortunately, he has not read The Investment Rate, at least I do not think so. The Investment Rate tells us that the amount of new money available for investment declines every year, and that will keep the economy under pressure.

- Commercial vacancies will increase

Small businesses are struggling. Wal Mart and the low cost leaders are attracting more business from smaller businesses, as they have for years, but now it is happening at a faster rate. In boom periods, this is not as significant, because consumers are more free with spending patterns. Now, that has changed.

Consumers are frugal, and they are more willing to wait in line, or sift through merchandise to find a bargain. Either small businesses need to compete on price, or they need to downsize. The number of consumers willing to spend in the same way as they did in early 2007 has declined significantly. Reasonably, businesses that cater to those spending patterns need to contract too, or the number of businesses doing so must contract, or both.

If small businesses do not compete by lowering prices, many will be forced out of business. In fact, even if they compete by reducing prices they may not be able to survive anyway. Margins are usually tight at smaller businesses, and with added healthcare costs and competitive pressures, those margins are likely to tighten even more.

The net result of this will cause the vacancy rate of commercial properties to increase even more. I expect this to begin in the first quarter of 2010, and maybe as soon as January. Retailers may be the

first to close. After struggling through the Holiday Season, I expect many of them to close their doors so the hard-earned money they were fortunate to earn in December is not wasted.

Remember, many retailers are individuals, not corporate entities. Pulling out of a retail location is not an easy decision, but some I know plan to do exactly that. Although shopping at major retailers may seem fine, the smaller retailers are not seeing the same traffic because of their relative price points. As a result, some will take what they can get this December, and call it quits.

- The size of our Government will increase

If you have any doubt about this, please re-read the sections above.

- Eventually, downside momentum will increase too.

This is the final stage. The Market will ebb and flow in the first half of 2010. I expect to see 10% swings up and down. With those, we should trade back and forth, patiently. We should buy the dips, and short the peaks. I believe we will see a peak in the early part of 2010, and that will get us started.

These oscillations should last for about 6 months. Then, as the second half comes clearer, the declines should resume. The headwinds I have listed will all be important, but none of this is more important than the Investment Rate.

Reasonably, Demand Levels have Returned to Parity. Prior to 2008, we saw an overshoot to the upside in net demand levels, in 2008 we witnessed an overshoot to the downside, and now we are back to even. We could overshoot to the upside again, but I am not expecting that.

Instead, we have returned to a declining curve, one that begins to decline significantly, as 2010 comes to an end. The Investment Rate tells us that the third major down period in US History is well underway, and significant weakness still lies ahead. In addition, the other factors I have outlined here suggest that the risks of a Greater Depression are serious. In fact, I believe one will come.

Stay proactive, control your risk at all times, and stay ahead of the curve. "Buy and Hold is Dead," for about five years. We will make money proactively until then, and then jump in with both feet. The net result will cause your real wealth to increase substantially over time, and allow you to catch the bottom when it comes. When the Greater Depression shows its head, we will be there to pick up the pieces.