January 6, 2012

“If you can get long-term returns of 5% from either stocks or bonds, you should consider yourself or your portfolio in the upper echelon of competitors.”
- BOND FUND SUPERSTAR, BILL GROSS

POINTS TO PONDER

1. Morgan Stanley’s former star strategist, Byron Wien, now vice chairman of Blackstone Advisory Partners, just released his highly popular list of surprises for the upcoming year. Number one was oil prices falling to $85 per barrel based on booming crude production from shale formations. Considering the 300% increase in oil rig activity in the US since 2009, his surprise may not be all that surprising.

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2. Ethane produced from natural gas competes with oil-based naptha as a petrochemical feedstock. Consequently, the prolific supply of domestic natural gas provides US chemical companies with tremendous cost advantages relative to their overseas competitors. This surging demand for ethane also is very good news for those companies that operate the pipelines, processing plants, and storage terminals along the natural gas value chain.

3. Berkshire Hathaway’s recent purchase of the Topaz solar-generating project in California is intriguing not only in that it represented the Warren Buffett-controlled firm’s initial foray into solar but also due to its cost-competitive nature. Berkshire’s energy unit, MidAmerican, expects Topaz to be “commercially viable without the support of governmental loan guarantees.” MidAmerican also plans additional solar investments.

4. 2011 was a vexing and perplexing year for many investors, pros and amateurs alike. One of the strangest twists was the fact that despite Asia’s superior growth and financial conditions (especially lower overall levels of government indebtedness), its stock markets actually underperformed those of debt-plagued Europe. In fact, backing out Japan, the lag was even more pronounced.

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5. In addition to an obviously deteriorating real estate market, another marker of an economic rollover in China is that auto sales are increasing at the slowest pace in 13 years.

6. The ebbing in Chinese demand from these two raw material-intensive industries might be a good thing for the planet’s resource capabilities. If China’s consumption of commodities maintained its pace of the prior decade, by 2020 the incremental demand would consume all of Saudi Arabia’s oil production, three times Iowa’s soybean harvest and almost 300% of Chile’s total copper output (which produces four times as much of the red metal as the rest of the world combined).

7. One of the key reasons the S&P 500 surprised so many experts by being the best performer among both developed and emerging markets was the equally unanticipated surge in US economic indicators over the last few months. Citigroup, however, sounds a reasonable note of caution pointing out that prior activity spurts have sharply reversed in the months ahead.

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8. A recurring investment theme in EVAs over the past year has been that real estate investment trusts (REITs) appeared materially overvalued. Yet REITs provided respectable total returns for the year, notwithstanding a brutal third-quarter sell-off. Apartment REITs have been among the leaders, but enthusiasm for this sub-sector should be tempered by the fact that new construction is surging, implying future rent softness.

9. In the entire history of the S&P 500, there have been just 11 trading sessions when 490 or more issues all moved in the same direction. Yet, underscoring the remarkable correlation in stock prices seen in 2011, six of those occurrences have happened since last July.

10. Among the numerous advantages America enjoys vis-à-vis Europe including increasingly abundant domestic energy resources and our emergence as a lower cost production venue the US is also much further along than the Continent in deleveraging.

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11. Spanish bond yields have come down dramatically over the last two months, providing Europe with some badly needed positive news. However, Spain’s new government just disclosed that its budget deficit for 2011 will likely come in some 33% over its most recent official target.

12. Market participants who are hungry for yield—a description that might apply to almost all investors these days—may want to continue to focus on the corporate bond space. Though absolute returns are low, yield premiums (aka spreads) have been higher only 10% of the time in the last 20 years. Moreover, it is possible to find good credits yielding over 6% with intermediate-term maturities.

13. Much as assertions about the US effort toward energy independence were initially greeted with skepticism, the same reaction often accompanies the idea that manufacturing is moving back to our country. Honda Motor Co., however, has become a believer as it has recently announced plans to increase its share of North American auto production from 37% to 50% (though some of this expansion will occur in Canada and Mexico).

14. Although US stocks had a slightly positive year in 2011, inclusive of dividends, the same is not true when it comes to the housing market. Average new home prices fell at an annualized rate of 25% from July through November. Meanwhile, prices for existing homes dropped by 3.4% on a year-over-year basis.

15. Despite weak housing prices, US home building stocks have been on a roll of late, possibly signaling that a turn in this devastated sector may be at hand. Yet, given the still massive overhang of properties foreclosed on by banks but still retained in their portfolios, it is hard to believe a major pivot point has been reached.

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