TW ADVISORS

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NEWSLETTER

ANOTHER REASON TO FAVOR LARGE CAP STOCKS

The fragile economic recovery is treating Wall Street and Main Street very differently. **Wall Street** is improving but **Main Street** is struggling. Most large banks have either paid back their TARP funds or are in the process of doing so. A year ago the plumbing of the financial system completely clogged up and even the highest-rated business could not raise funds.

Thankfully the capital markets are now open for high-quality, large enterprises especially those in good financial health. In the third quarter American companies raised an estimated $39 billion in new stock and convertible debt and $156 billion in bonds, according to Dealogic, up by 57% from the third quarter of 2008. Most of this activity was by larger U.S. companies.

It is a different story for small businesses in America that rely on bank financing. According to the Federal Deposit Insurance Corporation lending by U.S. banks plunged by 2.8% in the third quarter, the largest drop since at least 1984 and the fifth consecutive quarter in which banks have reduced lending.

The National Federation of Independent Business (NFIB) survey indicates that confidence remains well below the long-term trend (see chart below). According to NFIB's December report: "For those who want to borrow, getting a loan continues to be difficult, with a net 15 percent reporting loans harder to get than in their last attempt. Twenty-four months of recession have sapped the financial strength of many small firms."

Access to capital is critical for growth and is yet another reason for investors to favor high-quality, large capitalization stocks who often have reliable access to capital outside of the banks.

As always we appreciate the opportunity to work with you and look forward to answering any questions you might have. Have the **Happiest of Holidays.**

Jim Tillar, CFA Steve Wenstrup

OUTSIDE COMMENTARY

Will The Three Trends of 2009 Prevail in 2010?

GaveKal Five Corners via John Mauldin's Outside the Box

Looking back at the past year, we can conclude that three inter-related trends have dominated financial markets: 1) an impressive weakness in the US$, 2) a significant rally in commodities, and 3) a pronounced out-performance of emerging markets, including Asia. Today, these three trends appear to be running out of steam: the US$ has been rallying, commodities have rolled over and, in November, for the first time in what feels like an eternity, the US MSCI actually out-performed all other countries in the World MSCI index. For us, this begs the question of whether the trends of 2010 will prove different to those of 2009? And the answer to that question may be found in the most unlikely of places, namely the Middle-East.

The news that a Dubai World unit would be suspending payments to creditors, was promptly followed by the rumor that two defaulted Saudi groups (the Saad group and the Ahab group) were treating their domestic creditors differently than foreign banks. From our standpoint in Hong Kong, all these bleak headlines lead us to ponder how the Middle East could find itself in this tight spot? After all, who, a decade ago, would have bet on Dubai (soon to be followed by Venezuela?) going bust with oil at US$80/bbl?

Of course, the apparent squeeze may be nothing more than a few bad apples that blatantly mismanaged their liabilities and blew up their balance sheets. But we have to admit that we are also intrigued by the recent announcements that some of the region's sovereign wealth funds (Qatar, Kuwait...) have lately been selling the large stakes they acquired in Western financials at the beginning of last year's financial crisis. Of course, these disposals may be the result of a deep relief that the banks are back above their purchase price and, like a money manager who has just been on a gut-wrenching ride, the SWF are happy to turn the page and put this episode behind them. Or perhaps, the sales are an indication that the Middle East needs US$ right now and that we are now confronting some kind of squeeze on the US$.

Thus, the recent strength in the US$ may be highlighting that we are experiencing an important change in the investment environment. Indeed, at the risk of making a mountain out of sand-dune, we believe that one thing is for sure: recent developments in Saudi and Dubai will most likely give pause to foreign banks looking to expand their lending operations in that region. And if financing for projects becomes more challenging, then this raises the question of whether the Middle East will look to pump more oil in a bid to generate the revenue necessary to keep the wheels churning? Could an unfolding financial squeeze in the Middle-East lead to the kind of massive cheating on OPEC quotas that we witnessed in the 1980s?

Of course, a proper financial squeeze in the Middle-East, one that triggered a US$ rally and lower oil prices, would de facto justify the Fed's decision to keep interest rates low for a long time. With lower oil would come lower inflation expectations, while a higher US$ would help keep the US economy from overheating under the twin stimulus of lower oil and low interest rates. But where would all this leave other emerging markets, most specifically Asian equities which have soared in the past year?

Historically, Asian equities tend to struggle when the Dollar rallies as a strong US$ forces Asian central banks, who typically run pegs or managed floats, to print less aggressively. But at the same time, most Asian economies would likely welcome the extra liquidity that lower oil prices would provide, not to say anything about an environment of continued low interest rates. More importantly, a possible environment of higher US$/weaker commodities would likely lead to a massive rotation within the markets away from commodity producers and property developers (the key beneficiaries of an ever falling US$ and big components of Chinese indices), and towards manufacturers and exporters (whose margins have been caught between the rock of weak US demand and the hard place of rising materials costs). In other words, a reversal in the weak US$/strong commodity trend would likely trigger a rotation away from 'price monetizers' towards 'volume monetizers'.

Commentary comes from Gave-Kal Via John Mauldin December 2009