Weekly Commentary
December 21, 2009

The Markets

Major fluctuations in the stock market tend to grab the headlines, but there's something else investors should keep their eye on, too – the value of the U.S. dollar.

As the worldwide financial system melted in late 2008/early 2009, investors fled to the perceived safety of the U.S. dollar and its value soared compared to a basket of other currencies, according to *The Wall Street Journal*. There seemed to be an inverse correlation between the dollar and the stock market; as the stock market went down, the dollar went up and vice versa.

Following the pattern, the dollar was very strong leading into the stock market's nadir in early March and as the market started its dramatic reversal, the dollar reversed, too. The so-called "risk trade" was on as investors dumped "safe" investments and moved into "risk" assets such as stocks and commodities. Massive liquidity and ultra-low interest rates also helped fuel the movement into riskier assets.

But, like a great book, the risk trade will end at some point. On December 4, the Labor Department reported a much stronger than expected employment report. This helped strengthen the dollar as investors began anticipating a quicker return to higher interest rates. Higher interest rates help make the dollar more attractive compared to other currencies, but may have a side effect of slowing economic growth. Concerns about debt problems in countries such as Greece, Spain, and Portugal are also supporting the recent rise in the dollar. Sticking to the script, the U.S. stock market rally has stalled over the past few weeks as the dollar appreciated.

Here's the tricky part. Historically, the dollar and the stock market did not always have an inverse correlation. It is possible to see the dollar and the stock market go up in unison. Correctly forecasting when the dollar and the stock market will break their recent inverse link would just be a lucky guess. Since we don't rely on luck to be a successful investor, we continue to monitor the value of the dollar and look for clues on what it might say about the future direction of the equity markets.

Data as of 12/18/09	1-Week	Y-T-D	1-Year	3-Year	5-Year	10-Year
Standard & Poor's 500 (Domestic Stocks)	-0.4%	22.1%	24.2%	-8.1%	-1.6%	-2.5%
DJ Global ex US (Foreign Stocks)	-1.7	35.4	32.6	-6.6	3.3	0.7
10-year Treasury Note (Yield Only)	3.6	N/A	2.1	4.6	4.2	6.3
Gold (per ounce)	-1.7	27.0	29.1	21.6	20.1	14.5
DJ-UBS Commodity Index	1.8	15.6	20.7	-6.7	-1.8	3.8
DJ Equity All REIT TR Index	1.6	25.8	35.9	-12.6	0.4	11.0

Notes: S&P 500, DJ Global ex US, Gold, DJ-UBS Commodity Index returns exclude reinvested dividends (gold does not pay a dividend) and the three-, five-, and 10-year returns are annualized; the DJ Equity All REIT TR Index does include reinvested dividends and the three-, five-, and 10-year returns are annualized; and the 10-year Treasury Note is simply the yield at the close of the day on each of the historical time periods.
Sources: Yahoo! Finance, Barron's, djindexes.com, London Bullion Market Association.
Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly. N/A means not applicable or not available.

SPEAKING OF GUESSES, what do you think will be the average inflation rate over the next 10 years? Interestingly, there is a simple way to determine how bond investors would answer that question. All you have to do is look at the spread between yields on 10-year Treasury notes and 10-year Treasury Inflation Protected Securities (TIPS). TIPS are Treasury securities that adjust the principal twice a year to reflect inflation or deflation as measured by the Consumer Price Index (CPI). By comparing the yield difference between the two, you have the market's best estimate of inflation over the next 10 years.

As of last week, the spread was 2.3%, according to Bloomberg. That means bond investors expect inflation to average 2.3% over the next 10 years. This is the highest expected rate in 16 months. By contrast, during the height of the financial panic late last year, *The Wall Street Journal* reported that the spread was actually negative, which means investors were predicting 10 years of deflation!

The government may not be too concerned about inflation right now because it may help them dig out of the debt hole by paying back the debt in "cheaper" (i.e., inflated) dollars. However, too much inflation, like eggnog, would be painful and cause new problems.

Inflation is one of those indicators that has the potential to move markets and, fortunately, it is easy to track. We can track the expected inflation rate as described above. We can read the government CPI report each month. And, of course, we can go to the grocery store and see if prices for milk, eggs, and bread are rising or falling. Currently, inflation appears under control, but the tail risk – either rampant inflation or deflation – is still possible.

Weekly Focus – Think About It

"Inflation is the one form of taxation that can be imposed without legislation."
--Milton Friedman

Best regards,

Tony Hartman

P.S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.

Securities offered through Madison Avenue Securities, Member FINRA/SIPC.
* The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.
* The DJ Global ex US is an unmanaged group of non-U.S. securities designed to reflect the performance of the global equity securities that have readily available prices.
* The 10-year Treasury Note represents debt owed by the United States Treasury to the public. Since the U.S. Government is seen as a risk-free borrower, investors use the 10-year Treasury Note as a benchmark for the long-term bond market.
* Gold represents the London afternoon gold price fix as reported by the London Bullion Market Association.
* The DJ Commodity Index is designed to be a highly liquid and diversified benchmark for the commodity futures market. The Index is composed of futures contracts on 19 physical commodities and was launched on July 14, 1998.

* The DJ Equity All REIT TR Index measures the total return performance of the equity subcategory of the Real Estate Investment Trust (REIT) industry as calculated by Dow Jones.
* Yahoo! Finance is the source for any reference to the performance of an index between two specific periods.
* Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.
* Past performance does not guarantee future results.
* You cannot invest directly in an index.
* Consult your financial professional before making any investment decision.
* To unsubscribe from the Weekly Commentary please email us at team@DenverFinancialGroup.com

Securities and advisory services offered through Madison Avenue Securities, Inc. (MAS) a registered investment advisor, member FINRA & SIPC. MAS and Denver Financial Group are not affiliated companies.