Forecasts for 2011: Opportunities and pitfalls

BY MICHAEL SINCERE — 01/25/11

Market experts weigh in with their outlooks.

What may be ahead for the economy and stock market in 2011? We asked three respected investment professionals with long forecasting track records to share their thoughts on possible long-term and short-term market opportunities—as well as the potential pitfalls.

A positive economic outlook

Bernard Baumohl, chief global economist at The Economic Outlook Group and author of "*The Secrets of Economic Indicators*" (Pearson Prentice Hall, 2007), laid out the most positive 2011 economic scenario of the experts we interviewed. “We are looking at a 3½% GDP growth for 2011, which would be the fastest the economy has grown in six years,” he says. Based on this projection, he believes the Dow Jones Industrial Average could end the year at 13,007, a 12.4% gain; the S&P 500® Index at 1,485, an 18% gain; and Nasdaq Composite Index at 2,963, an 11.7% gain.

He sees Fed moves as the primary driver of these healthy gains. “The enormous amount of fiscal and monetary stimulus coming out of Washington is beginning to have a positive impact on the economy. I do not believe the full QE2 (quantitative easing) will even be necessary.”

While Dr. Sung Won Sohn, professor of economics at California State University, agrees the economy will grow in 2011, he thinks it “will do so at a painstakingly lethargic rate.” At this early stage of an economic recovery, it should be growing at a faster pace than at 3% or below, he says. “That is the primary reason why I think the jobless rate will be stuck at a high level. The economy will continue to struggle, and some segments such as housing will go into a double-dip recession.”

Potential pitfalls: Fed moves

Although Sohn believes the Fed has been successful thus far, he believes there may be pitfalls ahead. “The real challenge is when the Fed’s exit strategy comes,” he cautions. “If they exit too late, it causes inflation. If they exit too soon, they’ll push the economy into another recession.”

Baumohl also agrees there could be potential problems. “Bond watchers are nervous that the Fed is overshooting the economy as they proceed with QE2,” he says. “The Fed and the bond market are involved in a delicate dance. It is very nuanced.” He believes yields on the 10-year Treasuries are starting to creep up because the bond market is worried about future inflation. “It’s something to be concerned about,” he adds.

It is essential, Baumohl says, that the Fed continuously calm the bond market. “The Fed’s pumping out more and more funds to bring unemployment down—even though the economy showing new vigor agitates the bond market. “Given all that monetary stimulus, this is precisely the time the Fed should reaffirm its commitment on keeping inflation expectations low,” he says. “If they do that, they will sooth the bond market and we’ll see yields relatively low.”

Stock suggestions for 2011

Because the economy is not growing that strongly, Sohn is staying on the conservative side. “I think you should choose good, healthy companies that you know and that have reasonable dividends.”

He is also putting the emphasis on stocks primarily because bond yields are low, but are starting to go up.

Fred Hickey, *Barron’s* roundtable member and editor of *The High-Tech Strategist* newsletter, no longer thinks that stocks are cheap, and he believes they are riskier than a year ago. “Sentiment numbers are high and could go higher,” he also points out. “Excessive bullishness tells you to be leery of having aggressive long positions in stocks right now.”

Nevertheless, he has stayed out of the short side. “In a money-printing environment, it’s difficult to short. If I had to be in stocks, I’d be in large cap, dividend-paying stocks that are underperforming and unloved.” He also likes gold stocks, believing that the gold bull market has been going on for almost 11 years, but still has further to go.

Baumohl, on the other hand, suggests that investors allocate 70% to equities, evenly split between foreign and U.S. stocks. He also recommends that investors reduce their exposure to fixed income (cash or short-term bonds) to 20% and says the final 10% can be invested in precious metals.

Potential threats

Even with the most optimistic forecast, reality often gets in the way, and sometimes when it’s least expected. “I can draw a scenario where we have a crash,” Baumohl says. “For example, let’s say a major war breaks out with Iran and they block the Strait of Hormuz, and oil shoots to $150 a gallon. What do you think will happen to the stock market?”

Another source that could cause market volatility is if the European financial crisis gets out of control. “That can scare off a lot of investors who fear the contagion could spread to U.S. banks,” Baumohl says. “Lenders here would suffer new losses and reduce loans. Credit will dry up and hurt the economy.”

Sohn is concerned that in Europe, the problems are “not being solved but being pushed around. I expect economic conditions in the U.S., although not exciting, are going to be better than in Europe or Japan.”

Sohn says China could also contribute to volatility. “China is the locomotive that is pulling the world economy forward, but they are trying to slow down their economy because of concerns with inflation and property bubbles. The question is whether they can engineer a soft landing.”

Bond warning signs

Hickey is studying the bond market for potential danger signs. “If the bond market backs up so much that it tightens on its own, or if the Fed even hints they are raising rates, I would consider getting out,” he says. “We are so dependent on the Fed’s juice that if they are not printing, I’d be thinking about shorting.”

Baumohl agrees that if the Fed overshoots on the monetary side, “everyone will sell their bonds quickly because bond prices drop rapidly. We would see yields on the 10-year Treasuries spike to 5% midyear,” he says. “If they go above 6%, it could endanger the economy. If the Fed is perceived as being behind the curve, no one wants to be the last out the door.” Investors who fear the higher Treasury yields will move into cash or foreign equities rather than U.S. stocks and bonds.

Nevertheless, Baumohl says, “If bond yields go up gradually in response to a stronger economy, you’ll see more investors move out of fixed income and into equities. Our assumption, and the key to our 3½% forecast, is the Fed will be successful in calming the bond market and prevent a more harmful spike in yields.”

The almighty dollar

The dollar will probably play a major role in the equity markets. As the United States continues to engage in quantitative easing, Sohn says, “the value of the dollar will continue to depreciate, although against the euro and yen it might strengthen.”

Sohn also notes that many countries are purposely depreciating their own currencies. “I don’t think that many leaders are looking at the overall global picture, but are more concerned with their own domestic political situation,” he notes.

Baumohl, on the other hand, believes the dollar will weaken just enough to help the stock market in the second half of 2011.

2011: cautiously optimistic

Although 2011 could be an extremely profitable year, the warning signs should cause investors and traders to be cautious. It’s definitely not a year where you can afford to let your guard down. For example, many will be watching how QE2 evolves in 2011 and whether the increased liquidity affects the stock market.

In addition, investors and traders want to be aware of new investment opportunities. For example, during the last quarter of 2010, eighteen new non-leveraged exchange-traded funds (ETFs) were introduced, and many more are in registration waiting for approval. The new Congress is also likely to make a number of regulatory changes that could affect your investments.

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Michael Sincere is the author of All About Market Indicators (McGraw-Hill, 2010), *Understanding Options* (McGraw-Hill, 2006), and *Understanding Stocks* (McGraw-Hill, 2003). Views expressed do not necessarily represent the views of Fidelity Investments and are subject to change at any time based on market or other conditions. Fidelity disclaims any responsibility to update such views.

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