



INVESTMENT COMMENTARY

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THE GREAT RECESSION IS OVER CONSUMER CONTINUES TO STRUGGLE BUT MARKETS GAIN STRENGTH

Layoffs have eased and most economic indicators point to an end to this long drawn out recession. Equity markets are strong, productivity is very high and many corporations have adjusted to the downturn very well. It will be 2010 before the National Bureau of Economic Research, the arbiter of when recessions begin and end, makes it official that this recession is over. It is most likely that the Great Recession ended sometime late last summer.

Officially, The Great Recession Probably Ended Late Last Summer

Predicting the pace of the U.S. economic recovery is still very difficult. The GDP will probably grow at a rate near 2% to 2.5% for this coming year – the recovery will not be overly vigorous, but it appears to be very sustainable. There is still a myriad of potential headwinds looming which could influence how strong a recovery we enjoy, but the main drag on the economy will be a lack of jobs and a very tight credit market – we do not see any great pickup in hiring in the U.S. economy until later in 2010 at the earliest. The other feature which seems to indicate a less than robust recovery ahead is the balance sheet of the typical American consumer. Credit is tight, jobs are scarce, homes are difficult to sell, and the average consumer feels very insecure about their future.

A Scarcity Of Jobs And Very Tight Credit Will Act As A Drag On The Recovery

The most recent measurements of consumer confidence (Investor's Business Daily and CNN Opinion Research Poll) demonstrate a dip in optimism amongst a majority of Americans. Over 80% of all Americans report having seen no improvement in the economy in the past year at the local level. It is going to take time for the average American and the American economy itself to fully recover from the aftershocks of the Great Recession. The optimistic American consumer is not going to return until the jobs return.

Credit – Consumer credit has contracted for the ninth consecutive month. Retail sales continue to struggle as most retailers are forced to slash prices severely just to stimulate foot traffic. The most recent data from an in depth *Wall Street Journal* analysis reports corporate and consumer credit markets have shrunk by about 7% or \$1.5 trillion dollars in the past two years. The financial markets which have historically supported credit-card lending, auto loans, and those mortgages

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not backed by the federal government are now 10% to 40% smaller than those which existed in late 2007. Not only are consumers feeling the lending squeeze, but many small businesses are suffering a lack of credit availability. Federal Reserve Chairman, Ben Bernanke said in a recent statement, “Despite the general improvement in financial conditions, credit remains tight for many borrowers, particularly bank-dependent borrowers such as households and small businesses.” In an economy which depends on consumer spending for 60% to 70% of its economic growth, reduced lending to consumers and small businesses will place further downward pressure on any chance of a strong or robust recovery.

Real Estate The housing picture is complex. Residential real estate continues to strain under the pressure of 10% unemployment. Housing data is being skewed by the government tax credits which have been extended into the spring of 2010 – Goldman Sachs estimates the tax credit programs may have lifted home prices about 5% this year, but they caution prices may drop 10% in 2010 as the tax credits are removed and new home buyers retreat back to the sidelines. No one is certain what home sales will look like after the tax credit stimulus program is withdrawn. Sales of new and existing homes continue to improve mildly with some regions faring much better than other areas. Home prices, while still declining, are falling at a more modest rate than in previous months. The October median price for a new home fell on average 0.5% to \$212,000.



Tax credits and historically low mortgage rates make buying a home very attractive for new buyers, but for many existing homeowners their mortgage is a living nightmare. About 7 million households (12.5%) are behind on their mortgage by 30 days or more or are in foreclosure. Millions of homes stand empty, casualties of the sub-prime mess. Almost a quarter of all borrowers are underwater in their homes, and a growing percentage of these homeowners are simply walking away on their loans because they are so far underwater. According to a recent study by Experian, 588,000 borrowers defaulted on mortgages last year even though they could afford the mortgage – more than double the number in 2007. The stigma of walking away on a mortgage is quickly becoming a thing of the past.

For those looking to buy a home, we feel the worst of the housing decline is behind us. If you find a home you love or need buy it. If you are shopping, but can wait odds are good that you will be able to buy it later at the same price or maybe a little lower – however, keep in mind mortgage rates may begin to climb in 2010. Home prices are not going to rebound anytime soon. The history of housing busts (Texas in the 1980s, Southern Calif. in the early 1990s, and the Northeast in the late 1980s) is that housing recoveries are protracted after a severe bust and usually take years and years before home prices rebound.

Commercial Real Estate continues to deteriorate. Vacancy rates are soaring in many markets, rents are deflated, and property values are still falling. Investors are increasingly speculating the economy is not growing fast enough to shield banks from increasing losses. Analysts forecast a suburban office vacancy rate of 20% across the U.S. by year's end. While there is much bad news concerning commercial properties, the problem appears painful but manageable. The entirety of possible losses will not threaten the banking system, but hundreds of smaller regional banks will probably fail in the next two to three years. The highest risk loans were written in 2006-2007 (hyper-inflated sale prices blended with creative financing and balloon payments) and will not mature until 2011-2013 when over \$300 billion in loans will need to be dealt with. For the time being, banks are dealing with these loans by *extending and pretending* – extending the repayment terms and pretending the loan does not exist at the present time. Sooner or later the losses will have to be dealt with, but by extending and pretending, it probably will not be a market shaking issue in 2010.

Taxes



It is paramount that investors stay abreast of the avalanche of new tax laws which will be advanced in 2010. From the federal government to the local level, the nation's politicians are awash in tax proposals which could have a profound impact on an investor's financial health. Beyond changes in the federal income tax rates, capital gains taxes, estate taxes, and any new health insurance taxes, there is chatter in the halls of congress for a possible new VAT (value added tax) tax, financial transaction tax on stock trades, and a plethora of other tax changes. State and local governments are also eyeing a variety of ways to increase revenues through taxes and penalties. Many of the proposed changes are the standard venue – increasing sales tax, hiking property taxes, etc. Some of the new state and local tax propositions are innovative at best and bizarre in scope: Georgia speeders clocked at over 85 mph will now pay an additional \$200 *super speeder* fine starting Jan. 1, 2010 – the state hopes to gain nearly \$23.9 million in added revenue, other states have plans to tax particular television services, sugared soft drinks, certain professional services, digital downloads, visits to your veterinarian, student's tuition, garbage service, parking fees, specific medical procedures, and a wide variety of other products, services, and activities.

If You Take A Walk, I'll Tax Your Feet, Cause I'm The Taxman - The Beatles

Mark a date on your calendar in 2010 to set aside for speaking to a financial planner or tax adviser regarding the impact of all these planned tax changes – especially if you are a business owner, in a high income bracket, retired, or nearing retirement. Calendar year 2010 will be a critical year for tax planning as most of the proposed tax changes for this coming year will become law in 2011.

Markets



Tax changes will probably play a larger role in investment planning than they have in decades. The impact on investments from all the proposed tax changes are unknowable at this time, as are the unintended consequences which always occur when governments interfere with normal market forces. We expect the Federal Reserve to begin to increase interest rates sometime in mid to late 2010. The stock market is in position to move up nicely in 2010. The stock market could realize a 10% to 13% gain. Blue chip large cap companies in the U.S. should provide good returns, especially those paying a nice dividend. We continue to emphasize the purchase of high quality stocks with steady earnings - both domestically and abroad. Emerging markets look promising, especially those with strong currencies. We are apprehensive at this time regarding emerging markets with natural resource based economies such as Latin America and Russia. We expect the commodities market to become less volatile in 2010. We anticipate modest price swings and downward pressure on energy, base metals, and precious metals, but agriculture has an upward bias.

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Geopolitical

Iran stands out of the crowd of usual suspects as the greatest potential hot spot on the global map. Iran's ongoing nuclear ambitions remain a very real possible flashpoint in 2010. Any military flare-up in that oil rich region of the world will instantly rattle the world's financial markets. The recent debt troubles in Dubai have raised fears of a wider problem. Investors, aware worldwide debt levels are soaring, worry Dubai could be the canary in the coal mine. A handful of nations, Greece, Italy, Ireland, and Spain, are seen as being in the most danger of possibly defaulting on their debt. Any sovereign debt default could spur a worldwide crisis of confidence by investors. In a worst-case scenario, interest rates around the globe could climb rapidly on news of any sovereign default. The most recent problems in Dubai were followed by the cost of insuring debt in Greece to spike 16% in less than a week. Greece currently suffers debt levels 4 times greater than the EU limit. Investors need to remain atop of international events regarding sovereign debt or possible defaults, as they will impact worldwide interest rates very quickly.



SUMMARY



Long-Term (5-6 years) U.S. equities could double
Significant, short-term correction possible in U.S. stock market due to profit taking after substantial gains since March low
Maintain target weighting in foreign and emerging market equities
Maintain target weighting in U.S. equities with preference for large cap stocks
Overweight investment grade corporate bonds and preferred stock
Maintain very limited positions in high yield bonds and real estate
Intermediate U.S. Treasuries attractive for total return and hedging
Inflation Protected Treasuries (TIPS) attractive as long-term holdings
Agriculture commodities remain attractive but energy, base metals and precious metals have limited upside but remain useful for hedging
Emerging market currencies should appreciate in relation to the U.S. dollar
Euro should be weak relative to U.S. dollar
Covered call writing (selling call option contracts against equity holdings) very attractive for hedging and generating additional income
Global financial crisis abated but economic growth will be modest in coming year
Greatest risk to investors in coming year is global government debt and instability in the currency market

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