January 10, 2011

10:31 PM EST

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Selective Amnesia

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Hello and welcome back to 2011! I hope you had a fantastic New Years!! After braving a 24 inch blizzard in Vermont, fixing my youngest son's separated elbow, eating enough food for a small army and spending some of the best quality time with family and our cast of Vermont friends who are really family, I am back, full energized, excited and ready to attack 2011. I know it's cliche, but I have every intention of making this year our best ever.

Usually after the first week of the new year, my end of year break was all but a distant memory. Not so this year. We're still talking about my two older kids' enjoyment, exploits and progress skiing. The times when the family (minus the little guy) skied together will never be forgotten, not to mention my daughter beating my wife down the mountain and my five year old son skiing his first two black diamond trails. This was a boy who was terrified on the hill last spring and began this year in the lowest level ski group, only to progress to the second highest level in 5 weeks.

OK. Enough family stories. Once I get started, it's hard to stop. I could
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go on and on and on without getting to the meat of this issue. Anyway, before I begin my forecast for 2011, I want to touch on a bit of revisionist history.

I think we all know and remember how tough 2008 was. Emotionally, financially, economically, systemically, politically. The very core of capitalism was being threatened, not to mention the very real risk of a modern day depression. Money managers all over the world saw their worst weeks, months, quarters and years of their entire career. The "deer in the headlights" syndrome fell over a good part of the industry.

What I find so "interesting", just three years later, is how many people either predicted the whole financial crisis and bear market or actually had an up year for clients. I cannot remember the last person who told me they got crushed in 2008. All I hear now is "well I knew it was coming" or "we finished in the black". You knew what was coming? You finished in the black what? Hole?

It's really incredible. I don't know if it's revisionist history or selective amnesia, but it sure sounds like a lot of bull to me! While our business really grew in 2008, and none of our programs lost what the market did, I don't think I want to live through a repeat of that scenario any time soon. There was nothing fun about it.

FYI, I will be on CNBC's Squawk on the Street on Tuesday (1/11) at 9:35am.

If you use Twitter or Facebook, I am finally taking the business plunge after using so many years personally. Follow me at Paul_Schatz on Twitter or search Heritage Capital on Facebook.

Forecast 2011

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One of the most worthless yet enjoyable topics of the year is the pundits annual forecast. An unusual amount of time is spent discussing this in the media, but after January, no one ever reviews again nor seems to care. I usually end December with an idea of what I see ahead and then adjust according to how many others agree with me. As longtime readers know, I don't like to be in the majority as that group is typically wrong.

Before I get to my forecast, which is not my annual "Shockers" list due out later this month, let's do a quick review of what I envisioned for 2010.
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Stock market - I thought we would see a generally flat market, somewhere between -5% and +5%, not the 15% we so gladly enjoyed! I thought the April peak would stand for the year. Stocks did go higher at the end of the year, but that call was pretty much correct. I forecasted a double digit decline, but thought it would unfold in Q4. We saw a 16% hit during the summer.

Long-term treasuries - would be a surprise leading asset class. They actually melted up through August and then melted down through November, finishing up 9%.

Dollar - I was bullish the dollar in 2010 and it gained a whopping 1.37%.

Gold - I was positive on gold and it gained 29%.

Inflation - It's been the same forecast for 2010, 2009, and 2008. Inflation remains under wraps and not problematic.

Economy - I thought GDP would hang in above 0% during the first half and slip back into negative territory later in the year. I was right on the first part, but wrong on the second part.

Bernanke & Co. - Short-term rates would not be touched in 2010 and they are still in the same spot as they were 12 months ago.

So now, let's get to my forecast for 2011. The sooner I get it out there, the sooner I can be proven wrong! As always, I had a lot of fun thinking about it and creating it, although it has no bearing on how we manage money for our clients.

Stock market - We are now in the 3rd year of Obama's term (presidential cycle) and traditionally, it's the most bullish of all with an average return of 17% and only one down year in the past 70 years. When you examine the stock market decade by decade (decennial pattern), you find that the first few years of the decade tend perform worse than later in the decade. That's two nice contradicting pieces.

Let's add the almost uniformly bullish predictions from Wall Street into the mix with the average strategist forecasting double digit returns. USA Today ran a front page piece last month with the headline *"5 Wall Street Heavyweights Say It's Time To Get Back Into Stocks".*

Even former Merrill Lynch honcho and usually skeptical Richard Bernstein sees a 15-20% return for stocks. That's shocking and worrisome! Can it be that easy? I have research dating back to 1990 and that group has been uniformly wrong roughly 75% of the time, although they hit the bulls eye in 2010. Kudos!

For 2011, I think the stock market will end the year modestly in the black, but only in the mid single digits. I envision corrective behavior in the spring with a more significant correction in late summer to fall. I haven't done enough sector work yet, but given that almost everyone hates healthcare and utilities, I'll take those two sectors as winners in 2011.

Long-term treasuries - After attempting to rally in Q1, bonds resume their slide during the first quarter and into Q2, but firm up during the second half of 2011.

Dollar - I remain bullish on the greenback over the long-term, even if we see another selling wave back to the old lows. Ultimately, I think the dollar index will hit 100 and the euro will slide back below 100 on its way to oblivion.

Gold - Clearly, after back to back strong years, gold is due for some pause to digest, in the short, intermediate and long-term. That can take shape in many ways. I think 2011 will bring a significant increase in volatility and I would not be surprised to see a $100 down day during the year. When all is said and done, I believe we will see at least $1500 hit during the first half of the year, but not another vertical assault like we saw in 2009 and 2010. Based on history, the year should end up with modest single digit returns, best case scenario, but outperforming its cousin, silver. Should that roadmap unfold anywhere close, that could set the stage for a monster blow off to the upside in 2012. But that's getting laughably ahead of myself.

Inflation - Unlike the past few years, I see headline inflation percolating a bit, especially during the first half of the year, but the core (excluding food and energy) remaining tame.

Economy - If this was a "normal" recovery, GDP should explode higher this year, but especially during the second and third quarters. I just can't subscribe to the "normal" recovery theme. The economy has been juiced with free and easy money for years and once that spigot is turned off, similar to what FDR did in 1937, I believe we are in for trouble.

Thankfully, Congress learned from their predecessors' mistakes in 1937 and did not allow taxes to increase in 2011. In fact, by cutting the payroll tax for 2011 and 2012 by two full percentage points, I have to upgrade my take on the economy to a better than just plodding along at 2%. Don't underestimate how much not raising income taxes and cutting payroll taxes will do for the economy and markets!

Federal Reserve - As the voting members of the FOMC turnover, expect the Fed to mirror Washington and get stuck in gridlock. Bernanke loses some internal power with Kevin Warsh sliding more towards the hawkish side and Plosser and Fischer coming back to dissent and push a more neutral stance once QE2 runs out by June. Keep a close eye on the two year note as the markets may force Bernanke's hand later in 2011 to take action he clearly won't want to take.

Unemployment - Sadly, the jobless recovery continues and unemployment stays stubbornly elevated above 8.75%. I think it's going to take a second recession to cleanse the system and get put unemployment on a path back to 6% or lower sometime later this decade.

Natural Gas - Surprise! Surprise! Finally, the bulls take control and natural gas ends up as one of the top performing assets of the 2011.

So that's it. Another fearless forecast in the books. I may add some items next Friday as I continue to read, research and digest, but I think you get the picture. As always, I am eager to hear to your comments. Please don't be shy about emailing me!

It's Easy... Just Cut the Budget

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One of the big themes in Washington this year is going to be fiscal restraint. Both parties know that the budget absolutely has to be cut. We've already heard from the Republican leadership that cutting their own Congressional budget is first on the list. While that's great symbolically, I don't think anyone has really heard substantive reductions from that party.

Why not?

Cynically, I don' think either party has the answer. All you need to do is read what the goods folks at Casey Research put together below. I know what will end up happening. Congress and the President will spend all year going back and forth, fighting about minutea that won't add up to even $100B.

The politically untenable answer is that entitlement programs and defense are the areas that really move the needle, but what politician in their right mind would publicly campaign to cut them? Anger the senior citizens? Appear soft on defense? Not if you stand any chance of
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getting re-elected!

Some sound bites:

- **If you got rid of the whole Department of Education, you'd only shrink the budget 1.9%.**
- **If you got rid of the Department of Agriculture, you'd only shrink the budget 3.4%.**
- **If you were able to get rid of the EPA, NASA, and the Department of Interior, you'd only shrink the budget by 1.0%.**
- **If you were able to cut <u>all</u> discretionary spending from the budget, you'd only be cutting 36.9%.**
- **Mandatory budgeted outlays of the Department of Health and Human Services (responsible for Medicare and Medicaid) are greater than the total budgeted spending of all the following departments combined:**
    - **Dept. of Agriculture**
    - **Dept. of Commerce**
    - **Dept. of Education**
    - **Dept. of Energy**
    - **Dept. of Housing & Urban Development**
    - **Dept. of Interior**
    - **Dept. of Justice**
    - **Dept. of State & Other International Programs**
    - **Dept. of Transportation**
    - **Dept. of Treasury**
    - **Dept. of Veterans Affairs**
- **If you cut the Department of Defense budget in half, you'd only shrink the budget 9.4%.**

Upcoming Appearances

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CNBC's The Call - January 4 at 11:05am

CNBC's Squawk on the Street - January 11 at 9:35am
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CNBC's Worldwide Exchange - January 20 at 5:30am

You can view most of the past segments by clicking below.

Media Appearances

(http://www.investfortomorrow.com/InMedia.asp)

Investment Quotes/Adages To Live By

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"When in doubt, get out!"

"If it's obvious, it's obviously wrong."

-Joe Granville

"It's ok to be wrong, but it's not ok to stay wrong."

"This time is different."

"The markets require the patience of a dozen men."

-Robert Rhea

"Luck is the residue of effort."

"The most bullish thing a market can do is go up in the face of bad news."

"The most bearish thing a market can do is go down in the face of good news."

"The market can stay irrational longer than you can stay solvent."

-John Maynard Keynes
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"Government is best which governs least" - Thomas Jefferson

Inflation is the one form of taxation that can be imposed without legislation.

-Milton Friedman

"You cannot legislate the poor into freedom by legislating the wealthy out of freedom. What one person receives without working for, another person must work for without receiving. The government cannot give to anybody anything that the government does not first take from somebody else. When half of the people get the idea that they do not have to work because the other half is going to take care of them, and when the other half gets the idea that it does no good to work because somebody else is going to get what they work for,that my dear friend, is about the end of any nation. You cannot multiply wealth by dividing it." - Dr. Adrian Rogers, 1931

"Bear markets seem to be divided into three phases: the first being the abandonment of hopes upon which the final uprush of the preceding bull market was predicted; the second, the reflection of decreased earnings power and reduction of dividends, and the third representing distressed liquidation of securities which must be sold to meet living expenses. Each of these phases seems to be divided by a secondary reaction which is often erroneously assumed to be the beginning of a bull market."

- Robert Rhea via Tim Woods

"Free enterprise is a rough and competitive game. Nobody too big to fail. Nobody too small to succeed. It is a hell of a lot better than government control." - Ronald Reagan via Dan Kennedy

"A government big enough to give you everything you want is big enough to take everything you have." - Gerald Ford via Dan Kennedy

"The problem with socialism is that, sooner or later, you run out of other people's money." - Margaret Thatcher via Casey Research

"Diversification alone is no longer sufficient to temper risk... You need something more to manage risk well."

- Mohamed El-Erian

Friends And Family Plan

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Finally, as you know, our firm and this newsletter continues to grow mostly from your referrals. If you know anyone who is interested in securing their retirement, planning for it or just plain worried about it, please send them here. As always, thanks for thinking of us with your circle of family and friends.

Sign Up Here

You can also forward this email to family and friends by hitting the "forward email" hotlink at the bottom of this email.
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