Seeking Alpha α

11 Themes for 2011

by: Nicholas Cavallaro

December 09, 2010 | about: DIA / EWJ / EWY / FXE / FXI / GAF / IEV / QQQQ / REZ / SPY / XLF

As the calendar year comes to a close, many financial pundits will surely pontificate their wisdom to the masses with investment ideas for the upcoming year. Most of this investment advice is portrayed through generalities, like a top ten list, and lack fully-developed conclusions. The reality is, after the article is read, the author is rarely held accountable.

So, I'm going to take a modified approach. I'm not going to prognosticate straight investment advice. Instead, I offer 11 themes for 2011. Here, I postulate eleven investment themes to consider for the upcoming year. Although I don't necessarily have a conclusion for each theme, I offer various perspectives for the reader to consider.

Let's start globally and work our way back home.

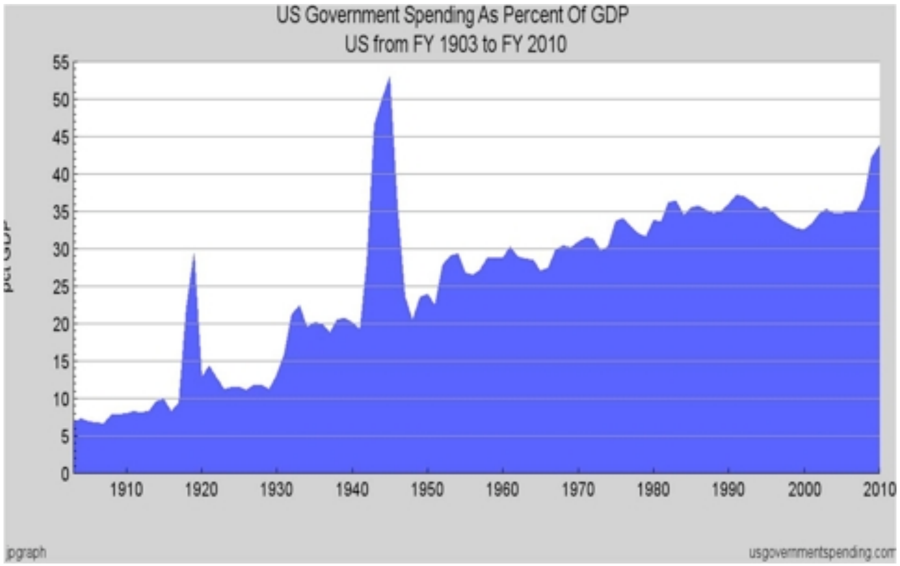
1 Europe - European countries have some serious balance sheet dealings to resolve. This is not an issue of Greece, Ireland, Portugal, and Spain. Although the Spanish domino falling would provide a thundering boom, the weak links continue with Belgium and Italy. These countries cannot continually be bailed out without underlying economic growth to support themselves. If these bailouts spread (making the debtors whole), the euro will surely come under additional pressure. At what point will the German economic stalwart refuse? Then what?

2 Asia – Asia offers much to contemplate. China, contrasted to the rest of the world, still has a booming economy. Yet, an oversupply of housing could trump this, and short sellers are readily taking this trade. On the Korean Peninsula, recent combat aroused all sorts of diplomatic and nuclear worries. Moreover, the North Korean ascendancy of Kim Jong-un to power raises many more questions than answers. Financially, long volatility and defense contractors may benefit should flames ensue. Across the Sea of Japan, 2011 may finally allow everyone to see Japan's bond market bubble pop.

3 Middle East – A year ago, I read an argument predicting that Israel would preemptively strike Iran. This was one of the reasons for my purchasing oil back in May. I've since exited this trade, and the price of oil continues to soar. Granted, there are many variables in play here, but I wish to focus on a relatively new aspirant, WikiLeaks. By publicizing secret information intended for senior policy makers—information bestowed in confidence—the precarious Middle East has become much more dangerous. If fiery tensions didn't already exist, an abundance of fuel has suddenly presented itself for a conflagration extraordinaire.

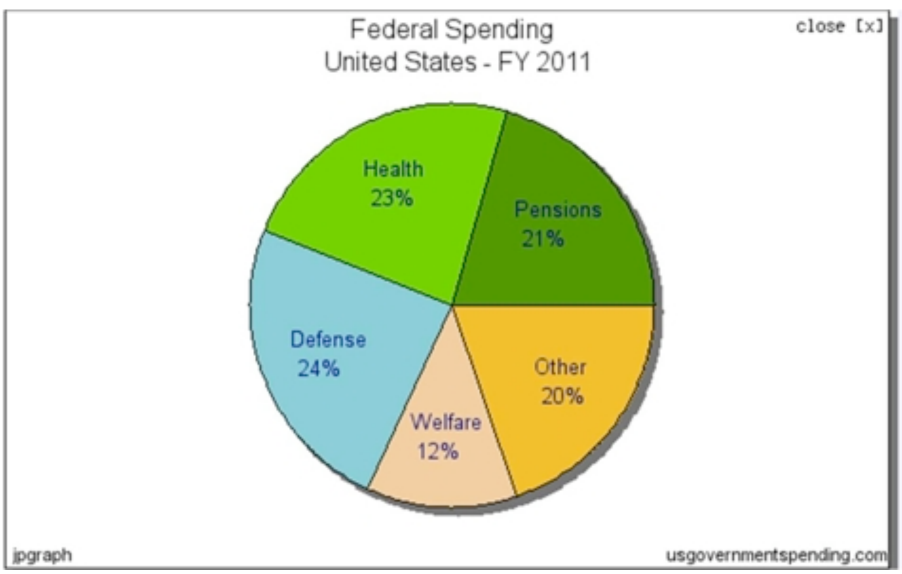
4 US Balance Sheet Woes – The current and future state of the US Balance Sheet is incredibly lopsided. Government spending, as a percentage of GDP, has climbed for decades and soared over the past few years.

click to enlarge images



This matters because government allocation of funds is almost always inefficient. When a central government takes a command and control approach to managing an economy, that economy is subsequently prohibited from effectively allocating resources. The end result is detrimental to everyone within that economy.

Here are the leading culprits.

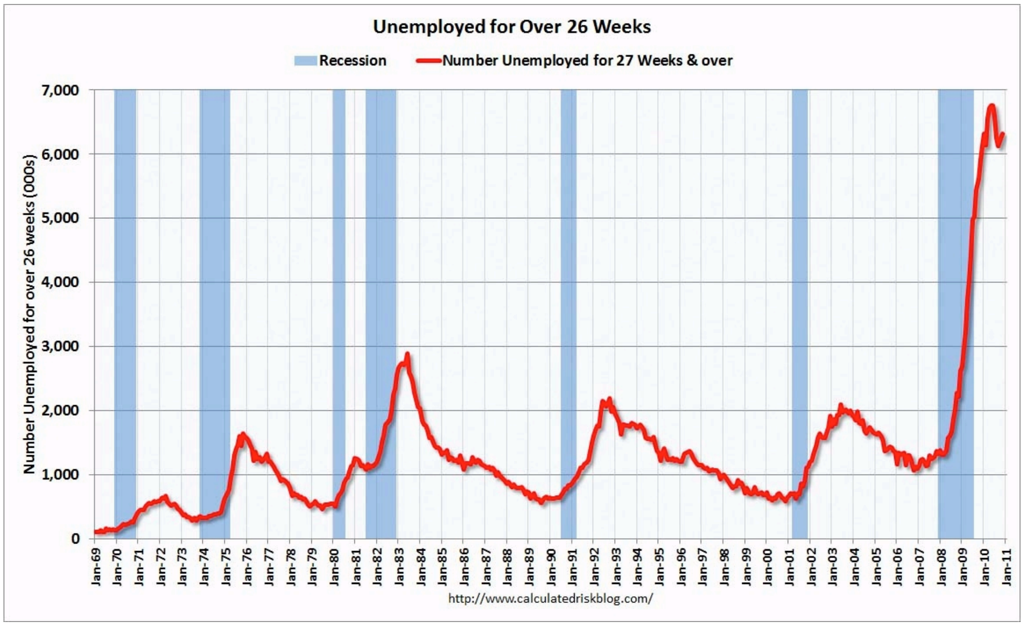


Even worse, entitlement spending (Pensions, Health Care, and Welfare) is projected not only to grow in dollar terms, but also to grow at an increasing rate. Something has to give (a change to spending, tax levying, or both). Too many liabilities exist for the nation's ability to pay for them. As the US continues to borrow and spend, US interest rates will rise, the foreign exchange markets will push down the value of the dollar (and appear as inflation), or both.

5 The Economy – Likewise, the economy will continue to spin its wheels. Looking back, the past handful of reporting quarters have been supported by fiscal stimulus, something that will not continue. Moreover, I doubt many capital investments have been made, and capital investments are usually associated with and responsible for economic expansions. What is more, the greater the government involvement in an economy, the more it crowds out private sector opportunities. With an economy that fails to grow as expected, production will lag, forcing consumer spending to lag as well.

6 Housing, Banks – The US will continue to suffer from the housing bubble's effects, primarily because current and future supply of available houses vastly outweighs demand for them. The result of this environment is that home prices will continue to sag or plateau nationwide. As a corollary, mortgage related assets that are nonperforming or impaired that are held on banks' balance sheet produce less revenue. Thus, individual banks may face continued headwinds.

7 Unemployment – The unemployment rate is a discomforting 9.8%; the all inclusive unemployment rate is 17.0%. I doubt either of these will see much relief in 2011 with fluctuation of plus or minus 0.5% and 1.0% respectively. Part of the unemployment problem is that people are upside down on their mortgages and cannot relocate to take a new job. Other regulations prohibit employers from hiring, and without production, an economy does not grow. A final thought is that as the duration of unemployment lengthens, potential workers' skills atrophy, and become less employable (graph). Unfortunately, I foresee no quick fix in 2011.



8 Monetary Policy, Asset Valuations – The Federal Reserve has taken a lot of heat this year, especially after announcing its second quantitative easing intentions with the goal of flooding capital markets with money to create inflation. Just taking a step back and thinking about how many fiat currencies succumbed to inflation, it almost sounds absurd. Peter Schiff's 7/20/10 forecast, that asset prices (real estate, stocks, and bonds) will fall and that consumer goods prices (food, energy, clothing, healthcare, and education) will rise, still seems to be the right call.

9 Municipalities – *House prices never fall... Municipalities never default...* Coming back home, municipalities are susceptible to fiscal imbalances with a continued weakened economy. Additionally, many benefit programs are underfunded, and states are merely using accounting gimmicks to survive. Investors are increasingly recognizing these risks, and municipal bonds are sporting daringly high yields as a result. If local shenanigans continue or remain unresolved, municipal defaults may make headlines in 2011. Even worse headlines could ensue: municipal bailouts.

10 Estate Tax – Including this one on the list may seem not to jive with the rest, but the financial impact is quite meaningful. As of January 1st, the estate tax will rise to a top rate of 55%. So, die on December 31st—no tax. Watch the ball drop in Times Square and keel over an hour later—over half of your estate is gone. It appears that the rate will settle closer to 35-45%, yet who is impacted by this and by how much seems to change on a daily basis. If the impact of this goes through in force, then a gargantuan leap from 0% immediately incentivizes people to circumvent the tax. An alternative way of passing on inheritance tax free is through life insurance policies. In this situation, life insurance companies could charge increased prices and benefit from this one time jolt.

11 Individual Investors – Reasonably thinking, where do individual investors put their money in 2011? Unfortunately, no easy answers present themselves. Stocks are probably overvalued, as are bonds. Real estate will be problematic for years. Savings accounts and CDs are yielding next to nothing. Municipal bonds could shatter. China still lacks the regulatory structures that Americans are accustomed to, and its economy could run out of steam. Commodities have rocketed upward, yet how much longer could this go on? It seems that every asset class has stronger arguments against it than for it. Sure you can profit from tactical trades, but the low hanging fruit seems to have been picked. Significant risk will accompany additional sought-out gains. For anyone to proclaim otherwise, would be imprudent.

Disclosure: I have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

Comments on this article

Add a comment

Plan B Economics

Interesting.

Here's another 11 for 2011 list. This one takes more of a contrarian approach: www.planbeconomics.com.../

fundspoken

This article seems reasonably grounded in reality to me. It is not overly optimistic about making profits in 2011 without taking chances and knowing the sector of the market you choose to invest in pretty well. It is kind of "let the investor beware" type of market for coming year with far more short-term traders than buy and hold traders because of economic gloominess in the global markets and our inability to look more than a couple of month into the future with even a modicum of certainty.

Econdoc

another very soft editor's pick. what a laundry list. talk about boiling the ocean.

I love this time of the year - when an unemployed stock analyst from Chicago can opine like Henry Kissinger on geopolitics

here are are some better ideas

1. emerging market consumerism. there are more of them and the want to tade up - not down. buy anything that meets this demand. and I don't mean commodities. I mean companies that provide cheap branded consumer products. Tupperware is a terrific example of this.

2. continued upside earnings surprises for US large caps. earnings will rise and this asset class which is currently the cheapest it has been for a long time - will get cheaper. Buy it.

3. The death of fixed income. The Fed will chase you out of bonds. Do not buy. The only area here which is worth it is high yield. It will trade as stocks do. Default in these bonds is way over expected for the next couple of years.

I also like Europe but only becasue I like tuff that's cheap. I Am sure we will have more turmoil there. I just don't care.

Here's a bonus for you.

4. stupid 2011 prediction articles will proliferate on SA.

E

TonyP4

* Estate tax. Seems to be 5 million exemption now.

* It should not have a double dip in 2011, but seems the economy is still the same as 2010.

---

telkontar

Commodities are based on supply and demand. Whether it is emerging market consumers, China's spending its cash reserves, or fear of inflation, I think the downside is limited. Though the increases may limit the upside. No asset seems cheap to me. Diversification seems the safest bet for investors. I have more cash than ever, but expect near time deflationary forces with inflation in the next few years.

Whitehawk

"House prices never fall... Municipalities never default"

I'm hearing a lot of the latter lately, especially from those hocking munis and muni funds as a value buy after the recent selloff. Another lift here would be a ripe short at some point, and the market will be roiled again with talk of pending defaults and Fed bailouts. The entire bond market has overbought risk and will be a short in case of any muni turmoil. High yield won't be spared. Wait for the crater to buy back in.

2011 will be a trader's market. Learn how to trade long, short, options, etc. and you'll be fine.
