1Q 2010 Commentary

"I think the economy appears to be moving towards escape velocity."

Larry Summers

Escape velocity is often defined as the minimum speed needed for an object to break free from a gravitational field. In current macroeconomic terms, this might be viewed as not only the cyclical trend at which the economy is growing but the sustainability of that upturn. Mr. Summers is certainly correct in that we do hear much less talk of "double-dips" than a couple of quarters ago as the odds of falling back into recession have decidedly abated. Clearly, the unprecedented global fiscal, monetary and even inventory stimulus have precipitated a manufacturing-led recovery. However, we have discussed from the onset of the financial crisis that there are secular headwinds in the requisite foundations for a durable economic expansion. While we have seen some welcome improvement in the positive trends for employment, housing and the consumer, each still face a very long road back to normal levels of activity, much less expansion. Historically, the aftermaths of financial crises commonly exhibit years of housing price declines, high unemployment and an explosion of government debt that act as a drag on future economic growth. We see little yet in this cyclical recovery that would make us confident that this time is any different.

What we do know is that the cyclical recovery is in full swing led by the manufacturing sector and appears to be accelerating. Both the Institute of Supply Management (ISM) manufacturing and non-manufacturing indices jumped in March to 59.6 and 55.4 respectively, expansionary levels last seen in 2004. Industrial production is now up 5% since the bottom in June of 2009 though still 10% below pre-recession levels. This resurgence in manufacturing has fueled optimism that global growth is sustainable as the Eurozone, United Kingdom and China are all in expansion mode.

Though the 3Q GDP was revised down to 2.2% from the initial read of 3.7%, 4Q GDP exceeded consensus expectations (and our 4% target) with a print of 5.6% growth as the inventory rebuild contributed fully 2/3rds of this gain. Following such a deep recession, it is typical for the inventory cycle to behave in this manner. In the downturn, businesses satisfy tepid demand from existing inventories rather than increased production (a component of GDP). This cycle was extreme in this area as industrial production declined over 15%. As inventories are drawn down to the bare minimums, production restarts to meet current demand. For this to continue, however, requires production to equal final sales as demand recovers. On this point, we are not as confident. For now, we expect that inventory rebuilding has not yet run its course and should contribute, though to a lesser degree, in the 1Q period as we look for GDP to approach 3%. We have stated previously that we expect the 4Q GDP print to be the high for this cycle with continued moderation into the second half. While current momentum leads us to raise our full year expectations for GDP above 3%, we still see a greater likelihood of a second half deceleration as the impact of fiscal, monetary and inventory stimulus fades.

Massive labor and production cutbacks during the recession allowed corporate America to maintain trough profit margins at a higher level than any prior recession. According to the Bureau of Labor and Statistics, unit labor costs have declined over 6% in this cycle as productivity soared. As a result corporate profits are growing much faster than is typical at this stage of the business cycle. Thomson Financial estimates that 4Q profits were up 47% and 1Q are expected to rise 35% albeit from trough levels. S&P 500 earnings for 2009 were over $57 and are expected to jump to over $78 in 2010 and exceed $90 in 2011 (prior cycle peak was $92) as Wall Street analysts forecast a V-shaped profits recovery (shocking!). U.S. equity markets following a flat opening to 2010 enjoyed a sterling month of March to close the first quarter with a gain of 5.4% and 4.8% for the S&P 500 and Dow Jones Industrial indices respectively, the best opening quarter in over a decade.

With U.S. non-financial companies sitting on a record $950B in cash (according to a data released by the Federal Reserve Bank of St. Louis), corporate America is in good shape. This should augur well for increased M&A activity and solid capital spending along with the hoped-for paybacks to shareholders in the form of increased dividends (which were reduced over 21% in 2009) and share buybacks.

The improving markets and economic data have increased fears that the inflationary concerns are not nearly as far into the future as we have postured in previous commentaries. Assets tied to strong global growth such as commodities and oil have retraced declines from the onset of the crisis. The interest rate on the U.S. 10-Year Treasury Bond has increased from about 3.25% in December to 4%, the highest rate since 3Q 2008. There is almost unanimous opinion that rates will continue on the rise and the expansion of the balance sheet of the Federal Reserve from $800 Billion to over $2.25 Trillion should strike fear into the bank accounts of all of us. If it does not, perhaps a budget deficit over 10% of GDP or a Federal Government debt-to-GDP ratio of 85% in 2009 estimated by the CBO to approach 94% in 2010 might. By contrast, Fitch Ratings calculates that Greece's debt levels on these two measures are about 12% and 110%.

However, much of the expansion of the Fed balance sheet may be found sitting in idle excess reserves on bank balance sheets while the money supply has been contracting.

If that money is not placed into circulation (borrowed and spent) then inflation is more of a concern than a reality. The core Consumer Price Index has declined over the last 4 months and is now running only 1.3% y/y. With manufacturing capacity still at only 72% and deflating wages and rents, core inflation should not be a concern. In the aftermath of a credit bubble with perhaps years of deleveraging still in front of us, deflation may still be the primary worry. In fact, we would still feel there is a very strong likelihood that rates actually fall over the next year from the 4% current levels.

The confidence that Wall Street may feel, however, has yet to filter down to Main Street. As noted last quarter and since little changed, the National Federation of Independent Business (NFIB), considered the voice of small businesses, continues to track at recessionary levels. Small businesses are still more negatively impacted by concerns of rising healthcare costs, taxes and constrained access to credit. On the consumer side, the growing GDP numbers of the last 2 quarters have come despite real final demand of only 1.5% and 1.7% respectively. Real disposable personal income is up only 1% over the last year as wages (outside of the public sector) have remained flat. It is probably not shocking to note that fully 100% of total personal income gains in the last year have come from government transfer payments! That is correct. Fully 20% (versus a 12% long term average) of personal income now comes from the largesse of our government.

An area of clear improvement with the consumer may be found in areas previously noted here as fundamental concerns for years. The analysis by the Federal Reserve shows that debt service ratios have declined back to levels of 2002 rather quickly as consumer credit has undergone an epic contraction of over $129 billion since 2008. While much of this improvement is certainly an increased aversion to and pay down of debt, more may be due to credit card write-downs and mortgage foreclosures improving the liability side of consumer balance sheets. This in turn is allowing an improvement in consumer spending which is showing a 3.1% gain in the first quarter and March now represents the 7th consecutive month of retail gains.

Looking deeper into the averages, we are definitely seeing indications that higher end consumers have picked up spending even more. Sales of luxury items increased over 22% y/y while overall retail sales grew modestly. The stock market increase has disproportionately benefitted this demographic and the Federal Reserve report on Household Net Worth has now increased over $5.7 trillion from the trough of March 2009 though still down over 16% from the peak. It is important to note that the top 20% of wage earners are estimated to own 90% of stock in the hands of the public and are responsible for about 50% of discretionary spending. This pick-up in higher end spending should not be expected to sustain the economy, however, as it may very likely be sabotaged by the large pending tax increases set to take effect in 2011 (as the Bush tax cuts expire) and 2013 (as Medicare taxes are slated to take effect). With credit creation impaired, wage growth will be necessary to sustain overall consumer spending and that will be a function of the labor market.

After the loss of 8.4 million jobs from December 2007 to the end of 2009, we can assuredly say that the worst of the job market is in the rear view mirror. According to the data released by the Labor Department, we have had 3 straight months of private payroll gains which included a March tally of 123K jobs in that sector. Though we still expect the unemployment rate of 9.7% to rise back over 10% (as the number of people looking for work increases faster than the new jobs), we no longer feel that 11% is in the cards. We have long held that the household survey is a greater indicator at turning points (as it picks up many more small businesses) than the establishment survey which garners most of the headlines. This has now shown 3 consecutive months of gains totaling over 1.1 million new jobs. We must note that over half of the new employed are categorized as working part-time for economic reasons (meaning they cannot find full-time work) and many more are considered temporary. Historically this is a precursor for full-time employment. We are cautious on this subject as this cycle has ushered in the new term "perma-temp" into our lexicon for good reason.

What is most sobering in the data is the emergence of a concerning dichotomy. The unemployment rate for those out of work for over 6 months is now about 4.4% which is about equal to what the TOTAL unemployment rate was at the job peak in 2007! There are permanent job losses in industries such as construction, real estate and finance. These are structural aspects to the employment picture which cannot be ignored and give us pause as to what may happen when the impact of the stimulus fades. Given that it takes over 125k new jobs each month to just maintain the current rate of joblessness, we fully expect the unemployment rate to remain over 8% through 2011 and feel we may be optimistic in that assessment.

Housing on the other hand may be on the precipice of rolling over again. The purchase by the Federal Reserve of $1.25 trillion of mortgage-backed securities had succeeded in moving mortgage rates below 5% which combined with the homebuyer tax credits had appeared to some to stabilize the housing market. In our annual commentary we noted, " by creating artificial demand we are delaying the market clearing process of consumers giving up on unaffordable loans and banks recognizing these loan losses. In so doing, we are actually artificially maintaining prices higher than they would otherwise be and transferring home ownership between still weak hands. As the homeowner tax credit expires and the Fed ceases purchases of mortgages (thus increasing rates), greater pressure on this market will ensue." We are at that point now. New home sales hit an all-time low in February and existing home sales are off over 20% from levels of last fall just at a time when stimulus for this market is being withdrawn.

We are also entering a period where increased credit strains from option ARM and other mortgage resets might be hitting their peaks after a period of relative calm. Additionally, the administration's most recent efforts at modifying mortgages and principal reductions will have an unusual effect on the markets. The processes being put in place are now likely to move the system more quickly in determining what does and does not qualify for modifications and short sales. This in turn will have the perverse consequence of dramatically increased foreclosures hitting the market place imminently. Fannie Mae's chief economist Doug Duncan recently cited over 5 million additional homes that are seriously delinquent. With the expiration of the home buyer tax credit set for the end of the month (I would expect this will be revisited as true market price discovery does not seem welcome during this period) and mortgage rates back over 5.25%, this will be a critical spring selling season.

With perhaps the peak periods of stimulus soon to be behind us, we may be shortly entering a period whereby the economy meets the true test of escape velocity. We are often asked what concerns us most over the short to intermediate term that might derail the markets. That question alone indicates how much continued skepticism there continues to be in this monster market rally, a bullish sign in itself. We would probably cite two areas with the first being the above-mentioned second wave of credit strains hitting the housing market this spring.

The other would be both the short and long term concerns of sovereign debt most specifically in the Eurozone. The credit crisis was certainly global in scope and the collective response has been the same. In fact, estimates by the International Monetary Fund (IMF) are that the debt-to-GDP ratios of G-7 developed nations has grown from a collective 44% in 2006 to over 71% in 2009 with the average annual deficit approaching 10%. The problems impacting Greece are well known, and their poorly received, recent issues of 6% bonds are already priced to yield over 7.5%, an unsustainable cost to the nation. Greece is not alone and we expect there are not good choices to fix the fiscal imbalances. The most tenable of which are major austerity plans that cut spending and benefits in much of the developed world. This will have the effect of dramatically lowering global growth over the next few years. This is the good choice. Unfortunately, developed nations are conditioned to "kick the can down the road" and choose shorter term fixes. Excessive debt is not cured via additional debt.

The U.S equity market based on normalized 10-year earnings is now overvalued, though not egregiously. Value Line now estimates that the median stock in their universe now is priced at a price/earnings ratio of 18. This compares with 10 in March of 2009 and 19 at the market peak of 2007. Volatility and credit spreads are now indicating high levels of complacency in the markets and with institutional cash levels to levels back at market peaks, we are at higher risk levels. This market has been characterized by extremely low volume indicating a lack of sellers and it might not take too much of a disappointment to initiate a correction. As we do not make short term calls, we rather rely on valuations to help position portfolios and in this area we feel a more defensive posture to be more appropriate. As this cyclical bull rally has been dominated by the outperformance of economically sensitive and lower quality stocks, we continue to find the high quality, U.S companies historically attractive on both a relative and absolute basis.