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Don't Waste a Good Recession

I have just returned from James Doti/Chapman University's 31st Annual Economic and Business Forecast Conference. They have a good, long term track record and were one of the first groups to forecast a recession for 2008 and Obama's victory. Here are some of his predictions:

Economy - In the fourth quarter of 2008, we will have a very large drop in G.D.P. (gross domestic production) of 4.1%; by far the worst since the Great Depression as most recessions peak at a drop of about 2%. He also predicts a similarly oversized jobs loss of 600,000+ in the fourth quarter (unemployment eventually peaking at 8% in mid 2009). However, he believes these will both be peak levels of drops in G.D.P. and employment and they will be less in the 1st quarter, less still in the 2nd quarter and positive in the second half of 2009. In other words, he believes that we are currently at the worst part of the recession and will start a general recovery in the second half of next year.

What will stop our current downward spiral? Ultimately consumer and business spending will have to pick up and housing prices will have to stabilize. He believes that the bailout packages in place along with Obama's new \$600 billion first half of 2009 fiscal stimulus package (similar to the \$160 billion early this year) will kick start consumer spending and will lead to inventory replenishment for businesses. Federal and state works programs will kick in by late 2009 and give the economy a second jolt. Lower gas and commodity prices will also help consumer's budgets.

However, he reminded us that we are in for a multi-year de-leveraging by consumers who will not be as willing to borrow to spend and will continue to reduce debt and save. This will cause the recovery to be more muted than in the past.

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Home Values - Doti forecasts a drop in the median Orange County home/condo of 7% for 2009, which will be the bottom. He cites that inventories are dropping from 17 months to 4-5 months and homes, relative to incomes, are now in line with long term averages along with our relative value to the overall U.S. market (but not yet undervalued). By the end of 2009, he believes that the combination of very low new housing construction for 3 years, vacancy absorption and attractive prices will finally form a bottom for housing.

Commercial Real Estate - Doti forecasts that commercial lending will not return to "normal" until the second half of 2009. In addition, office vacancy, tied to job losses, will peak at 20% in late 2009. These factors will push cap rates up and rents down for 2009. In other words, commercial real estate will struggle and follow the recovery, not lead it.

Stock Market - Finally some good news! Doti forecasts an end to the recession next summer, lasting 17 months (the longest since the Great Depression). However, the stock market has always anticipated recoveries by 3-8 months. This puts the timing for a bottom anywhere from our November lows until as late as March 2009.

Interest Rates in 2009 - He forecasts that short term rates will drop further and long term rates will stay about the same.

Bail out the Auto Industry? - No. Let them go into bankruptcy, unwind the inefficiencies and emerge smaller but competitive.

Next Bubble? - Long term U.S. Treasury Bonds.

Long Term Inflation? - Pick up in 2010 and 2011.

My Come Away and Investment Implications

Doti makes some good arguments for his forecasts and was right about the recession, so I believe he has a good chance of being right about the eventual recovery. There have been so many surprises this year, especially since August, that I am sure we will have additional unforeseen bumps in the road as this recession unfolds and eventually recovers, but my overall main take away is that we will recover next year, despite how bad it seems today. While this recession is different than the last (they are all different), they were all followed by recoveries that lasted many times longer.

I started as a stock broker at Smith Barney in the late 70's and ever since then I've "dreamed" of having the chance to go back in time and invest at the bottom of the 1974 recession when stock prices were down 45% (the Dow Jones was in the high 500's). The Dow quickly went back up to 1000, stayed there a few years until inflation peaked, then in 1982 started a 10 fold increase over the next 20 years. What a great "do-over" to invest during those years with a start in 1974!

While our current recession and weak economy resulted from different circumstances, the result has been the same. Whether the November low of the Dow Jones at 7400 (down 47%) was the bottom or it has yet to be reached is immaterial in the long run. The current opportunity in the U.S. stock market for long term investors is one that only comes along every few decades and should not be wasted.

How cheap are stocks today? Last year, The Royal Bank of Scotland bought another bank for almost \$100 billion in cash. If they had waited until today, they could have purchased City Corp, Goldman Sachs, Merrill Lynch, Morgan Stanley, American Express and Wachovia, and still have had enough money to buy Ford and GM. That's what \$100 billion would buy today.

I will two make predictions of my own: The U.S. stock market will gain at least 40% from the November lows at some point by the end of 2009. While that may sound bold, it is just a recovery to levels we were this past September. Further, if history is a guide, we should gain 150% before the next market peak in 4-6 years. I have also put my money where my mouth is and started an aggressive stock market account in November. It looks like I will get my dream after all, and you can too.

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CEO



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