# SEPTEMBER 2010 MARKET COMMENTARY

As the summer draws to a close, **there's much speculation that the already weak recovery may be getting weaker.** The FED has acknowledged that the U.S. economic recovery is actually more "modest" than they had previously expected. There's even speculation that we could be heading towards another recession. Well, as always, anything is always possible.

**In spite of all the bad news, we'd like to point out that we're still moving forward**, not backward, and while there is ever present bad news, there's still a lot of good news. Possibly more importantly, we believe much of the bad news is already priced into the market making many of the doomsday predictions unlikely.

While there are several areas of bad news, a few primary factors are dominating the headlines. **Recent home sales data were quite poor.** Existing home sales dropped a record 27.2 percent from June versus projections of only 12 percent. The end of the popular home-buyer tax credit resulted in huge drop in sales. Most experts believe the recent sales drop off is simply an overcorrection that is likely to last another month or two. This is exactly what happened after the end of the "cash for clunkers" program.

**Adding to housing uncertainty is unemployment** which continues to remain stubbornly high. Obviously, high unemployment is affecting many different issues, and is a major factor in home sales. Many people are sitting on the sidelines waiting to be certain the recovery continues. Yet, there is progress here. Companies in the U.S. added workers in July for a seventh straight month as private payrolls that exclude government agencies rose by 71,000 after a June gain of 31,000, Labor Department figures showed.

Of course there's other less positive news as well ranging from smaller than expected increases in orders of PC, inventory, and commodities. And consumer credit continues to contract with recent credit card reforms worsening this trend as credit card companies adjust to restrictive regulations.

**However, there's also significant good news** as well as various factors that strongly signal stabilization and forward progress. As mentioned in several previous commentaries, corporate profits continue to be very high. Corporate spending on equipment and software jumped at a 22 percent annual rate last quarter, the biggest increase since 1997, signaling confidence. Big firms are rolling in cash they can spend. Profits for S&P 500 companies were up 46% from second quarter 2009 to second quarter 2010. Huge post recession productivity gains must eventually give way to hiring as employers can only do so much with current workers. When businesses finally start to expand, they'll have the money to hire.

**Many other positive factors also exist.** The economy has never contracted with the difference between short- and long-term Treasury yields as wide as it is now. While that gap has narrowed since reaching a record 2.91 percentage points in February, it's still almost double the average since 1990. This indicator has probably been the single most reliable indicator of slowdowns and recessions. During the last and only double dip recession in the early 1980s, short term rates were higher than long term rates. Now, we're not even close.

**Though economists are paring their forecasts, they still predict growth in gross domestic product of 3 percent this year** and 2.8 percent in 2011, according to the median of 66 estimates in a Bloomberg News survey. Goldman Sachs Group Inc. economists say most of the sectors that drag down an economy, including housing, employment and capital spending, have "already suffered big hits."

**Production in the U.S. rose more than forecast in July.** Production at factories, mines and utilities climbed one percent according to the Fed, twice the median forecast in a Bloomberg News survey.

**Most major components needed for growth already exist in many areas.** In fact, there are enough positive factors to suggest that when businesses and consumers are feeling secure enough to loosen the purse strings, the upswing could be surprisingly swift. Big banks are sitting on piles of money to lend thanks to shrinking loan losses combined with strong earnings. Banks have rebuilt their capital base to record levels.

**And the deleveraging of consumers has happened quickly.** In 2007, 19% of household income went to servicing financial obligations while today, the number has dropped to 17%, the lowest since 1998. Consumers may continue in the opposite direction for a while, but if they decide to spend money, they'll have it.

**There's been a sharp rise in utilization of transportation services** including air, rail and trucking. All of these industries report significant increase in demand for their services which signifies increasing general economic activity. The hotel industry is reporting a sharp increase in business and consumer demand for rooms. While all hotels and hotel chains are not out of the woods this return in demand and a belief that hotels can begin to raise prices signals growth in the economy – at least in the future if not immediately.

**Other problem areas are showing very positive signs.** Real estate investment trusts (REITs) are raising capital quickly and using the new money to buy. After nearly disappearing in 2009, the sale of securitized real estate loans will likely reach $10 billion this year. Although this is just a fifth of the pre-bubble level, it's still about four times the lows reached previously. The reemergence is a positive sign for construction and related sectors, and is an early indicator that normal lending behavior is returning to the market. There's still a lot of debt coming due in 2010 and 2011, so the press will inevitably make much of some high profile defaults. But, the underlying trends are quite positive and strong.

**Retail sales rebounded in July** but showed hints of lingering economic softness. Although sales show that the economy has slowed in recent months, they were still judged to be sufficiently strong to dispel fears of a renewed downturn, at least for now.

**Obviously, the recovery of the U.S. economy has slowed, but pauses like this are common** in economic recoveries. The economy is growing and appears very likely to continue to grow even if the pace is anemic. We fully expect the next several months to be rocky as people are very nervous about many different issues.

**However, we're also fairly upbeat about the direction of the market** beyond the next few months. High levels of current pessimism usually lead to future gains when sentiments improve. The economy is finding firmer footing, albeit slowly. Factors that caused the last major slowdown are largely past us. The elections will remove an element of fear and uncertainty within the business community. Yields on stocks versus treasuries are at nearly all time attractive levels. There's cause for concern – as always – but there are also many positive factors that we believe point toward higher valuations once we've moved past the current nervousness. And this holds true even if we go back into a recession which we believe is unlikely.

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