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## FIVE MAJOR INVESTMENT THEMES FOR 2010

We believe strategists can be useful to institutional investors in three ways: 1) by correctly forecasting the direction of the market; 2) by identifying major investment themes; and 3) by publishing useful charts and data that allow investors to make up their own minds. In Monday's Quarterly Review in Charts we hope we accomplished the last of these three objectives, highlighting 39 pages of facts and figures that should help in writing those end-of-year investment letters. Today's piece focuses on the second of our three major goals – identifying the most important themes investors will need to heed in 2010. As for the first goal, being right on the market, we'll leave that to the man upstairs to figure out.

### 2010's Major Investment Themes

1. **The Emergence of a New Nifty Fifty**
2. **Fed Watching – A Lost Art Rediscovered**
3. **Rent Seeking – The Aristocracy of “Pull”**
4. **The Great Immoderation – Volatility Makes a Comeback**
5. **Crowding Out – Competition for Credit Among Sovereigns**

### *Just for reference, 2009's Investment Themes Were:*

1. A New “New Deal” & the Start of the Great Treasury Bear Market
2. “Reversion to the Mean” Reverts to the Mean
3. Monetarism Makes a Comeback
4. The Balance Sheet: Not Just for Sissies Anymore
5. Geopolitical Tensions as the Sticky Residue of Economic Dislocation

## THEME # 1

### THE EMERGENCE OF A NEW NIFTY FIFTY

In hindsight, our worst call last year was our belief that quality would outperform. With the financial system damaged and the shadow banking system a “shadow” of its former self, we reasoned, it was unlikely that the most marginal companies would be the biggest beneficiaries of a rally as they were when the last bear market finally ended in March 2003. While it did turn out that banks remained content to enjoy the carry and largely avoided large increases in their loan portfolios, we were surprised at the extent of the improvement in the credit markets and, by extension, the ability of the weak to survive one of the most severe credit contractions in history. But with the S&P up more than 70% from its March 2009 low, it seems fair to assume that the survivability premium granted to the weakest companies has already largely been exploited. While it is true that banks, with the aid of near-zero percent interest rates, have returned to profitability more quickly than anyone could have hoped, it seems safe to assume that a whole generation of loan officers will never quite look at risk the same way. In short, we still believe that the access to and the cost of credit has been generationally altered, rendering a company’s ability to easily access the debt markets one of the most enduring competitive advantages in a period of weak nominal growth. One of the most curious features of last year’s rally was the fact that the retail investor was largely MIA. Through November, 2009 inflows into equity market mutual funds totaled only \$6.2 billion, while inflows into bond funds exceeded \$350 billion. While it is understandable that the average investor, burned by two 50% declines in the last decade, would remain fearful of stocks, the massive liquidation of money market funds suggests that investors are growing tired of earning six basis points on cash. **A combination of weak nominal GDP growth, a likely bear market in bonds, and a still-palpable fear of capital losses will, in our view, likely lead investors to seek out a middle path of high-quality, dividend-paying equities, especially as the bull market matures.** While it seems unlikely that these companies will achieve the “one-decision” status conferred on their forbears in the 1970s, blue chips may be the first stop for a restive investment public. The companies on the next page could be considered good candidates for this new nifty fifty – large cap companies having an above-market dividend yield and a proven ability to grow earnings during tough times.

## Strategas' Nifty 50 Portfolio

		<b>Last Price</b>	<b>Market Cap &gt;\$5BN</b>	<b>Dividend Yield &gt;2%</b>	<b>3Yr EPS Growth &gt;0%</b>
EXC	Exelon	48.87	32.2	4.3	440.0
PSA	Public Storage	81.45	13.8	2.7	48.8
DO	Diamond Offshore Drilling	98.42	13.7	8.1	39.4
RTN	Raytheon	51.52	19.7	2.4	32.8
HCBK	Hudson City Bancorp	13.73	7.2	4.4	31.5
CAG	ConAgra Foods	23.05	10.2	3.5	30.8
TAP	Molson Coors Brewing	45.16	7.2	2.1	30.2
SLE	Sara Lee	12.18	8.5	3.6	29.3
PEG	Public Service Enterprise Group	33.25	16.8	4.0	27.5
HRB	H&R Block	22.62	7.6	2.7	27.4
MCD	McDonald's	62.44	67.4	3.5	26.3
ADP	Automatic Data Processing	42.82	21.6	3.2	25.8
HNZ	H.J. Heinz	42.76	13.5	3.9	25.1
ABT	Abbott Laboratories	53.99	83.5	3.0	25.1
CL	Colgate-Palmolive	82.15	40.8	2.1	23.4
BMJ	Bristol-Myers Squibb	25.25	43.2	5.1	22.5
MRK	Merck & Co	36.54	111.6	4.2	21.2
WMB	Williams Cos.	21.08	12.3	2.1	19.4
GIS	General Mills	70.81	23.3	2.7	18.9
GD	General Dynamics	68.17	26.3	2.2	17.8
YUM	Yum! Brands	34.97	16.4	2.4	17.2
KMB	Kimberly-Clark	63.71	26.5	3.8	14.6
LMT	Lockheed Martin	75.35	28.5	3.3	13.6
SJM	J.M. Smucker	61.75	7.3	2.3	13.4
CLX	Clorox	61.00	8.5	3.3	12.1
LO	Lorillard	80.23	12.9	5.0	11.8
FPL	FPL Group	52.82	21.8	3.6	11.3
SYI	Sysco	27.94	16.5	3.6	10.6
AVP	Avon Products	31.50	13.5	2.7	10.5
PG	Procter & Gamble	60.63	177.1	2.9	10.1
NTRS	Northern Trust	52.40	12.7	2.1	9.9
PGN	Progress Energy	41.01	11.5	6.0	8.8
K	Kellogg	53.20	20.2	2.8	8.4
JNJ	Johnson & Johnson	64.41	177.7	3.0	8.2
AEP	American Electric Power	34.79	16.6	4.7	7.5
PCG	PG&E	44.65	16.6	3.8	7.5
D	Dominion Resources	38.92	23.2	4.5	7.3
WMT	Wal-Mart Stores	53.45	203.7	2.0	7.3
KO	Coca-Cola	57.00	132.1	2.9	7.2
HON	Honeywell International	39.20	29.9	3.1	6.9
ETR	Entergy	81.84	15.5	3.7	6.6
CPB	Campbell Soup	33.80	11.6	3.3	6.3
TRV	Travelers Cos.	49.86	27.2	2.6	5.7
UTX	United Technologies	69.41	65.1	2.2	5.4
PEP	PepsiCo	60.80	94.9	3.0	4.4
WEC	Wisconsin Energy	49.83	5.8	2.7	4.1
ED	Consolidated Edison	45.43	12.7	5.2	3.0
PCL	Plum Creek Timber Company	37.76	6.1	4.4	3.0
T	AT&T	28.03	165.4	5.9	2.9
AEE	Ameren	27.95	6.6	5.5	2.2

## THEME # 2

### FED WATCHING – A LOST ART REDISCOVERED

It may be hard to believe for the relatively young financial professional that has become accustomed to being constantly and passively bombarded with investment information to believe that there was a time in American finance when not everyone, and least of all Fed officials, believed in transparency. Before the 1980s, the Fed's process for determining the path of monetary policy, and the tools used to affect it, changed frequently and it was commonly believed that a central bank's decisions should be as opaque as possible. These circumstances gave birth to a now all-but-extinct Wall Street professional – the Fed watcher, an economist whose sole function was to not only predict the future path of monetary policy but also, and perhaps more importantly, determine what the Fed had already done. Investors became slaves to the weekly money numbers, especially M1, which could (and often did) result in violent stock market swings. With more competent central bankers, a greater commitment to transparency, and the advent of modern information technology in the 1980s, there was increasingly little need for the dark art of Fed watching. For a good part of the last generation, it hasn't been all that difficult, mercifully, to determine what the Fed is up to and to a lesser extent, what it was likely to do. All of that may be about to change however, as the Fed attempts to unwind the massive expansion of its balance sheet (about \$850 billion before Bear failed and over \$2.2 trillion today) through the use of monetary tools that were previously outside of its legal authority. The good news is that this gives the Fed greater latitude to seek a more nuanced monetary policy, critical for a central bank in the unenviable position of having to avoid the deflation of the 1930s and the inflation of the 1970s simultaneously. **The bad news is that determining the nature of monetary policy will be far harder for the rest of us than merely looking at the Fed Funds rate.** In the past, open market operations, and by extension the size of the balance sheet, determined the level of the fed funds rate. Today, the Fed's new power to pay interest on reserves effectively splits the funds rate from the size of the Fed's balance sheet. A whole host of other new tools (reverse repos, Treasury deposits, etc.) are likely to be employed to provide credit for troubled areas of the economy without unintended consequences for price stability. Our Chief Economist, Don Rissmiller, believes that Chairman Bernanke's July 2009 *Wall Street Journal* editorial provides the best explanation of how the Fed will employ these new tools to carry out monetary policy.

Chairman Bernanke's WSJ Op-Ed: <http://online.wsj.com/article/SB10001424052970203946904574300050657897992.html>

### THEME #3

## RENT-SEEKING & “THE ARISTOCRACY OF PULL”

As a Catholic, I’ve always felt somewhat conflicted when it came to the subject of Ayn Rand and her musings on objectivism, agreeing with many of its basic tenets but also feeling uncomfortable with its apparent rigidity and lack of humanity. And so I had avoided reading *Atlas Shrugged* until this year, when, after seeing countless *Who is John Galt?* signs at this summer’s tea parties, I broke down and bought it to see what all the fuss was about. At 1,200 pages I must admit that it reminds me, at times, of Truman Capote’s flip dismissal of Kerouac’s work when he said “that’s not writing, that’s typing.” Still, the book is not without its insights, not the least of which is what she described as the “aristocracy of pull” and her revulsion of crony capitalist systems in which political connections rather than merit determined business success. It may seem hard to believe, but government spending was 3.4% of GDP in 1930. Since World War II, this figure has never exceeded 22% of GDP, but today the number stands at nearly 25%. With government’s shadow over the economy set to remain at historically high levels, it seems likely, regrettably, that many companies will in turn spend more resources seeking government subsidies or political protection. In an effort to measure the extent and efficacy of big business’ efforts to influence policymakers, Dan Clifton and his team in Washington have assiduously collected data on the amount companies in the S&P 500 have spent on lobbying back to 2002. And wouldn’t you know it, Strategas’ K Street Index of the companies spending the most on their efforts to influence Washington has outperformed the broader market *every* year under both Republican and Democratic administrations alike. He has also noted that there have been an increasing number of changes in the constituency of the Index that have included any number of companies, like Monster Worldwide (MWW) and Meredith (MDP) that one would presume would have little to fear or to gain from Washington. **We’ll save our own normative judgments on this phenomenon for the Rothmanns, but we believe that a company’s ability to lobby Washington effectively is growing as an asset investors would be ill-advised to ignore, no different than, let’s say, research and development.** The companies listed on the following page spend the most on lobbying as a percentage of assets and may be best able to take advantage of the elevated levels in government spending.

## Strategas 2009 K-Street Index:

### S&P 500 Top 50 Lobbying Firms: Measured by Lobbying Expenditures % of Assets

MO	Altria	GD	General Dynamics	NOC	Northrop Grumman
AMGN	Amgen	GENZ	Genzyme	NUE	Nucor
ADSK	Autodesk	GR	Goodrich	BTU	Peabody Energy
BAX	Baxter Intl	HRB	H&R Block	QCOM	QUALCOMM
BA	Boeing	HRS	Harris	RTN	Raytheon
CELG	Celgene	INTU	Intuit	RAI	Reynolds American
CF	CF Industries	LLL	L-3 Communications	RHI	Robert Half Intl
CNX	Consol Energy	LMT	Lockheed Martin	SO	Southern
CMI	Cummins	LO	Lorillard	TE	TECO Energy
DRI	Darden Restaurants	MRO	Marathon Oil	TDC	Teradata
DVA	DaVita	MA	MasterCard	TXT	Textron
LLY	Eli Lilly	MHP	McGraw-Hill	TSN	Tyson Foods
FII	Federated Investors	MDP	Meredith	UPS	United Parcel Service
FDX	FedEx	MON	Monsanto	X	United States Steel
FLIR	Flir Systems	MWW	Monster Worldwide	VRSN	VeriSign
FLR	Fluor	MCO	Moody's	WPI	Watson Pharmaceuticals
FMC	FMC	NSC	Norfolk Southern		

## Proprietary Lobbying Portfolio: Annual Performance

### Relative Performance vs. S&P 500 (Non-Cumulative)

	Tracking Year	+1 Year from Inception	+2 Years from Inception
2002 Constituents	9.6%	20.9%	13.8%
2003 Constituents	16.0%	19.2%	13.0%
2004 Constituents	20.5%	21.1%	1.4%
2005 Constituents	20.0%	5.5%	17.9%
2006 Constituents	4.2%	26.3%	4.3%
2007 Constituents	30.6%	-0.2%	18.1%
2008 Constituents	1.6%	12.5%	--
2009 Constituents	9.9%	--	--
<b>Average</b>	<b>14.1%</b>	<b>15.0%</b>	<b>11.4%</b>

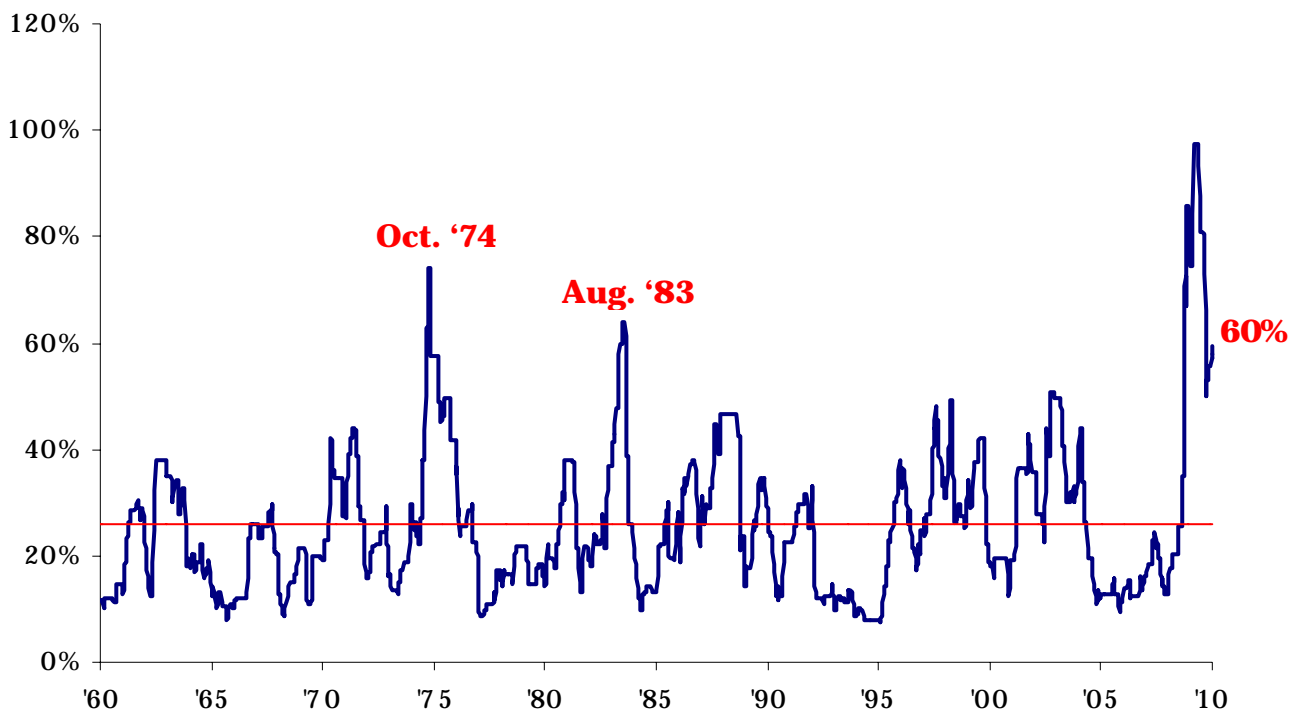
*Note: Equal Weight, Rebalanced Annually by top 10% of S&P 500 Cos. Lobbying Expenditures % of Assets, 2009 Constituents Above*

## THEME # 4

### THE GREAT IMMODERATION - VOLATILITY RETURNS

With the VIX hovering just above 20, a 23% gain in the S&P in 2009, and the prospects for an economic expansion growing by the day, it might be tempting to believe that we are on the precipice of a return to the great moderation in economic activity and financial market volatility that was a hallmark of the markets for the better part of the past three decades. Before Chairman Volcker's victory over inflation in the early 1980s, the amplitude of swings in economic growth, and by extension stock prices, was large and it wasn't uncommon for the economy to experience frequent recessions, damaging the ability of consumers and businessmen alike to make long-term plans and most efficiently allocate resources. Although it is always dangerous to say "it's different this time," it seems clear that this economic recovery has not been driven by the typical cyclical forces of pent-up demand for durables like housing and autos. Whatever demand has occurred in these areas of the economy has been the result of government subsidies, essentially "G" (government spending) masquerading as "C" (consumer spending) in the GDP equation. If Japan's experience with deflation over the past two decades has taught us anything, it has been that economies reliant upon government spending, contrary to popular opinion, are far more volatile than economies driven by more endogenous cyclical forces. There is little question that the imbalances of the U.S. consumer will take years to sort out, resulting in a slower trend rate of growth that puts the economy naturally closer to the 0% dividing line between recession and expansion. Like it or not, we are all Keynesians now. **While mid-cycle slowdowns will be more rare, real recessions will be more likely as the economy restructures. The implications of this for investors will, most likely, be far greater financial market volatility and violent swings within broad trading ranges, a la the 1970s.** While this isn't particularly fun, the silver lining in this cloud is that the benefits of active management have been demonstrably better in periods of economic volatility and multiple contraction. Determining when "the bill will come due" in the form of higher long-term interest rates and taxes, while no easy feat, should give professional investors more than a few fat pitches as the economy restructures. Simply a measure of the magnitude of the range in which the S&P has traded each year, the chart on the following page is what we affectionately call our VIX for English majors. It indicates that, generally speaking, market volatility tends to move in secular fashion. After a period of exceptionally low volatility in the '90s and the early part of this decade, we believe the tail risk associated with the market and economy's dislocations over the last few years, and policymakers exceptional measures to counteract them, should result in a durable increase in the market's unpredictability.

### Rolling 12-Month S&P 500 Price Volatility (12Mo High minus 12Mo Low as % of 12Mo Low)



### **We're Bullish Until... (Bearish Inflection Points Worth Monitoring)**

- 1.** A poorly subscribed Treasury auction signals reduced appetite for U.S. debt.
- 2.** 10-year yields break out above long-term down-trend.
- 3.** Increased anxiety over significant tax increases to close the structural deficit gap takes hold.
- 4.** Holiday sales come in below expectations with income under pressure as government transfers fade.
- 5.** Commodity price inflation prompts China to slow economic growth (again).
- 6.** Mortgage rates push above 6.0% in 2010.
- 7.** Signs of protectionism creep into global policy.

## THEME # 5

### CROWDING OUT – PUBLIC AND PRIVATE

Perhaps we shouldn't be surprised, but we have been struck in recent weeks at the number of times we've been asked to handicap the possibility of U.S. treasuries losing their Triple AAA status. Given the fact that all of us in the financial markets have been given an education in the theatre of the absurd over the past few years, it makes sense for investors to spend more time thinking about the possibility of developments that were previously thought to be inconceivable. Certainly, absent the burden of convention, it would seem to make eminent sense to worry about the credit rating of any institution who has sextupled its debt issuance in the past three years, is dependent on an unpredictable monopsony to fund it, and appears to have a penchant for issuing short-term paper to pay for massive and growing long-term liabilities. Unhappily, the U.S. Treasury continues to look like Bear Stearns in drag. The good news, at least as far as a credit downgrade is concerned, is that the U.S. is not the weakest gazelle in the herd of profligate spenders – at nearly 180%, Japan has a far greater debt to GDP problem, and the U.K. has far greater political concerns about its growing deficits. We know that savings must equal investment. Each country must fund its investment by either personal, corporate, government, or foreign saving. There are no other options and, as such, no country can systematically dissave through budget deficits without either far less investment or far more savings. With the benefit of having the world's only reserve currency, the U.S. Treasury has been fortunate that private demands for credit have been so weak, for it has only been in this way that the costs of funding its growing deficit have remained so low. **A pick-up in the economy and a concomitant increase in private credit demands are almost certain to raise interest rates for public and private credits globally in the year ahead, potentially crowding out the ability of all but the most financially healthful to access the debt markets. In this regard, it seems likely that Greece and Dubai will not be seen as isolated incidents a year from today.** Bearish bets on sovereign credits are almost certain to continue to increase and the differences between winners and losers in the private sector are likely to widen, potentially providing another tailwind for the emergence of a new nifty fifty. Client and friend, Byron Wien, recently issued his 10 surprises for the year ahead. As usual, they were insightful and provocative. The next time I see him, though, I might ask him to handicap the odds of one of the country's four Triple AAA companies (MSFT, ADP, XOM, JNJ) issuing debt cheaper than Uncle Sam.