

Market Memo—Look Back, Look Ahead I: Some wild predictions we made that worked out (more or less)

December 6, 2010

As we cap off another year and look at where we think the markets and the economy are headed in 2011, we thought it may be fun and useful to first look back at where we've been. We'll do so by highlighting key conclusions in pieces we wrote since the onset of the 2008 global financial crisis. As we were compiling this list, we were surprised—and perhaps you will be, too—at how prescient some of our calls and recommendations for equity investors proved to be. We had our share of whiffs (see accompanying sidebar, "*Our timing was off*"), so not to worry, we remain humble! But certainly our process of pulling together some of the best, and not always internally consistent and agreeable, thinking of Federated's equity and fixed-income managers served us well in steering our clients through one of the most volatile and hazardous market environments in our collective lifetime.



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Another thought dawned on us while doing our review. As bad as the back-to-back recessions were in the early 1980s, I think it's fair to say that the financial collapse that brought the world's economy to a halt in late 2008 and early 2009 is unrivaled in the post-World War II era. We were dead in the water two years ago. Talk of Armageddon was not hyperbole. That we escaped this fate is due in no small measure to quick actions by ours and other governments and central banks, working in conjunction with the natural inertial forces in our capitalist global economy which inevitably seem to tug that economy back towards its normal growth path. While we clearly have pockets of "economic resistance" to mop up in the quarters ahead (a little advertisement for Part II of this "Look Back, Look Ahead" piece), we can all be thankful that boldness gave no brook to timidity during this tumultuous time, and that our capitalist system bent but did not break!

Now let's take that trip down memory lane:

September 26, 2008 (S&P 500: 1,213.27) The Paulson Plan: 10 Reasons the pundits are wrong (and why it's good news for retirement savings)

"Our research of the six of the largest financial crises over the last 20 years—Sweden, Mexico, Russia, Thailand, Hong Kong and Japan—shows that markets tend to bottom sometime between 'immediately' and 12 months from the bailout announcement. And while returns during this bottoming process can be volatile, the average market appreciation in local currency terms from the point of the bailout to three years out was +49%. This is not a forecast, and every financial crisis is different, but the data suggests that the next 12 months present a historically good time to average into equity markets."

November 26, 2008 (S&P: 887.68) Where to now? Policy prescriptions to break the downward spiral

"... while every financial crisis is different, many share similar characteristics and patterns. The current one appears to be

Our timing was off

Not all our calls were on the mark. In mid-June 2009, we wrote that the dollar was primed to rally against the euro, fueled by the U.S.'s relatively stronger growth prospects and troubles spawned by the EU's fiscal straitjacket. Arguably, we were right—only six months too early! While fiscal issues did come to haunt the euro this year as its weak peripheral countries struggled with unpopular ways to pare debt, the reality is the dollar, having declined 12% against the euro the prior three months, fell an additional 9% from early June through early December 2009.

Several months later, I wrote about all the forces aligning for a V-shaped recovery—a necessary inventory restocking after a record depletion; globally coordinated stimulus; substantial corporate profit growth; history, which shows the strength of a recovery tends to be in proportion to the magnitude of the recession; a job market on the verge of substantial gains; and a housing market that was about to shift from stabilization to growth. While we right on most of these reasons—the job market has been on the verge of growth for a while now and housing has yet to get up off the floor—the economy failed to maintain its earlier momentum, with growth slowing dramatically in the summer as euro worries, Washington politics, and declining consumer and business confidence kept growth in check. We've seemed to have put

following on course. We are now in the 'massive government intervention and support' phase, which follows shortly on the 'fear and panic' stage. We are about to move into the deep recession phase, which will be painful. Sooner or later, though, the stimulus measures and policy initiatives already undertaken and about to be undertaken will begin to heal a weakened economy. Financial markets will discount this long before the recession bottoms. We now appear to be in the midst of a bottoming phase, which history suggests can last three to six months. For the brave, equity returns coming out of these phases can be superior to long-term averages, even spectacular. However, attempting to 'time' the bottom is fraught with peril and likely to lead to poor results. We continue to recommend investors average back to their targeted portfolio equity mix over the coming three to six months."

March 10, 2009 (S&P: 719.60) Will this rally have legs? Market's move up could have staying power but policy questions linger

"... we do believe that positive catalysts for equities in the days and weeks ahead will come from a more constructive fiscal policy stance out of Washington, a realistic banking fix out of Treasury, a more aggressive balance sheet expansion out of the Fed, and/or some sign that the news flow on the economy and corporate earnings is getting progressively less worse. These are the gauges against which long-term investors should measure the staying power of Tuesday's sharp rally. Our current neutral stance on equities reflects hope that these catalysts could spark a more significant up move in the face of very negative sentiment and cheap valuations, balanced by realism that the current environment is difficult and none of the positive factors outlined above are a sure bet."

June 1, 2009 (S&P: 942.87) Onward and upward. There are many reasons to believe this market run has some legs

"It would be understandable if equity investors, having weathered the worst recession and bear market since the Great Depression, pocketed their gains from March's new lows and followed the adage, 'sell in May and go away.' Unfortunately, we believe if they did this last month, it would have been a mistake. Mounting evidence suggests this economy may start growing again in this quarter and if not then, almost certainly in the third quarter. In other words, the recession—finally—is ending, which means now is hardly the time for longer-term equity investors to be selling and walking away."

August 25, 2009 (S&P: 1,028.00) Market memo: Near-term economic strength remains underappreciated

"... we think stocks are set to enter what we'd call a third leg of the market recovery. In the first leg (March 6 through early May), we had a short covering rally as investors who'd bet that the world was about to end were forced to cover their shorts when it became apparent that 'Great Depression II' had been avoided. Next, from June through mid-August, we had the first big earnings upgrade cycle, driven largely by aggressive cost cutting at the corporate level that produced better-than-expected earnings even as sales were light. We are now entering phase III, which will be a second round of earnings upgrades driven by more positive-than-expected GDP growth, which should generate better than expected corporate sales and earnings. ... With this in mind, we are recommending long-term investors remain overweight equities, with a particular tilt towards more cyclical sectors...."

September 16, 2009 (S&P: 1,068.76) Market Memo: The myths of bears and other monsters

"We're not Pollyannas. We understand the economy faces tough structural and long-term issues, from record and growing public debt that is all but certain to lead to higher taxes to household finances that are entering the recovery in relatively bad shape compared to historical norms. But we believe those issues aren't likely to rise to the fore anytime soon, and that others may be reversed by more near term events. The Federal Reserve has shown no inkling of tightening. The Obama administration has shown no rush to raise taxes. And an economy that's likely to spurt out of the gate much faster than consensus will provide some short-term relief. So, we take comfort that a bull market climbs a wall of worry; especially when many of the worries out there are built on myths, not fundamentals."

this soft patch behind us, but the V that was envisioned has yet to shift from a lower-case to upper-case version.

Finally, speaking of housing, we wrote in April of this year that housing starts were poised to double heading into 2011, aided by a record low pace of starts relative to household growth. We still believe this organic demand will materialize; it's just not coming as quickly as we thought. While we believe this setback will prove temporary, just as with our calls on the dollar (it did rally this year) and the V-shaped recovery (there's evidence the pace of growth is finally ramping up), if we were grading our performance on these calls at the time, we would have given ourselves a D- (subject to revision as events merit, of course!)

December 14, 2009 (S&P: 1,114.11) Market Memo: When it comes to the euro, think five little PIIGS

"To keep the euro from suffering, Germany and other euro members with more solid financial foundations likely will end up having to step in and bail out their weak brethren to forestall credit downgrades across the euro zone. But don't expect Germany to move quickly or easily; it will first negotiate with the PIIGS and extract as much fiscal pain as it can. This process is likely to be noisy at times, and even unsettling as it unfolds in the first half of 2010 ... While we don't expect anybody's financial house to actually be blown down by the fiscal wolf, we do see the dollar rising against the euro as this modern-day version of the popular fairy tale plays out."

February 26, 2010 (S&P: 1,104.49) Market Memo: Beware of arguments that sound plausible but miss the mark

"There's been a lot of discussion of late about three issues that could undermine equities this year—a China tightening, a Greece blowup and mounting U.S. debt. But the headlines on these concerns are stronger than their stories, diverting attention away from what we still believe will be the best story of this year: An economy and earnings that surprise to the upside, taking the equity markets with them. We continue to think the preponderance of evidence suggests that the current V-shaped recovery we are in will continue to take hold, with above-trend economic growth lasting well into 2011. This could push the S&P 500 to 1,200 in the near term and possibly to 1,300 or higher over the course of this market cycle."

March 17, 2010 (S&P: 1,166.21) Market Memo: President Obama's 'final push'—'Pickett's Charge' or something else?

"In the end, we believe the ultimate outcome of this monumental health-reform battle is that it will make clear that we are nation of centrists. We don't want government to get too big, taxes to get too high and change to come too fast. What we want in many ways is what we had in the mid-to-late 1990s, after President Clinton's health-reform push went down in flames and the Republican revolution in the House fizzled out—a White House and Congress that seek to make only modest, incremental changes with an eye toward achieving fiscal stability while improving the efficiency of government and the competitiveness of U.S. markets and business. It is a lesson the Obama administration may painfully learn once all is said and done with health care, one that may forever tarnish the Obama mystique while making him more receptive to the center where the majority of Americans live. That, we believe, is the message emanating out of this epic health-reform battle. If it sticks, the economy, the markets and the public will all benefit."

May 7, 2010 (S&P: 1,110.88) Market Memo: Near-term events add to equity risk (and opportunity to join longer-term rally)

"... Our base-case scenario remains positive on the global recovery, led by the United States and emerging markets. Europe's sovereign debt problem is primarily a euro-area issue (they owe most of the debt to each other), but given the lack of a central political structure, the resolution is likely to take time and ugliness ... [and] this increases the near-term downside risk in the markets. On the other hand, the profit cycle is well underway, corporations and even banks have strengthened their balance sheets, and equity valuations are getting extremely cheap as prices decline. We think this limits longer-term downside. As the markets consolidate over the next weeks, investors who have been underweight equities should use this opportunity to add to positions."

July 9, 2010 (S&P: 1,077.96) Equity Outlook: The pause that refreshes?

"As the market bounces down then up like a ping pong ball, it is appropriate to ask: 'What the heck is going on?' We certainly have been asking ourselves this question regularly of late ... some indirect factors have been negatively impacting markets and market psychology, with developments in Europe and the U.S. raising uncertainties about the outlook and causing the economic recovery seemingly to pause midstream. Whether this apparent pause ends up causing a 'stall-out' that leads to a double-dip recession and a retest of the 2009 stock market lows, or sets the stage for a period of renewed economic acceleration and a push through the recent 2010 market highs, may well be determined over the next few months. ... For now, we remain in the bullish camp."

November 10, 2010 (S&P 500: 1,218.71) Market Memo: A new dawn?

"As we evaluate the big, market-moving events of last week—the historic Republican takeover of the House and of the political momentum in Washington and state houses around the country, the Fed's launching of a new round of

quantitative easing (QE2), and the surprisingly strong October jobs report—we are tempted to declare the dawn of a new day for the economy and markets. While that conclusion is probably premature, we certainly are encouraged by the course of events and are maintaining our bullish stance towards equities. ... [We are] maintaining our 80% of maximum overweight equity call in our stock-bond allocation model, with expectations that the S&P 500 will test the 1,350 level over the next 12 to 18 months."

Look Ahead: What will 2011's headlines be?

Watch this space next week for Part II of this year-end piece, where we'll list a number of our more non-consensus predictions for the year ahead. Time will tell whether we'll again get more of these calls right than wrong, but one thing is for sure—it's likely to be another heck of a ride. Good reason in itself to remain diversified in your portfolio approach, while keeping that healthy equity overweight that's been the Federated house call since June 2009 and the position of our tactically managed balanced portfolios since mid-March of that year.

Views are as of December 6, 2010, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

Diversification and asset allocation do not assure a profit nor protect against loss.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

International investing involves special risks including currency risk, increased volatility of foreign securities, political risks, and differences in auditing and other financial standards. In addition, prices of emerging markets securities can be significantly more volatile than the prices of securities in developed countries and currency risk and political risks are accentuated in emerging markets.

PIIGS is the acronym for the European Union member countries of Portugal, Ireland, Italy, Greece and Spain.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

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