August 2010 Market Commentary

As we've been projecting, the economy continues to strengthen and investor confidence seems to be returning. While various indicators of economic health continue to be somewhat weak – as expected –, there's enough good news to convince investors and economists that the recovery will continue even if it's likely to be somewhat anemic.

Strong corporate earnings continue as a major area of good news. However, the story is actually much deeper than profits alone. Business spending and exports are both strong. Corporate America is spending heavily on new equipment with shipments of capital goods (excluding defense materials) rising at a 3.0% annual rate during April and May – equal to the pace of the previous 12 months. Even more encouraging, new orders for capital goods exploded at a remarkable 48.3% annual rate during the supposedly weak April–May period. This expansion comes after the already very rapid 25% expansion rate of the prior 12 months. *Please note that throughout this newsletter I use the latest month for which data are available.*

Businesses also continue to rebuild inventories and increase production. Stocks of finished goods rose at a 6.0% annual rate between March and May and work in progress increased at a 4.3% annual rate. The year-to-date rate through May has seen the industrial production measure of output in factories, mines, and utilities rise at an annual rate of more than 8%. In May, the pace actually accelerated to an annual rate of more than 15%. While these expansion rates are unsustainable, they clearly indicate continued growth and expansion.

While corporate data are generally quite positive, various other factors are positively influencing the economy and the stock market, and have also helped drive stock values higher in July.

Financial markets are healthier than the headlines imply. While this has been true for quite a while, Europe's biggest banks comfortably passing their mid/late June stress tests have helped convince investors. Goldman Sachs called the test a "substantial step forward" and said even in its own more rigorous scenarios, including one with a restructuring of Greek debt, exposures were much more manageable than it anticipated.

Throughout Europe's sovereign debt crisis, the strength of the financial markets provided much evidence that financial markets are growing much stronger. Contrary to the tone of headlines, markets have avoided the relapse into the 2008–2009 turmoil. For example, the TED spread, the gap between Treasury bill and interbank lending rates which is a good indicator of liquidity, widened from 20 basis points (0.20%) to about 40 basis points. This is a very long way from the 460 basis-point spread recorded during the 2008–2009 crisis. Other measures of liquidity were hardly affected, and spreads are again narrowing. Even bank lending has shown tentative signs of flowing again.

Various consumer issues are also showing improvement. Broad measures of personal spending continue to expand moderately. Although the 2.4% annual rate of expansion registered for overall outlays in May was slower than the 4.2% annual rate of expansion recorded for the prior six months, it was still an expansion, not a decline.

More importantly, household incomes have risen enough to support future spending. Overall personal income rose at an annual rate of 5.4% accelerating from the 4.4% annualized rate of increase during the prior six months. Meanwhile, the 4.0% after-tax personal savings rate generates a $454 billion annual flow of new money from which households can pay down debt while maintaining spending. If income continues to expand, as is likely, households will continue to possess the ability to de-leverage while increasing spending.

Housing also shows various signs of continued improvement. Sales of new U.S. single-family homes rebounded strongly in June from the prior month's record low that resulted from the expiration of the $8,000 housing credit. Currently, the number of houses on the market is at its lowest level in 42 years. As housing inventory drops, downward pricing pressure on new construction, sales, and pricing is reduced. According to the National Association of Realtors, for instance, the median sales price of homes sold in the United States has risen 5.3% so far this year, and prices continued to rise in May.

Unemployment is likely not the issue that headlines suggest. It's not that unemployment isn't a problem. Rather, the jobs market is slightly ahead of schedule in its recovery according to historical benchmarks. Hours worked, temporary employment, and even full-time employment have begun to edge up. While the unemployment rate has not fallen significantly, lags in jobs recovery during past business cycles suggest that a major drop would be premature at this time.

Exports also show strength. Through April, U.S. exports to the rest of the world expanded at an impressive annual rate of almost 17%. This growth argues that the world economy is far more robust than many suggest and will continue to help the US move forward. Imports have also expanded at a 23.5% annual rate so far this year through April indicating that the U.S. is spending.

Emerging markets, such as China, India and Brazil, continue to provide another global growth engine. Looking specifically at China, some headlines suggest that we should be worried about their future growth. While a slowdown in their growth is expected for reasons ranging from a deflating housing market to government steps to slow growth, China is not going to experience the collapse that occurred in the United States. China's overall growth is expected to slow from a blistering 11.9% annual rate in the first quarter to a still exceptionally strong 9.5% -- a rate of growth that is still so high that is has rarely been experienced by most countries.

What does all this mean for stocks? Given the continued volatility and uncertainty in the marketplace, it's not surprising that there's a lack of consensus. By some measures using certain assumptions, stocks are cheap. Other assumptions yield a different answer. This is ALWAYS the case. However, the severity and unique nature of the recent downturn mean that interpreting data now is likely more difficult than during past recessions. As covered above, I believe the growing stability of the economy makes a double dip recession very unlikely removing much of the reasoning used to declare stocks overvalued. However, I also believe it's likely optimistic to believe this recovery is going to revert to previous patterns in which growth is exceptionally strong. If the economy continues to display more signs of stability – which we expect – it's likely that stock prices will react well. Even so, considering various factors, we're probably not too far from reasonable valuations which positions stocks as a reasonable long term hold – as they should usually be viewed.

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