

REVIEW

2009 was a remarkable year for the economy and the capital markets. The first quarter was awful with stock markets and credit markets swooning. That was followed by stabilization and improvement in the last three quarters, resulting in most every global stock market ending the year up over 20%.

Last year saw an unprecedented level of U.S. government stimulus (fiscal and monetary) designed to keep the private sector of the economy from collapsing. Other governments and central banks around the world embarked on a similar course.

Taking a longer term perspective, the last decade was an unusual one for inflation-adjusted returns on U.S. stocks. Looking at rolling ten-year periods going back to 1871, the ten years ending in 2009 was the fourth worst out of 138 such periods. It delivered *negative* real returns. For this reason, many have referred to it as a “lost decade.”

ECONOMIC AND INVESTMENT OUTLOOK

Our economic and investment outlook has not changed materially from what we laid out in our early-December presentation to clients. To reiterate, the key points of our outlook are as follows:

Of the two pessimistic outlooks widely discussed today, neither deflation (caused by too much debt) nor hyperinflation (caused by too much government spending) is likely to unfold as feared.

We do not agree that the U.S. economic torch is being passed to other countries in a way that will keep U.S.-based companies from prospering in the years ahead. U.S. multinationals, for example, are very well positioned to take advantage of growth in other parts of the world.

The global economic recovery presently underway will continue to make progress. However, this recovery may be less robust over the next few years than previous recoveries have been.

While future global economic growth may be less robust, the more important issue is what the *nature* of that

growth will be. In the last cycle, consumer consumption in the developed world was enabled by cheap imports and cheap credit from many emerging economies. Emerging economies spent heavily on industrial expansion to build infrastructure for their exports. This produced “heavy” growth in areas like commodities, materials, and energy. We think the next cycle will be marked by more “light” growth in areas like healthcare, technology, and telecommunications.

We do not favor securities such as long-term U.S. Treasury bonds or gold whose current high prices reflect the unfolding of pessimistic scenarios. Stocks, on the other hand, are trading at average valuations relative to history. If the economy holds up as we expect it will, stocks should be a good *relative* bet.

RISKS AND CHALLENGES

The U.S. and the rest of the world must still overcome significant hurdles in order to avoid backsliding into another recession.

Within a year or so, the Federal Reserve and foreign central banks will have to start draining excess money supply from the global monetary system on a scale never before attempted. For this policy to be successful, it must not force up interest rates to heights that imperil economic growth or allow inflation to rise to a damaging level.

Consumer and business spending must continue advancing at a moderate pace to make the private sector less dependent on fiscal and monetary stimulus and to reduce unemployment.

There must be an improvement in the growth rate and quality of corporate profits in the financial, industrial, and service sectors of the economy.

Asian economic growth needs to persist unabated. Finally, Middle East oil supplies must not be disrupted as the world attempts to control Iran’s nuclear weapons programs and to suppress actions by various terrorist groups around the world.

PORTFOLIO STRATEGY

Based on the aforementioned considerations, our portfolios are presently positioned with equity weightings above the midpoint of target ranges.

Within the fixed income component of portfolios, we are focused on the following:

- **High quality** – We want safety with our bonds because equities have risk.
- **Liquidity** – Short-term, stable value securities provide the funds for client withdrawals. This enables clients to withstand a multi-year period of economic dislocation without having to sell securities that would be down in price.
- **Limited maturity** – With yields at generational lows, longer bonds aren't worth the extra risk.
- **Inflation protection** – TIPs have coupon payments that adjust upward with inflation.

Within the equity component of portfolios, we are focused on the following:

- **High quality, dividend-paying multinationals** – These stocks are an important contributor to overall portfolio yield. They should also profit from a growing global middle class.
- **Emerging markets with relatively little direct sensitivity to commodity prices** – Examples include markets like Singapore and Hong Kong.
- **Telecom companies** – These can generate earnings and dividend growth at a fairly low level of risk.
- **Pipeline MLPs** – These offer yields of 7%+ and can do well in an environment of steady economic growth with flat oil prices.
- **Small caps** – These continue to look undervalued relative to large cap companies.

SUMMARY

Longer term, we think that stocks have good relative appeal because they are reasonably valued and the economy is recovering. Clients also have greater financial flexibility now that the capital markets have recovered. As a result, equity weightings are above the midpoint of target ranges.

Shorter-term, we note that stock prices have come a long way from their March 2009 lows without a 10% or greater correction. This is unusual. Short-term interest rates have been held at artificially low levels for quite some time and will probably start to rise in 2010. This may be the catalyst for an overdue correction.

Such a correction would not necessarily negate our outlook for positive equity returns over the next couple of years. What would change our fundamental outlook for the worse *would* be negative developments among the risk and challenge factors noted above. Thus client portfolios are structured for some protection against that less likely possibility. On balance, however, they are structured to participate in what should be a relatively favorable environment for equities.

ABOUT CHATHAM

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