Hold onto your TARP—We Smell a Boom

-J. Kevin Meaders, J.D, CFP®, ChFC, CLU

August, 2009 - With the recent rise in the stock markets, I wanted to give you an update as to what we're thinking and observing.

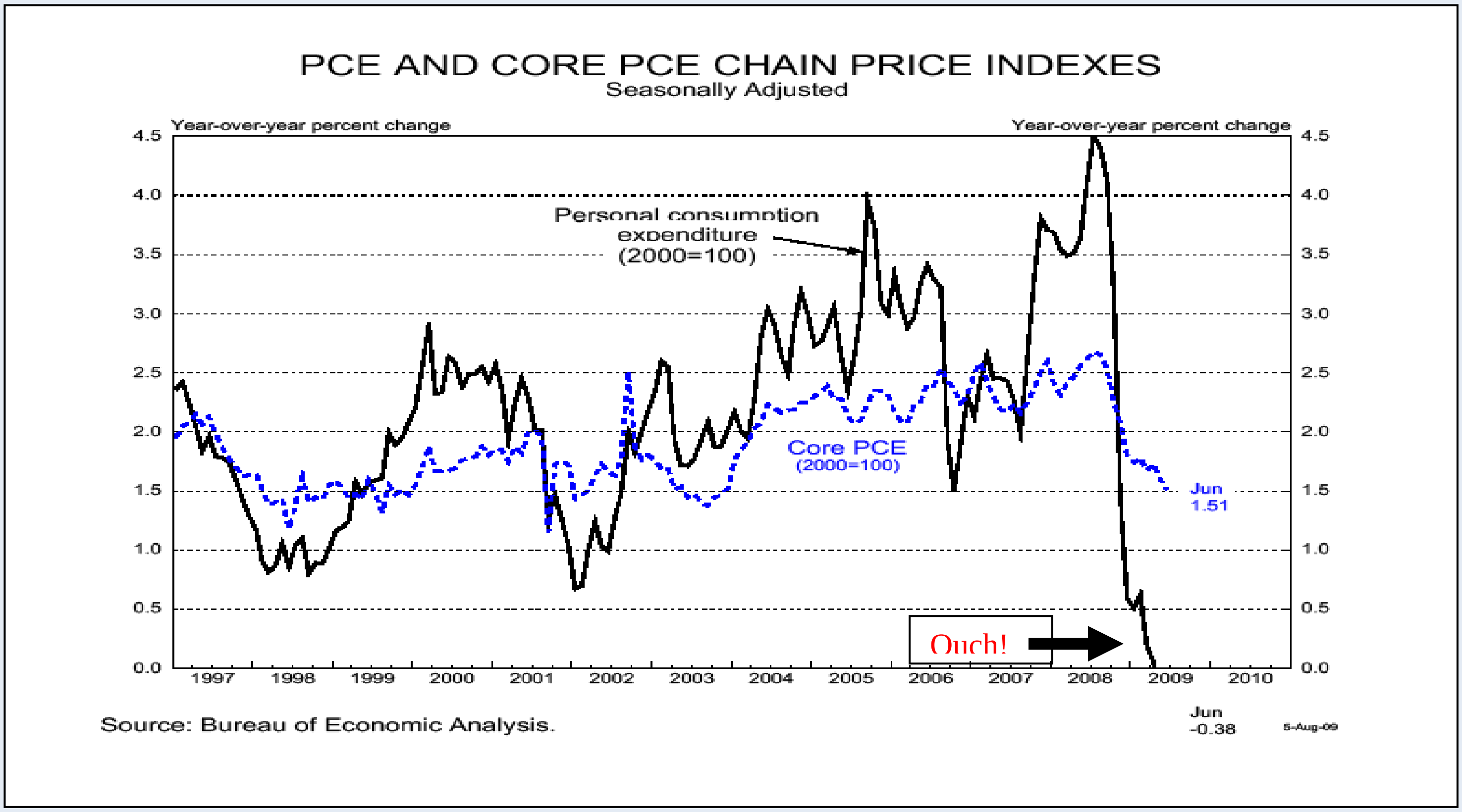
Certainly the economy has been in a better state, but we have seen worse as well. As you can see from the chart of the Dow Jones Industrial Average for the last 12 months, it would seem that we have experienced that "v" shaped bottom we had hoped for.

We expected the second bottom, and thus were waiting until earnings reports came out in July. As you are probably aware, earnings were overall mixed, but better than expected. Or more correctly, less bad than expected.

It is impossible to determine what portion of these earnings is real and what portion has been artificially inflated due to stimulus money. We know that TARP must factor in, but the degree is most uncertain, and indeed, practically unascertainable. To complicate matters more, corporate executives regularly push accounting rules to the limit (as we discovered to much chagrin in 2008), so it is hard to know what is actually "on the books" and what may loom elsewhere.

There are many other factors and indicators (with which I won't bore you here) that seem to confirm the hope that we're on the road to recovery, but not all. We still have three major concerns:

1. Personal consumption and hence corporate earnings.
2. Unemployment
3. Inflation (to come later)

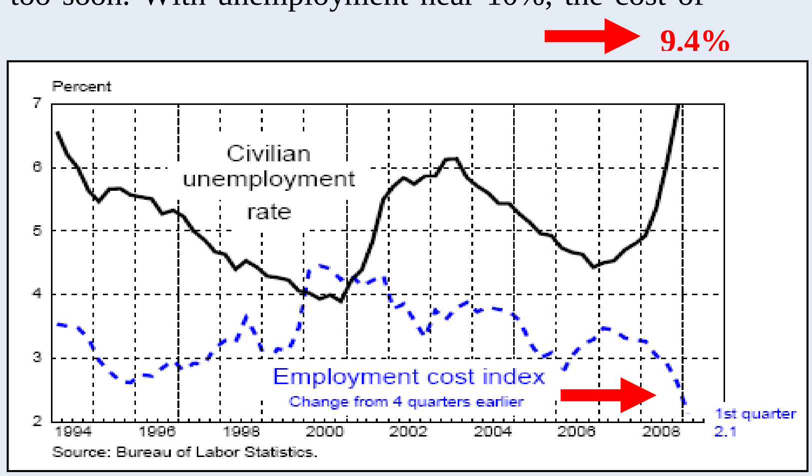


Over two-thirds of the domestic economy is driven by personal consumption.[1] When you look at the chart above, it should be obvious why we are concerned. You can think of the black line as consumer demand. When demand drops

and supply remains static, then prices will naturally fall. People consume less, companies earn less, their stock price falls—less profitable companies are less desirable to own. Thus, these companies either cut costs or file for bankruptcy. Either way, people lose their jobs.

It is common knowledge that the federal government has been dumping vast quantities of cash into the economy, though no one seems to be certain how much is "in play" or how much is "on deck." That is to say, there is no way of knowing how much of the recent (and hopefully continued) economic recovery is due to action by the government, and how much is normal economic behavior.

In any event, all agree that an imminent major challenge (after the current one and perhaps one other to come) will be inflation—but not too soon. With unemployment near 10%, the cost of labor has obviously dropped likewise.



The solid black line on the chart to the right indicates civilian unemployment. The broken blue line is an index of the cost of labor.

Unemployment is off the chart and the cost of labor is currently at a relative low. These are very strong deflationary indicators—but they are lagging indicators.

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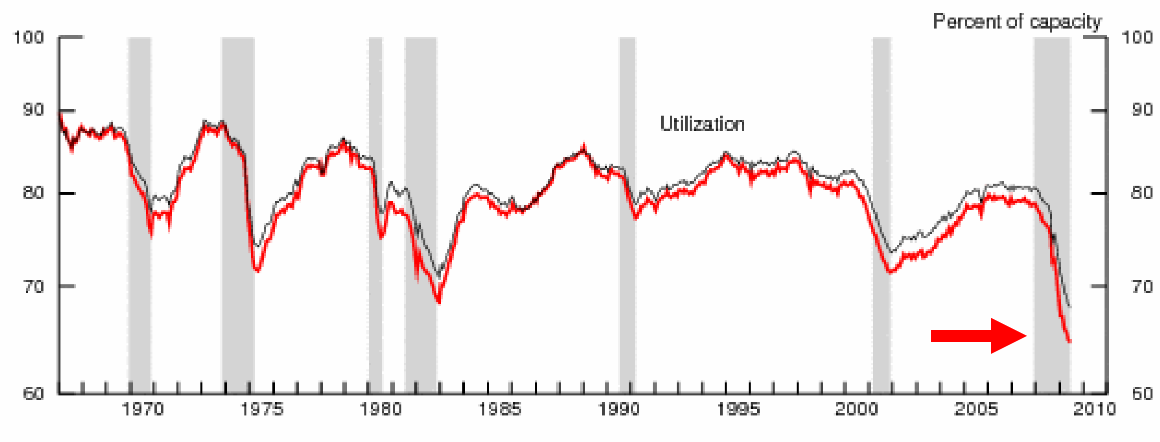
[1] *Economy Shrinks Modestly, But Consumption Falls*. Reuters, Friday, 31 Jul 2009

Another indicator that the Fed looks at closely when determining Fed policy is factory capacity utilization; i.e., the percentage of production at which factories are running based on a 100% capacity. The chart below shows capacity cranking down from 90% in 1967 to almost 80% by 2008. You can see that we are now around 65% of capacity today. With indicators like these, we remain confident that the Fed will not be raising rates anytime soon. Despite the extra trillions that are out there, inflation for now is simply not the concern. But it will be… oh yes, it will be….



Notes: The shaded areas are periods of business recession as defined by the National Bureau of Economic Research (NBER). The last shaded area begins with the peak as defined by the NBER and ends at the trough of a 3 month moving average of manufacturing IP.

All in all, the charts above do not paint a pretty picture; but then again what did you expect from the worst financial crisis since the Great Depression? I must say we are in completely uncharted territory here, and myriad professional sources contradict each other more than they build consensus. Nonetheless, there are a few things we know (or strongly believe) to be true:

1. Americans are addicted to shopping and spending, and will do so when they feel more comfortable.

2. When it comes to investing, Americans are lazy (they don't do in-depth research) and generally have a short term memory.

3. Sure, a lot of people are out of work. But before we started this crisis, unemployment was at 4.5%, so our net increase has been only 5 to 5½ per cent—a far cry from Great Depression numbers.

4. Unemployment is a lagging indicator and companies tend to lay-off too many employees, initiating a rehiring trend soon thereafter.

5. The earth's population is not decreasing, but increasing.

6. After every recession, there has been a significant bull market rally (see chart above—shaded areas indicate recession).

7. The Fed will not be raising rates for 6 – 8 months, perhaps longer.

8. The average level of the S&P 500 for the last ten years has been higher than current levels, and will certainly, eventually, normalize. (See chart below).

Taking in all these factors, we can feel relatively certain that time will bring us back to our pre-2008 levels, perhaps much quicker than you might think.

However, we also believe that volatility can be expected in the interim, and may even pull the market lower than where it is today.

Corporate bonds, which have recovered almost as much as we had hoped and predicted, will begin to fall out of favor when the Fed begins raising rates.

Interim volatility aside, the next eight to twelve month outlook is, as amazing as it may sound, bullish. Having sounded warnings and consistently reporting negative news and economic forecasts since fall of 2006, it is very refreshing to announce that we will be looking for an entry point back into the equity markets to a limited degree.

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About J. Kevin Meaders

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through ING Financial Partners (member SIPC).

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