

Market Commentary

by *Byron Wien*

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The Surprises of 2010

For the past 24 years I have prepared a list of ten investment-related surprises that I believe are likely to happen in the New Year, but to which the average investor would only assign a one out of three probability to the event taking place. I started doing this in the 1980's because I thought short term thinking was the curse of effective money management. Investors were too concerned about quarterly earnings, monthly sales, the latest unemployment report and other economic data. Once a year I wanted to take a longer view and reflect on what non-consensus (not necessarily contrary) events could have a major influence on the investment environment.

When I started doing this, I didn't think much about keeping score, but that was naïve. This is Wall Street, after all, and every one keeps score on every thing. Over the years I have generally gotten five or six of the surprises pretty close to target. There was a string of three years in the 1990's when I scored seven out of ten, but that was followed by my worst year, 1996, when I only got three. Last year, 2009, has turned out to be the best of my career; some part of eight or nine surprises were essentially right, depending on how tough you want to be with the scoring. Previously I had never done better than seven.

While I work on The Ten Surprises for the better part of three months I explore many sources. Clients and friends give me their suggestions. George Soros and I discuss possible surprises as we have for the entire life of the project and he was especially helpful this year. For many years I have been reviewing the geopolitical outlook with Jim Hoge, the editor of Foreign Affairs. Middle East expert Judy Miller and I debated the possible surprises in that region at length. My Third Thursday group of former Wall Street research directors provided helpful guidance. In the end, however, I decide on the final ten and I am responsible for the outcome.

Let's take a look at the Surprises of 2009. The first one was my expectation that the Standard and Poor's 500 would rise to 1200. It started the year at 903 and I believed the sharp market declines of October and November 2008 had left investors in a despondent mood. I further thought that the United States economy would be recovering from its recession during the second half of 2009 and the market would do well. That forecast looks pretty good now but during the first few months of the year stocks moved sharply lower with the index bottoming on March 9th at 670. (For a while there I thought this might be the last year of The Ten Surprises.) I also believed that the bond market would lead equities higher with corporates, leveraged loans and mortgages proving to be profitable investments.

The second surprise was that gold would reach \$1200 an ounce and this one has also worked out well. Gold started last year at \$865. I did not view gold as an inflation hedge or protection against political turbulence in the world although historically it has served that purpose. My enthusiasm for gold was because I thought it could serve as an insurance policy against growing investor disenchantment with paper currencies, not only the dollar, but also the yen and the euro. Major industrialized countries throughout the world had expanded money supply rapidly and run heavy fiscal deficits, policies likely to diminish confidence in their currencies. Although gold provides no current return it has proven to be something "real" that could be exchanged for other items of value during times of stress. I thought that there was sufficient uncertainty in the world at the beginning of 2009 to encourage investors to allocate a portion of their portfolio into gold as protection for their financial assets and a little incremental buying could go a long way. It did.

I was bullish on commodities last year. I thought crude oil would rise to \$80 a barrel from its \$59 starting point and some industrial commodities would double from their 2008 lows and that happened as well. Unfortunately I overreached, thinking natural gas would rise to \$9 per mcf and it ended the year closer to \$6. Demand for oil from the developing world has increased faster than demand from the developed world has declined as a result of the recession, displacement by alternative fuels and conservation. New sources of oil have only come on-stream at about the rate established wells have depleted, so overall production has been relatively stable at around 85 million barrels a day. Natural gas supplies, in contrast, are abundant and the problem is getting this energy source to end users. This situation may not change since new gas finds seem to be

taking place all the time.

In the fourth surprise I expected a significant decline in the dollar against both the euro and the yen. The sharp drop against the euro did take place (although it did not go as far as I thought), but the weakness against the yen was more subdued. My reasoning was that the United States was going to be running large budget deficits as a result of various programs designed to pull the country out of its recession. While I expected the trade deficit to decline, it would still be several hundred billion dollars. Since I thought the savings rate would stay low, most of these deficits would have to be funded abroad. Moreover the balance sheet of the Federal Reserve had become swollen with real estate related securities and had deteriorated in quality. Money supply had expanded rapidly raising concerns about inflation. Years of lending to the United States by Japan, China, the Middle East and Europe had made these sources of capital less willing to provide more funds. For all of these reasons I thought the dollar would be weak. A strong economy and a strong stock market in the United States might reverse the slide but I thought the prospect of both of those conditions taking place was small. I expected the economy to recover, but I did not expect growth to be dazzling.

In the fifth surprise the yield on the 10-year U.S. Treasury note reached my 4% target but it did not hold there. The yield started the year at 2.21%. I had expected that a combination of a weak currency, large budget deficits and a recovering economy would drive yields on government securities higher, but I underestimated the fear in the financial markets. Investors wanted to park their money in the safest assets and they were willing to accept very low returns to do it. The 10-year yield ended the year close to 4%, however.

At the beginning of 2009 most investors were very bearish on the outlook for China. Some of these had been suspicious that China's growth was unsustainable at best and artificial at worst. Many compared the situation to Japan in the 1980's and believed a bubble was forming. In any case the popular view was that the recessions in the United States and Western Europe would dramatically reduce China's exports and growth there would slow to low single digits, possibly causing problems in the banking sector and unrest in the population because of a lack of job opportunities. I did not expect this to happen. China implemented a \$585 billion stimulus program in an economy with a gross domestic product of less than \$5 trillion. They put all of it to work relatively rapidly. The United States has a \$787 billion stimulus program in a \$14 trillion economy and only 30% of it has been spent. I expected China to grow at 7% or more. Much of their stimulus has been spent on infrastructure projects which should have favorable long term returns. It is easy to underestimate the effectiveness of an authoritarian government structure. You assume the population will react unfavorably to its oppressiveness, but China has accomplished more in the last three decades than any country in history. It responded very quickly to the recent financial and economic crisis and growth in 2009 should approach 9%. Skeptics will question the data from the government, be critical of the lending policies of financial institutions and the quality of apartment and infrastructure construction, but in my view China is on a path to becoming the largest economy in the world. It may run into problems because of a lack of democracy, pollution or human rights infractions later on, but for now I believe the growth is real and will continue.

My seventh surprise recognized the lamentable financial condition of various states like New York and California. I said New York would go bankrupt and it has not, but I view that as a technicality. State revenues are woefully short of expenses and the legislature seems unable to cope with the pending crisis. The situation in California is similar and may even be more severe. Many other states are operating in deficit and will turn to the Federal government for help, putting further pressure on the Federal budget. This is a secular problem with no easy solutions. It will only become more serious in the future.

I expected housing to bottom in the eighth surprise and real gross national product to become positive in the third and fourth quarters and I believe both of these conditions have taken place. The Case-Shiller index of housing prices has turned positive. There are still many homes where the mortgage exceeds the value and many of those are behind in payments. The inventory of unsold homes and those in trouble is large so we are unlikely to see a reemergence of the heady atmosphere that created a bubble in the industry earlier in the decade. If the economy has started to grow again and the growth continues, then the worst is probably over but the health of the industry is only going to improve slowly.

In the ninth surprise I expressed the opinion that consumer spending had become an ingrained component of the American culture which was not likely to be reversed even during a financial crisis or recession. Almost nobody agreed with that. The general thinking was that consumers were frightened and times were uncertain. Thus spending would be cut back and the savings rate would increase, perhaps to 8 to 10%, the peak level of earlier cycles. My view was that the savings rate would stay around 3%. With tax rebates and other programs, the consumer did pay down home equity loans and

installment debt and the savings rate briefly went above 7% but it has settled back to something above 4% now and I believe that's where it will stay unless economic conditions materially worsen. At the end of this surprise I threw in the suggestion that Christmas 2009 would be the best ever. That did not turn out to be the case, but the holiday selling season was better than the consensus expected.

Finally in the tenth surprise I expressed the view that President Barack Obama, once he was inaugurated, would become more hawkish than his campaign rhetoric indicated. He would be briefed by the Central Intelligence Agency, the Defense and State Departments and would understand more deeply the problems presented by an unstable Middle East and Asia. I thought he would slow troop withdrawals from Iraq and actually increase troops in Afghanistan and that is what he has done. He has announced a program of troop withdrawals in the latter beginning in 2011 but we'll see if he sticks to that. This region has been a costly adventure in terms of both lives and appropriations and it is not clear that either country will be able to remain stable when American troops finally pull out. There has not been a successful terrorist attack in the United States since the World Trade Center fell. Luck and counter-terrorist efforts throughout the country have played a major role in accomplishing that but so has the elimination of an important part of the Al Qaeda leadership through our military efforts in the Middle East and we should recognize that.

To be effective the surprise must represent either a reversal of conventional wisdom or extend much further out in the direction of the consensus view. Most people today believe both gold and oil are moving to higher prices and China will keep growing at an impressive rate. So do I and that's why these three items, stalwarts in the past, are not on this year's list.

Now let's look at the list for 2010.

The Surprises of 2010

1. The United States economy grows at a stronger than expected 5% real rate during the year and the unemployment level drops below 9%. Exports, inventory building and technology spending lead the way. Standard and Poor's 500 operating earnings come in above \$80

2. The Federal Reserve decides the economy is strong enough for them to move away from zero interest rate policy. In a series of successive hikes beginning in the second quarter the Federal funds rate reaches 2% by year-end

3. Heavy borrowing by the U.S. Treasury and some reluctance by foreign central banks to keep buying notes and bonds drives the yield on the 10-year Treasury above 5.5%. Banks loan more to corporations and individuals and pull away from the carry trade, thereby reducing demand for Treasuries. Obama says, "The suits are finally listening"

4. In a roller coaster year the Standard and Poor's 500 rallies to 1300 in the first half and then runs out of steam and declines to 1000, ending where it started at 1115.10. Even though the economy is strong and earnings exceed expectations, rising interest rates and full valuations present a problem. Concern about longer term growth and obligations to reduce leverage at both the public and private level unsettle investors

5. Because it is significantly undervalued on a purchasing power parity basis, the dollar rallies against the yen and the euro. It exceeds 100 on the yen and the euro drops below \$1.30 as the long slide of the greenback is interrupted. Longer term prospects remain uncertain

6. Japan stands out as the best performing major industrialized market in the world as its currency weakens and its exports improve. Investors focus on the attractive valuations of dozens of medium sized companies in a market selling at one quarter of its 1989 high. The Nikkei 225 rises above 12,000

7. Believing he must be a leader in climate control initiatives, President Obama endorses legislation favorable for nuclear power development. Arguing that going nuclear is essential for the environment, will create jobs and reduce costs, Congress passes bills providing loans and subsidies for new plants, the first since 1979. Coal accounts for about 50% of electrical power generation, and Obama wants to reduce that to 25% by 2020

8. The improvement in the U.S. economy energizes the Obama administration. The White House undergoes some reorganization and regains its momentum. In the November Congressional election the Democrats only lose 20 seats, much less than expected

9. When it finally passes, financial service legislation, like the health care bill, proves

to be softer on the industry than originally feared. There is greater consumer protection, more transparency, tighter restriction of leverage and increased scrutiny of derivatives, but the regulatory changes for investment bankers and hedge funds are not onerous. Trading volume and merger activity increases; financial service stocks become exceptional performers in the U.S. market

10. Civil unrest in Iran reaches a crescendo. Ayatollah Khomeini pushes out Mahmoud Ahmadinejad in favor of a more public relations adept leader. Economic improvement becomes the key issue and anti-Israel rhetoric subsides. Talks with the U.S. and Europe begin but the country remains a nuclear threat. Pakistan becomes the hotspot in the region because of the weak government there, anti-American sentiment, active terrorist groups and concerns about the security of the country's nuclear arsenal

Here are some "also rans"

11. China grows weary of investing indirectly in developed countries. It works out a deal where it is permitted to take large positions, including control, of United States and European companies. Technology and defense contractors are excluded. In exchange it agrees to revalue the renminbi by 5% this year and more over the next five years

12. The health care bill passed by Congress was so watered down by compromise it has no kick: no public option, no real reform, no significant cost saving measures. As a result health care stocks, held back by profitability fears in 2009, become strong performers in 2010

13. Continued concern about paper currencies drives investors to insure their financial assets with something that has endured value erosion over time. After a strong year in 2009 gold continues to rise reaching \$1500 an ounce

14. In spite of some softening of demand from the developed world and some penetration from sources of alternative energy, growing oil consumption from the emerging markets drives the price of crude to \$100 a barrel

15. The Chinese economic miracle continues as the country grows at a 10% real rate in 2010 fueled by more consumer spending and less saving, but minimum capital requirements for the banks are raised throughout the year to prevent the economy from overheating. Inflation becomes a serious concern of policy makers there

16. The world begins to recognize that the rising standard of living everywhere is going to create shortages of commodities beyond industrial materials and energy. Food becomes the focus and the price of wheat, corn and soybeans rise. Water also becomes an issue as shortages grow

To view a replay of Byron Wien's January 5, 2010 webcast discussing his Ten Surprises of 2010, please click [here](#).

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