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## **ECONOMIC AND INVESTMENT FORECAST**

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As we enter the second calendar year in the recovery from the “Great Recession”, investors are understandably wary about the prospects for 2011. The S&P 500 Index has now recovered approximately 97% from its lowest point in March 2009, a substantial price rise over a short period of time. As the recovery took shape, investors made a substantial allocation change moving over \$750B out of stocks and into bond funds. This major shift by investors was driven by their quest for income and stable returns. Now at another crossroads, investors are being confronted with a new landscape of rising prices globally, increases in inflation expectations, and rising interest rates. Each of these trends is unfavorable for most bond investments.

Corporate revenues, particularly in the form of exported goods and services, have been growing steadily. The outlook for business is equally strong, with earnings estimates, capital expenditure plans, and dividend payment guidance all on the rise. But with this strong momentum comes inflationary pressures. Companies are being forced to raise prices to compensate for higher cost raw materials, while individuals in some countries are finding basic foods prohibitively expensive. While we are projecting continued inflation and eventual tighter monetary policy, we do not expect Federal Reserve Chairman Bernanke to begin raising U.S. interest rates until later this year or early 2012.

Foreign central banks are addressing regional inflation problems with different levels of urgency. China and India, both fast-growing economies, have responded hawkishly by raising interest rates meaningfully to slow growth. China is in an especially difficult position because lowering inflation via tighter monetary policy could trigger a collapse in their overbuilt real estate sector. A Chinese real estate collapse would have a major adverse effect on the global economy. Conversely, the Bank of England has expressed less concern about rising prices and opted to maintain low rates to stimulate growth. As to what is in store for the U.S., Japan’s recent credit rating downgrade by Standard & Poor’s and Europe’s sovereign debt crisis are likely preludes to what the future holds for indebted municipal, state, and Federal government agencies here in this country.

While we have witnessed improving economic data and benefited from rising stock prices of late, we note the struggles in the areas of unemployment and small business. Companies with less than 500 employees have accounted for 64% of new job creation since 1996. But in this recovery, small businesses have struggled, leaving more people out of work. Compounding the problem has been the damage to banks during the recession, and their consequent inability to assume their role as sources of credit. With banks not fully open for business, small businesses have been unable to access credit, invest in their companies, hire, and grow.

For 2011, economists are forecasting at least 3% GDP growth given the accommodative interest rate policy, ongoing stimulus, and broadly improving consumer confidence. So far, this has been a text book “balance sheet” recovery with consumers deleveraging and building savings. We anticipate the following investment themes taking shape as we move through the recovery cycle: equity leadership transitioning from small to large capitalization companies, outperformance in shorter maturity global fixed income securities, recovery in real estate globally, and good value in particular emerging regions like Eastern Europe.