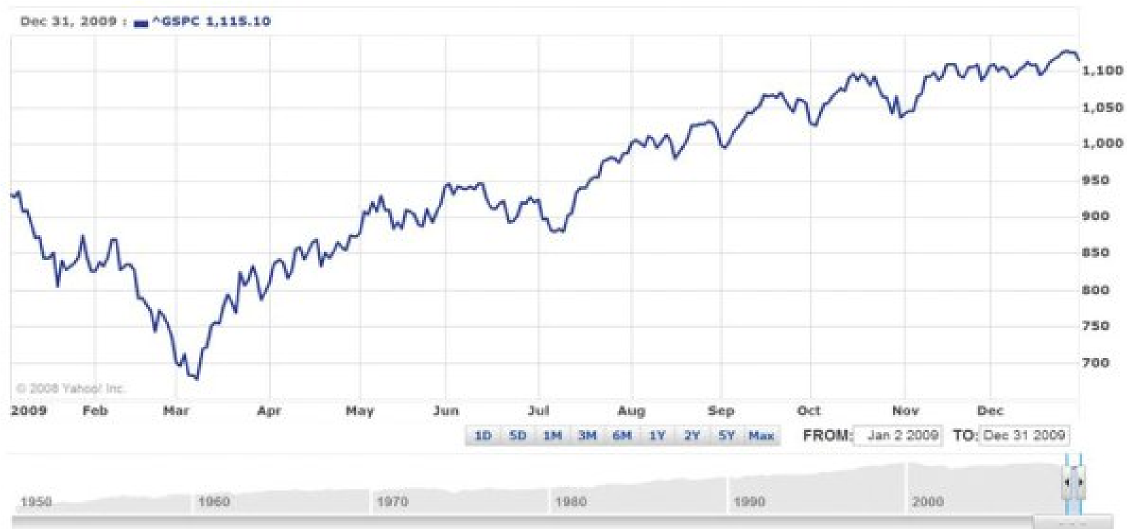
MARKET COMMENTARY - JANUARY 2010

Ray Gadbois, CFP®
Index Financial Advisors LLC

Dear Clients,

Happy New Year to all of you! As we celebrate the end of 2009 and look forward to 2010, I thought this would be a good time to review the past year in the markets and begin planning for the future. I apologize in advance for the length of this commentary. If you are short on time, I recommend you to read the bold text only, which will provide you with a quick summary.

2009: THE BIG PICTURE
Here is a chart of the S&P 500 index for 2009, followed by some high level commentary on the past year in the markets.



In retrospect, 2009 was an excellent year for investors. In March, we were all deeply concerned about the financial and economic crisis. The risk of a complete collapse in the banking system and another Great Depression was very real. But in response to aggressive fiscal and monetary policy, we managed to avoid the worst case scenario, stabilize the financial system, and begin an economic recovery. As a result, the stock market staged a dramatic comeback from the lows in March and ended the year with strong positive returns. For example, US large cap stocks were up about 26%, international developed market stocks were up more than 30%, and emerging market stocks were up more than 70% for the year.

We are back to where we started before the Lehman collapse. I am happy to say that my clients generally held their ground and did not panic during the market crisis that began with the Lehman Brothers bankruptcy in September 2008. As a result, we have recovered from the losses incurred in the markets during that period of time. Despite the crash, a well diversified portfolio that includes cash, bonds, domestic and international stocks should be back to where it started before the collapse. Especially if you continued to rebalance the portfolio on a regular basis.

The economic recovery still has a long way to go. Despite a strong recovery in the markets, the global economy still has a long way to go to fully recover from the recession, especially in the United States. Unemployment is very high at 10%, the residential and commercial real estate markets are weak, and the consumer is holding back on spending. The stock market is still well below the peak achieved in late 2007. So we are not completely out of the woods just yet. Which leads me to a discussion of the possibilities for next year...

SCENARIO PLANNING FOR 2010

Unfortunately, no one has a crystal ball which can provide a clear picture of the future. Instead, I prefer to do scenario planning, which looks at a range of possible outcomes, so we can estimate the probability of each scenario and assess the potential implications on our investment strategy. Although there may be other possibilities, here is my take on the potential scenarios for 2010:

Scenario I - Double Dip Recession (Low Probability). In this scenario, the residential and commercial real estate markets become much worse, causing more mortgage defaults and foreclosures. Bank losses increase, causing more bank failures. Consumer spending is weak and unemployment remains very high for a long period of time. As a result, the economy in the US and developed world falls back into recession. Corporate earnings decrease. Stock prices and corporate bonds fall back to previous lows, while the dollar and Treasury bonds rise as investors look for a safe haven. A similar scenario could be caused by an external shock to the economy such as a major terrorist attack, which is a real and ongoing risk, as we have seen recently. In my opinion, a double dip recession is possible but not likely because of the ongoing fiscal stimulus and easy monetary policy.

Scenario II - Rapid Inflation (Low Probability). In this scenario, government deficits combined with low interest rates and easy money policies lead to rapid inflation, especially in the United States. The dollar falls rapidly against other currencies, resulting in increased import and commodity prices. Nominal interest rates rise dramatically. As a result, economic growth becomes stagnant or falls back into a recession. Bonds prices decrease as interest rates rise. Stock prices ultimately fall as the economy stalls and corporate profits decrease. This scenario is possible, especially if oil prices rise dramatically as a result of a sharp reduction in supply from the Middle East, Russia, etc. But in my opinion this scenario is not likely as long as we have high unemployment and excess industrial capacity limiting wage and price increases.

Scenario III - Slow Economic Recovery (High Probability). In my opinion, this is the most likely scenario. In the United States and developed economies, the recovery will continue as a result of fiscal stimulus and low interest rates. However, economic growth will be relatively slow because of high unemployment, tight credit conditions, and restrained consumer spending. Inflation and interest rates will rise as the recovery matures, but general wage/price inflation will be restrained as long as unemployment and excess capacity remain high. On the other hand, emerging market economies will experience rapid growth, as domestic consumption replaces export growth, driving up commodity prices around the world. Stock prices will be volatile but should continue to improve over time as corporate earnings increase, especially for multinational companies doing business in the emerging markets.

A FEW IDEAS FOR YOUR PORTFOLIO

Here are some ideas to consider for your portfolio based on the most likely Scenario III described above. If you are very concerned about one of the other scenarios, please let me know and we can discuss the implications on your portfolio strategy for the next year and beyond.

Review and update your asset allocation strategy. Now that we have recovered from last year's panic in the markets, this would be a good time to review your risk/return profile and update your long term asset allocation strategy. For example, if you are concerned about the future, or just want less volatility in your portfolio, consider moving to a more conservative asset allocation.

Avoid Treasury bonds. I am not recommending Treasury investments at this point in time. Interest rates on Treasury bonds are near historic lows and will likely increase in the future, driving down bond prices, as the economy recovers and the Fed begins to implement an exit strategy from its easy money policy. Also, as the market recovers, investors will likely move from Treasury bonds to more risky assets, including corporate bonds and stocks.

Balance your portfolio with muni or corporate bonds. I still believe some portion of your portfolio should be invested in cash, municipal bonds, corporate bonds or other fixed income investments. These investments will diversify your portfolio and reduce the risk and volatility of your investments in the long run. As the economy recovers, the risk of higher interest rates will be slightly offset by a declining risk premium as compared to Treasury bonds.

Maintain healthy international exposure, including emerging markets. More than 50% of the global stock market is outside the United States. So a diversified investor should hold a similar share of international stocks. In addition, these foreign currency holdings will hedge against a decline in the dollar and allow you to participate in the rapid economic growth of the emerging markets.

Hedge against inflation with a small allocation to commodities. I am not concerned about a general wage/price spiral, but as developed economies recover and emerging markets continue to grow rapidly, the demand for commodities will likely increase. A small allocation to a range of commodities (energy, agriculture, metals, etc.) will provide a partial hedge against this type of inflation and diversify your portfolio.

Minimize taxes and other costs. I continue to believe that the best way to improve the return on your investments is to reduce the impact of income taxes, management fees, and transaction costs. This is just one of the reasons I recommend index based mutual funds to all of my clients.

Rebalance your portfolio on a regular basis. Maintain a disciplined approach to your investment strategy by rebalancing your portfolio when needed. Sell asset classes which have increased in value and buy asset classes which have decreased in value. And resist the temptation to increase your risk profile as the market recovers. Better to stay true to your long term asset allocation and risk/return strategy.

Please don't hesitate to call me if you would like to discuss this commentary or your investment strategy. Over the next couple of weeks, I will be working on the quarterly investment analysis for all clients and will contact you to schedule a call or meeting to discuss your individual situation in more detail. I look forward to talking with you soon...