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For Rebuilt Markets, a Test in 2010

Government Saved the Financial System From Collapse. Now Investors Have to Stand on Their Own

By [TOM LAURICELLA](#)

Financial markets staged a remarkable recovery in 2009, coming back from the brink of disaster thanks to unprecedented rescue efforts by governments around the globe.

The question now facing investors is how the markets will stand on their own in 2010.

After tumbling 25.4% to a 12-year low in March, the Dow Jones Industrial Average staged a blistering rebound to finish the year up 18.8% at 10428.05. The broad Standard & Poor's 500-stock index rose 23.5% to 1115.10 in 2009.

It wasn't just big stocks that rallied. Encouraged by government efforts to restart the financial system and stimulate the economy, investors who had fled from all but the very safest investments in 2008 dove back into the most volatile stocks and bonds, racking up big gains along the way.

The Dow's low point on March 9, when it was down 53.8% from its all-time high in October 2007, turned out to be the start of a powerful rally. Although the gains slowed in December and the Dow slid 120 points on the last day of the year, it finished 2009 up 59.3% from its March low, the fastest climb since 1933. The Nasdaq Composite ended 2009 78.9% above its March low and up 43.9% for the year.

Companies in sectors that had taken the biggest beating in 2008 and early last year surged, including autos and basic materials. [Ford Motor](#) shares more than quadrupled to \$10, while [Freeport-McMoRan Copper & Gold](#) more than tripled.

"You had an unprecedented amount of stimulus—both fiscal and monetary ... and you had unprecedented degrees of skepticism and pessimism," says Scott Migliori, chief investment officer for RCM Capital Management in San Francisco.

Going into the new year, the economy seems to be showing enough momentum that few investors fear a sudden dip back into recession, although most still expect a slow recovery. Corporate earnings, which have been far stronger than expected thanks to aggressive cost-cutting, seem on track to close out 2009 with another solid reading.

The market continues to benefit from the Federal Reserve's pledge to keep interest rates low for an "extended period" and the federal government's stimulus dollars that continue to pour into the economy. Stock-market valuations, while not cheap, aren't so rich that investors see better opportunity in other assets. If anything, many investors are more wary of a meaningful pullback in corporate-bond prices after a big rally in 2009.

Although many analysts expect the stock market to end 2010 with gains, they see some bumps along the way. A major unknown is how the markets will fare once the Fed starts siphoning off some of the unprecedented amounts of cash it pumped into the financial markets to support the economy, especially if the Fed moves sooner rather than later.

Investors will pay close attention to hints from the Fed as to how it's going to proceed, and watching for any signs that the central bank's exit strategy is proving disruptive. They especially will watch the housing market, which has been propped up by the Fed's successful effort to keep mortgage rates low through purchases of mortgage-backed securities.

In the past, the onset of interest-rate increases "at the very least led to some consolidation and indigestion," says Ronan Carr, European equity strategist at Morgan Stanley. Although he predicts a "strong year" for stocks, he adds that, "our fear is that you do have a negative effect on growth in 2011 on the back of tighter monetary policy."

Investors could decide the Fed is risking an inflation flare-up if it keeps rates too low. That could lead to a rise in long-term interest rates that could hurt the housing market.

Also hovering over the markets is a fear that the massive U.S. government deficit will lead to a steep decline in the dollar.

"The challenge going into [2010] is the costs associated with massive deficit spending and keeping interest rates at zero for an extended period of time," says Jason DeSena Trennert, chief investment strategist at Strategas Research Partners.

While many companies posted big stock gains in 2009 simply because it turned out they weren't going out of business, investors this year will be more discriminating, Mr. Trennert says. Companies "aren't going to get extra credit for just surviving; you're actually going to have to perform."

Looking back on the past year, Mr. Trennert says, "the good news is we're still standing and we've survived."

As good as 2009 was, the Dow remains down 26.4% from its all time high of 14164.53, and more discouraging, is down 9.3% from 10 years ago. For the Dow, which began in 1896 and now has 30 components, it was the worst decade since the 1930s, when it dropped 39.5%.

Measured more broadly, stocks traded on the New York Stock Exchange have lost an average of 0.32% per year, including dividends, since the end of 1999. That makes it the worst calendar decade for stocks going all the way back to the 1820s, when reliable stock market records begin, according to data compiled by Yale University finance professor William Goetzmann.

Many individual investors remained skeptical. Between March and the end of November, they pulled \$13 billion out of U.S. stock mutual funds and poured \$239 billion into bond funds, according to Morningstar Inc.

Although some of the money heading into bond funds reflected a shift out of money-market funds yielding essentially zero, as recently as November, investors were still exiting from U.S. stock funds, withdrawing \$7.7 billion that month.

"We're probably still only in the early stages of a potentially big economic recovery but I think it's probably not until well into next year that investors begin to broadly recognize it," says Thomas Lee, U.S. equity strategist at J.P. Morgan Chase.

Mr. Lee thinks there's enough slack in the job market to keep inflation from becoming a near-term threat as companies begin hiring. That, in turn, should allow the Fed to keep interest rates low for a prolonged period of time, he says.

RCM's Mr. Migliori also thinks 2010 will get off to a good start. Many of the trends that helped stocks rebound "will carry forward at least through the first and second quarters," he says. However, "as you get into the latter stages of 2010, he says, "a lot of the tail winds from monetary and fiscal stimulus are likely to become more headwinds."

Mr. Migliori thinks the market is especially vulnerable to the risk of the Fed raising rates, even if it's just by a half or three-quarters of percentage point. "Given the fact that stocks have essentially gone straight up from March 9, it could be enough to cause a decent-sized correction as folks recalibrate their expectations for Fed actions," he says.

Ultimately, however, he expects a decent year for stocks as the economic recovery takes hold. Improving fundamentals "should be enough to offset a modest rise in rates," he says, especially among technology and energy stocks.

2009 Investment Scoreboard

Total return on investment

STOCKS (includes price changes and dividends)

	2008	2009
Dow Jones Industrial Average	-31.93%	22.68%
Russell 2000	-33.79	27.17
Standard & Poor's 500 Stock Index	-37.00	26.46
Dow Jones U.S. Total Stock Market Index (float adjusted)	-37.23	28.57

BONDS (Barclays Capital Indexes)

Long-Term Treasury Index	24.03%	-12.92%
Intermediate-Term Treasury Index	11.35	-1.41
Mortgage-Backed Securities Index	8.52	5.75
U.S. Credit Index AA-rated segment	2.74	7.60
Municipal Bond Index	-2.47	12.91

MUTUAL FUNDS (Lipper Indexes)

Growth Fund Index	-42.24%	35.91%
Balanced Fund Index	-26.18	23.35
Growth and Income Fund Index	-37.54	29.10
Multi-Cap Value Index	-37.65	26.59
International Fund Index	-43.63	35.30

BANK INSTRUMENTS (Bankrate.com National Index)

30-Month Certificate of Deposit	2.46%	1.44%
One-Year Certificate of Deposit	2.39	1.16
Money-Market Deposit Account	0.72	0.39

MONEY MARKET FUND

iMoneyNet/12-month yield on all taxable funds	2.04% ²	0.16%²
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PRECIOUS METALS (S&P Goldman Sachs Commodity Index)

Gold	3.91%	22.86%
Silver	-25.44	47.64
Platinum	-38.22	54.04

RESIDENTIAL REAL ESTATE

Federal Housing Finance Agency (repeat-sale House Price Index)	-8.16% ¹	-3.76%³
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COLLECTIBLES

Classic U.S. Rarities Index	8.80%	-7.90%
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¹Revised ²Estimate ³Through third quarter

Sources: Thomson Reuters; WSJ Market Data Group; Russell Investments; Coin World (Classic U.S. Rarities Key-Date Investment Index Rare)

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