

global growth, and easy money fueled the price of oil. Natural gas, on the other hand, ended the year at \$5.6 per million BTUs—flat for the year. While oil is priced in global markets, natural gas is priced in local markets. New drilling techniques in the U.S. have produced an abundant supply of natural gas, and natural gas prices are often slower to respond to economic growth.

real estate—the pain continues

Home prices have fallen 30% since their peak in 2006, according to the S&P Case-Shiller index. One in seven homeowners is either in foreclosure or delinquent on their mortgage, and almost one in four homeowners has negative equity in their home. If house prices continue their fall and unemployment stays high, those who owe more on their mortgages than their homes are worth will have an incentive to turn in their keys. This will further increase bank losses and erode capital. Home prices have been helped by an \$8,000 tax credit to first time homebuyers and the Federal Reserve's commitment to purchase \$1.25 trillion of mortgage-backed securities. Both these programs run out in March 2010.

Meanwhile the last leg of the real estate bubble, commercial properties, has burst. Prices on industrial, retail, and office properties are down 20% to 30%. Many developers, property owners, and regional and community banks will go out of business over the next couple of years.

2010 outlook: clouded by moral hazard

The bursting of the real estate bubble in 2007 led to the near collapse of the financial system and the largest decline in economic output since the Great Depression. The Federal Reserve, the Obama administration, and governments around the world have poured trillions of dollars into the global economy in an effort to prevent a second Great Depression and alleviate the pain. These efforts appear to have worked as bank earnings have stabilized and economic growth resumed. However investors are asking questions such as, "What are the unintended consequences of these actions" and "Will the global economies prosper once governments withdraw their support?" Answers to these questions will determine the fate of the U.S. economy and financial markets.

Our views are based on the intentions of the Federal Reserve. The Fed believes that deflation and an unemployment rate that exceeds 10% are unacceptable. The Fed considers the economy to be at full employment when the unemployment rate falls below 5%. It is going to be a few years before we get

to full employment. The Fed would also prefer to inflate away our public debt obligations. Thus we expect the Fed to keep interest rates low for an extended period of time. Inflation is within the Fed's comfort zone and is expected to stay low, enabling the Fed's loose monetary policy. Emerging markets are growing at a torrid pace, which should be supportive of U.S. and European exports and the profitability of large multinational companies.

A "best case" scenario is that a self-sustaining recovery is underway and should build momentum as fiscal and monetary stimulus fades in the second half of 2010. This would be good for commodities and other hard assets, global equities, and corporate bonds. The Federal Reserve would gradually increase interest rates boosting the dollar and gold prices would fall. With the U.S. issuing record debt to fund its deficit, government bonds are likely to underperform riskier assets.

Another less desirable scenario could evolve as well. Once fiscal and monetary stimulus is withdrawn, economic growth will slow to 1%-1.5% in the second half of 2010. As a result, unemployment will remain high or increase, delinquencies will rise as homeowners with negative equity and no jobs walk away, and consumer deleveraging will hurt corporate profits. Such a scenario would be positive for government and investment grade corporate bonds, but would hurt equities, commodities, and high-yield corporate bonds. If the U.S. government continues to spend to support the economy, the dollar will fall and gold prices will rise.

Given the wide range of potential outcomes, investors should stay broadly diversified among the different asset classes—government and corporate bonds, equities, commodities, gold, and cash. For long-term investors, we have a couple of specific recommendations. First, with interest rates at historically low levels and housing prices down 30-35% from their peak, this is an excellent time to buy a new home or trade up to a more expensive home. Second, we recommend stocks of multinational U.S. companies such as McDonalds, IBM, Proctor & Gamble, and Johnson and Johnson. These companies have excellent balance sheets, access to credit markets, growth in emerging markets, and reasonable valuations. We expect these companies to outperform most other financial assets over the next five to ten years.

Sources: Wall Street Journal, Bank of America Merrill Lynch, Goldman Sachs