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Notes From Nagle: 4th Q 2010

Dear Client:

Happy New Year. I hope your holidays went well.

The global economic recovery moved forward modestly in 2010, with GDP growth in the 2-3% range in the US. This is far less than in a typical recovery, for reasons we have discussed extensively. Markets have gotten ahead of themselves, but that often happens – either way. Significant challenges remain as there is still a good deal of uncertainty as we enter 2011. I spend a great deal of time reading market research from many sources and what I'm seeing (what everybody is seeing) is hugely conflicting data and conclusions from very reliable people. It's always like this to some degree, but the difference in viewpoints on both what is happening and what is likely to happen are "all over the lot" these days.

Managing investments in this climate is a challenge. Which is precisely why our approach is flexible and adaptive: more than anything else this is what will be necessary in the world we see today, when unexpected changes can occur at any time.

Let's look at the facts, as they say, and see what we're facing in the coming year, then talk about how we'll deal with them. We can divide our analysis into 2 groups: downside risks and upside potentials. First the downside - let's get the depressing part over first! These are risks – they don't have to happen but they are real and if they do there will be consequences.

Downside Risks to Global Recovery

1.) Eurozone Contagion: Europe remains very problematic. Many countries there have far more Sovereign Debt than can be paid back to the European banks that lent it. That puts them in financial peril if countries default. Call it the potential for "Credit Crisis II". This would not be pretty. It isn't just that these countries (Portugal, Italy, Greece, Spain, Ireland to name a few) spent too much in the boom times. It's partly that, but mainly that when the downturn hit, their tax receipts plummeted. They don't take in nearly enough to cover their budgets. Therefore austerity programs have been introduced: spending slashed, taxes raised. Unfortunately that is not a formula for growth, it's the opposite. We could see strong headwinds to global growth if there are sovereign debt failures in 2011. The risk that this could spread to the rest of Europe and other parts of the world is significant. As we've said before, Spain is a critical player here. We will watch this situation closely. Most likely outcome: debt restructuring.

2.) US Economic Growth: a double dip in housing, which appears likely from the most recent data, could impact growth in 2011. As housing prices decline and unemployment stays high, more people walk away from their negative equity rather than pay the mortgage. This would be a recipe for disappointing GDP. Markets don't like disappointments.

3.) Banks Recovering but... there are still over 900 institutions on the critical list. This is an extraordinarily high number this far into a "recovery". If housing dips again more losses will occur on bank balance sheets, depressing their earnings. Banks are a leading indicator in any recovery, esp. in the markets.

4.) Labor Weakness Continues: Unemployment is effectively 17%. The numbers are showing signs of slight improvement, but we need a dramatic increase in new jobs in 2011 to support a real recovery. Government payments to the unemployed were extended again but will run out later in 2011. We have to hope employment recovers by then a lot faster than it has been.

5.) State and Local Deficits: Illinois currently takes in 55% of its budgetary obligations. They are clearly in the worst shape, but 34 other States and municipalities are "under water" in their budgets as well. An improving economy will increase tax revenues and along w budget cutting this problem could largely resolve itself. But that depends on continued growth; if we don't get it, this problem will worsen.

6.) Federal Deficits: This issue had faded from the conversation since the tax bill was agreed upon, as if it magically went away! It hasn't and will become an issue again very shortly in 2011. What this bill did (not like this is new) is simply kick the can down the road. We have too much debt as a nation too. It just that we're so big and viewed as "invincible" (so far - this will change if we stay on this path) that it's not seen as an imminent problem. But it is rapidly getting there. I've gone into this before and won't labor it here, but we have a LOT to do to address this issue and we need to get to it in 2011. The consequences of not doing so are very bad for our economy and markets intermediate to long term.

7.) Interest Rates: They could increase sooner than expected, crowding out any recovery. In fact this actually happened in Nov and Dec to some degree. The 10 year Treasury went up a full point. Mortgage rates went up about 3/4%. These are not fatal increases, and they have showed signs of leveling off but if it resumes in 2011 we could be in trouble. This recovery is largely founded upon extremely low interest rates. It needs more time to gain traction before rates go up, which they will eventually.

8.) China Overheating: China is already increasing their interest rates to cool inflation. 3-4 more hikes are likely in 2011. If they mismanage this process of slowing their economy a hard landing could result. This could have ripple effects worldwide as China is now the world's 2nd largest economy.

9.) Commodities Prices Rising: Notice what's happened to oil prices this past year? Virtually all commodities have experienced the same thing. This contributes to inflation eventually (if not sooner) and greater deficits for importing countries as they struggle to pay for needed resources. In addition at what point does this become another "bubble"? That's a danger with so much money chasing commodities. Bursting bubbles don't help anybody.

10.) Currency Wars: We've seen some skirmishes here as countries, including the US, race to devalue their currencies to reduce the impact of their debt brought on by all the stimulus being thrown out there ("QE II" etc.). If it gets out of control this would have very bad economic consequences.

11.) Geo-Political Risks: Unexpected things tend to happen in this arena but the most visible problem areas that could cause significant economic disruption are the Koreas and Iran. There are other risks of course, but these are the major ones we see. Now (finally!) for the positives.

Upside Potential for Continued Global Recovery

1.) Corporate Cash: Corp's are lean and profitable by and large and as a consequence have huge cash hoards on their balance sheets. They need to spend some of that cash to increase output and get people back to work and they will do so when they feel confident the economy is truly healing for the long run. There is evidence this is happening - if it does we could see positive surprises in GDP and employment.

2.) Eurozone Improves Unexpectedly: There could be positive surprises from Europe if they can manage their problems better than expected.

3.) Core Eurozone: Germany, France, and Great Britain are doing well and could surprise on the upside if their trading partners China, India, and the Emerging Markets continue to grow and buy more goods from them.

4.) Emerging Markets: They are strong and resilient - and have little debt. They can be the engines of global growth if they avoid any large setbacks and don't themselves become a bubble.

5.) Positive "Wealth Effect": As assets (stock markets and real estate) worldwide go back up people gain confidence and increase spending, which adds to growth.

6.) Positive Feedback Loop: Greater consumption = more growth = more corp. spending = more hiring = more consumption. This is the "animal spirits" theory: i.e. we need to get people more confident, and that alone is a significant factor in increased economic growth.

7.) Loose Monetary Policy: QE II and other similar programs are designed to keep interest rates low and stimulate growth. If they work world economies will be "jump-started" and sustain themselves, increasing economic growth, tax revenues, and improving employment, all of which could help resolve several of the above risks.

To summarize: if we can avoid or at least manage the downside risks in the first half of 2011, we could get to a more self-sustaining growth picture beyond that point and the upside scenarios could take precedence into 2012. That's the rosy picture. But we need to remember that we are in a recovery from a credit and balance sheet crisis. It takes years to repair balance sheets - it will not happen easily or overnight. And of course, there will be market corrections in between no matter what. There always are and we need to be prepared for them.

What are the Market Technicals Saying?

We are in the market at the present time with our quant models. But bullish sentiment is at 2007 levels, which was just before the last market high. From a contrarian perspective this is bearish short term. Markets are overbought and we're due for a correction - when and how much no one can say. It could be days, weeks, or months from now. If we see something happening we have our Quant systems to help us through, plus we can take other action if we see fit.

The big picture from here is the same though: we're in a range-bound market, not a long term bull market, and our strategies have to fit that reality. There was a good article in NYT Business Sunday quoting Ed Easterling, a brilliant analyst and someone we listen to very carefully (see his book: "Unexpected Returns"). I quote: "Based on the previous 10 years of earnings, the P/E ratio for the SP 500 is currently above its 100 year average. Given that, Mr. Easterling advises investors to reconsider their expectations about the buy-and-hold strategies that have sometimes worked so well in the past."

We've already done that. Long term bull markets don't happen with P/E's at 22, interest rates increasing, and inflation going up all at the same time. Up and down markets do. That's what we're prepared for.

Thank you,

Peter J. Nagle, CFP®, M.A.R.

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