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Retirement & Estate Planning & Investment Management

www.noyescapital.com

973-267-8120

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Back to Business as Usual

By Scott P. Noyes, CFA[®] CFP[®]

It looks like the economy and stock market are reverting back to “Business as Usual.” Multiple crises have been averted. Over the past two weeks, Fed Chairman Bernanke has re-confirmed his easy money, low interest rate stance. The European Union has successfully managed the “Greece problem.” Corporate earnings are improving through cost cutting rather than revenue growth. Most importantly, we have achieved regulatory reached gridlock again in Washington – this is typically good for businesses and the stock market.

So far this year, the stock market has held within our previously described trading range of 9,750 to 11,500. After starting the year at 10,400, the Dow Jones Industrial Average peaked on January 19th at 10,725. It then proceeded to correct for three weeks to February 8 where it bottomed at 9,909. Now we are back to 10,400, where we started the year. Similarly, interest rates and gold have gone nowhere for these two months. The only investments that really worked were to receive interest and dividend income.

The international story is decidedly different. European stock markets have drifted lower on continued fears of credit downgrades for Greece and several other countries. In China there are concerns about a real estate bubble, which has led to a tightening of credit from the Chinese central bank. This could lead to a slowdown of growth in the emerging markets. Together, these resulted in a more cautious atmosphere towards international investing and resulted in a rally in the US dollar.

The question is whether the recent correction is over or just resting before it takes another leg lower. My best guess is that the correction is over because:

1. **The economy is improving** – albeit not up to past historical standards. Multiple economic indicators are improving and suggest the end of the recession is upon us.
2. **Interest rates remain extraordinarily low.** While the forces of deflation remain strong, there is a risk that corporate and consumer borrowing costs could increase due to an overload of government borrowing. This could result in higher interest rates, even in a low inflation environment.
3. **The government continues to spend to stimulate the economy.** The administration’s proposals for a second stimulus bill are likely to receive bi-partisan support.

Investor psychology remains fragile and many investors are quick to over-react or panic. Wall Street traders and their media outlets are good at manipulating this psychology to their financial gain. There is always the chance that the herd of investors will start to stampede again. We are respectful of this possibility.

In our judgment, both the potential upside and downside for the market from current levels is limited. As we come out of the recession, we are likely to enter a “New Normal” economy constrained by lower household debt, higher personal savings and less consumption. While these themes used to be seen as virtues, they work to constrain economic growth and are likely to be with us for an extended period of time. For many people, the “American Dream” was built on credit which now has to be paid back. We believe that this “New Normal” economy will create disappointing economic growth for the next three to five years.

Inflation is not a Current Concern

I do not see inflation as a near term concern. Currently there is excess supply of US labor, housing units, manufacturing inventories, consumer debt, financial debt, state and local government debt and Federal Reserve liquidity. The risk of inflation as measured by the Consumer Price Index (CPI) can best be analyzed by looking at its components.

	<u>Weight</u>	<u>Trend</u>
• Housing Costs	42%	down
• Transportation (car + gas)	18%	sideways
• Food & Beverage	15%	down
• Education/Communications	6%	sideways
• Health Care	6%	up
• Recreation	6%	down
• Apparel	4%	<u>down</u>
Overall Index		sideways to lower

None of these appear to be a concern except health care costs and commodity prices. Over the next two to three years, we see little risk of inflation. We expect that CPI will average 2% through 2012. In particular housing inflation and labor inflation should remain subdued. However, we do see some risk of commodity based inflation. This would include agricultural commodities, energy costs and metals prices as the price of these goods are set globally. We envision investments in commodity type investments in the near future.

Interest rates have two components – an inflation component and a real interest rate. We see little chance that the inflation component will drive up interest rates in the near future. However, with a tremendous supply of government debt issuance, the real rate of interest that it takes to clear the market may increase. We envision marginally higher interest rates over the course of the year.

Our Market Strategy

We remain focused on building portfolios that succeed in a “New Normal” economy. In this light we have three biases in our portfolios:

- 1) **Add more income investments to portfolios.** We seek income opportunities in the form of high dividend stocks, investment grade bonds, municipal bonds and Income Trusts. We favor high quality over high yield. We believe this strategy will help add some stability to our portfolios during choppy stock and bond markets.
- 2) **Underweight international equity** exposure as we believe this year’s negative surprises are likely to originate overseas. We have been underweighted in European stocks since mid last year. Overseas concerns are currently causing the US dollar to rally. Foreign investors are moving to the US for safety reasons.
- 3) **Stay with long term equity holdings.** We believe that equities will outperform bonds over the next two years. While holding stocks may feel terrible at times, we believe that you will be rewarded for patience. Reminder – the investors who really lost in the crash were those who sold stocks and moved to CD’s. When markets go back up, they do not ring a bell to let you know to get in. We remain invested, diversified and patient.

Please call me if you have any questions at 973-267-8120.

Scott P. Noyes, CFA[®], CFP[®] is the President of Noyes Capital Management, LLC, an independent fee-only wealth management firm based in New Vernon, New Jersey.
www.noyescapital.com

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