



# K E R N S

## CAPITAL MANAGEMENT, INC.

### Kerns Capital Management Market Report

January 4, 2010

Clients and Friends,

Happy New Year!

Last letter I said "color me optimistic". That optimism was rewarded with a strong close for 2009. We had a fantastic year!

Having emerged in 2009 from the deepest downturn since the Great Depression, the economy enters 2010 with momentum but plenty of baggage and a steep climb ahead.

Rising stock prices, slowing job losses and signs that home prices are stabilizing are supporting a modest rebound in consumer spending.

Consumer spending represents roughly 70% of our economy, so having it finally start rising is very good news.



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### The Good, The Bad, and the Ugly

According to the Chief economist for the U.S. Chamber of Commerce, the outlook is a combination of "the good, the bad and the ugly".

"The good news is that we're growing again. The bad (news) is that we are probably not going to grow at a very high rate. The ugly part is that in the long run, we're facing some truly daunting problems" tied to out of control fiscal policy (government spending).

Forecasters polled by Blue Chip Economics expect the U.S. to add 1.1 million jobs in 2010, leaving the jobless rate only slightly lower than it is now. My personal feeling is that we will do better than

1.1 million. We will see.

## **The Economy Versus the Market**

Remember that the market can do poorly or great while the economy is doing something different. The market usually leads the economy by six to twelve months. The market has been good, so that bodes well for the economy. However, there is every possibility the market will have a temporary stall sometime in the next few months - if not weeks.

The main driver of a strong market is first-and-foremost corporate earnings. If corporations are earning more, their stock is worth more! Earnings reporting season for the S&P 500 starts with Alcoa reporting on January 11th. Earnings for S&P 500 companies are expected to be substantially higher than a year ago. It would be hard for them not to be.

If earnings continue to surprise to the upside, the rally that started last March should continue. If earnings just come in as expected or lower - we will probably have a correction. Estimates are a correction of 10-15% if this happens. Nothing serious, but it would probably cause us to take some evasive action if it occurs. However, we expect the market to be higher during the first half of 2010.

## **The Current Market in Perspective**

The problem most investors have is controlling their emotions of Fear or Greed and not putting current market actions into a bigger picture perspective. What part of the economic cycle are we in now? What typically happens in this part of the market cycle?

The following is paraphrased from today's Investor's Business Daily and I think helps put our expectations on some type of a reasonable basis.

By percentage gains, 2009 was the best market year since 2003. Yet the mood for 2009 was not all that confident. Headlines were glum in the days just before the March 12 bottom and many investors refused to believe that an uptrend was under way. Unemployment was at a 25 year high. Dividends were on track to fall the most since 1938. Bankruptcy loomed for General Motors.

Yet that kind of atmosphere is typical of market bottoms.

The market ended 2009 in a confirmed uptrend, but with a second-leg question hanging over it. While no one knows the future, history has dealt with the second-leg question before. Since 1900, seven bear markets have been comparable to the sharp 2007-2009 decline. Let's do a quick survey:

**Bear of 1901-03:** The Dow dropped 46% in 29 months in this little-mentioned bear market. A U.S. drought and the assassination of President McKinley were contributing factors. The market bottomed in November 1903, but the first leg of the rebound didn't find consistency until seven months later.

First leg: a climb of 54% in seven months. First correction: 10% in one week. Second leg up: a 27% bounce in four months after the low of the correction.

**Bear of 1906-07:** The Dow lopped off 49% over 22 months in the midst of a credit crunch and President Teddy Roosevelt's anti-trust efforts.

The market bottomed in November 1907, but the first consistent leg began in February 1908. That marked a 71% surge in 19 months. A correction of 27% unfolded over 10 months. The second leg up was a 17% rise in three months, but didn't reach the previous high.

**Bear of 1919-21:** The Dow staggered 47% in 22 months. A stock bubble based on the fledgling auto industry - soared and burst. The bottom came in August 1921. First leg: a 61% climb over 14 months. The Dow corrected 10% over one month. The second leg up: 15% in four months.

**Bear of 1929-32:** The Dow plunged 89% in 34 months. First leg: a 101% surge in two months. That was followed by a correction of 39% over six months. The second leg up: 122% in 4 1/2 months.

**Bear of 1937-38:** The Dow lost 50% in 13 months as the Great Depression persisted and rumors of war stirred. First leg: 63% in seven months. Correction: 24% in six months. Second leg: 31% in five months; didn't reach previous high.

**Bear of 1973-74:** The S&P 500 corrected 50% in 21 months. After a false start, the rebound began in December 1974. First leg up: 51% in seven months. Correction: 16% in two months. Second leg up: 33% in 12 months.

**Bear of 2000-02:** The Nasdaq plunged 78% in 31 months after the tech bubble burst and 9/11. The Nasdaq made a low in October 2002, but a consistent rebound didn't begin until March 2003. First leg up: 72% in 11 months. Correction: 19% in seven months. Second leg up: 25% in four months.

**Bear of 2007-09:** The Nasdaq careened 56% in 17 months after a housing bubble. First leg: The Nasdaq rose as much as 81% from its March low. Three of the four major indexes have yet to suffer a 10% correction. ***End of IBD.***

In our opinion, we need to manage the correction without losing any big money and then capitalize on the second leg up. We have done this fairly well in the past as demonstrated in the charts below.

## How Are We Doing?

We're had a great December with our Aggressive Model up about 2.88% for the month! That is .95% ahead of the S&P 500 which came in at 1.93%.

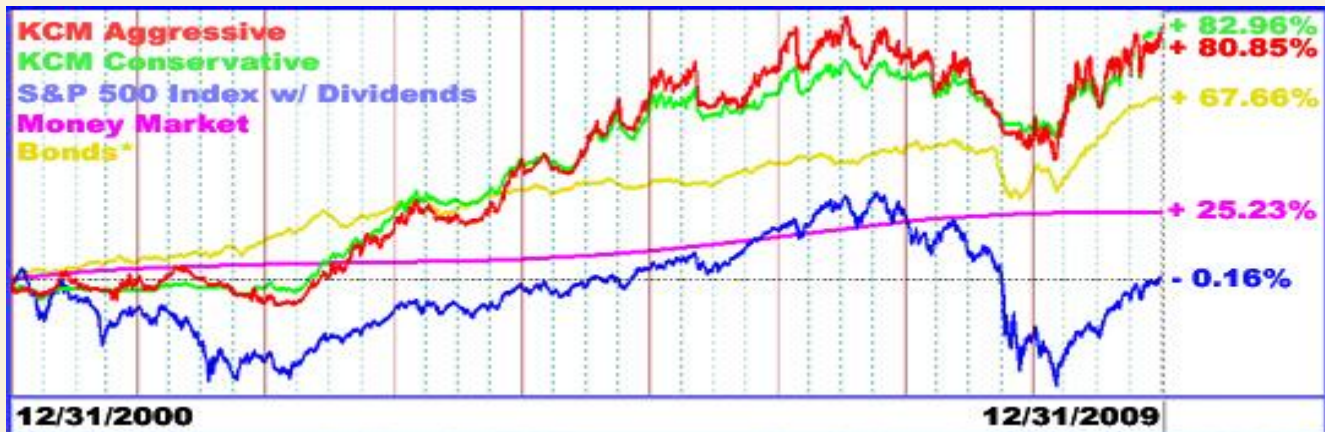
There are two charts below.

The first chart compares the major choices you have had for investing - stocks, bonds and cash. It compares Money Market using Schwab's best returning MM fund, the S&P 500 including dividends, Bonds represented by the average of all major bond funds (excluding junk bonds) and our

Aggressive and Conservative models.

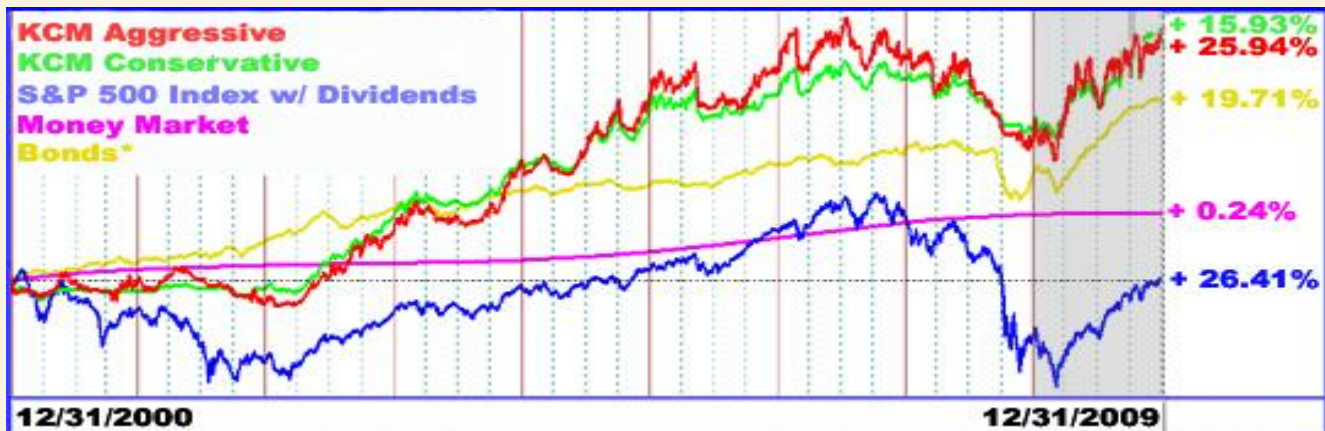
Over the nine year period, we have performed better than the alternatives.

### NINE YEARS PERFORMANCE FROM 12/31/2000 TO 12/31/09



The second chart shows the same nine years but highlights 2009 and gives 2009 performance.

### 2009 Performance Only



Our goal is to miss the majority of down markets while capturing the majority of up markets. The combination of the two charts shows that we have succeeded in both up and down markets.

Note, for 401(k) plans without self-directed brokerage accounts, please see your Plan's monthly Investment Performance Summary for actual performance.

## KCM Macro Trends Fund

The **KCM Macro Trend Fund (KCMTX)** is an out-growth of the model portfolios we have been successfully managing for our clients for more than 15 years. It is a proprietary fund open only to our clients and Investment Advisors (for their clients) via Fidelity, Charles Schwab, TD Ameritrade, Pershing, Southwest Securities and Trust Company of America.

Our Aggressive Model has been invested 100% in KCMTX since August 2008.

For more information about the Fund, including its objectives, strategies and performance, please give us a call at (800) 945-2125, or click on the following direct links: [KCM Macro Trends Fund](#) or [2009 3Q Fund Fact Sheet](#) (FINRA reviewed).

## In Closing

The market had a frightening year - but a good one. We had a good year without the big roller coaster ride. Let's me sleep better at night!

As I attempted to show above, it may be time for a market correction followed by a second leg rally. We should make some money this year and at the very least, we will try not to lose any.

KCMTX made a new high in performance and assets today. See the section above for details and disclosures.

Best wishes for a great 2010. We will do our part to help make it that way.

Lane Kerns

### **Important Notice & Disclosures**

**Performance data is historical.** Past performance does not guarantee future results. Current performance may be lower or higher than the performance data quoted.

**Kerns Capital Management, Inc. ("KCM") performance figures** represent a composite of all individual portfolios managed in accordance with the investment category, are after the deduction of KCM's actual management fee, and include reinvestment of dividends and earnings. The composites contain accounts structured with mutual funds that are managed with a view toward capital appreciation. Standard Deviation and Alpha are calculated monthly and then annualized to be consistent with Morningstar®.

**Mutual Fund investing involves risk including possible loss of principal.** Investors should carefully consider the investment objectives, risks, charges and expenses of the **KCM Macro Trends Fund**. The Fund may invest in small, less well-known companies, which may be subject to more erratic market movements than large-cap stocks; foreign securities, which are subject to currency fluctuations and political uncertainty; and derivative securities, which may carry market, credit, and liquidity risks. The Fund may also engage in short selling activities, which are more risky than "long" positions because the potential loss on a short sell is unlimited. These risks may result in greater share price volatility. This and other important information about the Fund is contained in the prospectus, which can be obtained by calling 1-877-275-5599. The [Prospectus](#) should be read carefully before investing. The KCM Macro Trends Fund is distributed by Northern Lights Distributors, LLC member FINRA/SIPC.

**The S&P 500 Index** is an unmanaged composite of 500 common stocks. This index is widely used by professional investors as a performance benchmark. You cannot invest directly in an index. **The Dow Jones Industrial Average** is a price-weighted average of 30 of the largest and most widely held stocks traded on the New York Stock Exchange and the Nasdaq.