September 2009 Market Commentary

Progress in the economy is becoming a more constant and expected theme. For investors, this is obviously a very welcome change, and has translated into strong gains with most global markets continuing their upward trend (China being the major exception). All the positive news has helped fuel world stocks to a 10-month high as July closes. After the past two years, it's nice to be able to choose from many different sources of good news.

Housing's continued improvement is probably the most obvious on-going development. Sales of previously owned U.S. homes jumped 7.2% in July to mark their fastest sales pace in nearly two years. New home sales were also way up, increasing 9.6% in July. Both categories enjoyed a fourth straight monthly gain, and July's existing home sales increase was also the largest monthly gain since the series started in 1999. The NAR also noted that the last time sales rose for four consecutive months was in June 2004.

Personal incomes probably rose 0.2% in July as well, following a 1.3% decline in June according to economists. Linked to the spending increase, the Conference Board's consumer confidence index rebounded from 47.4 in July to 54.1 in August.

The End of the Recession is likely here. GDP this quarter could grow as much as 3%, though some are predicting a slowdown to around 2% in either fourth quarter of this year or first quarter of 2010.

Companies are finally outperforming the pessimistic expectations embedded in their market valuation. At the start of the second quarter, the consensus estimate was that S&P 500 earnings would be down 35% from a year ago. With 50% of the S&P 500 reporting second quarter numbers, the collective EPS change has been just -24.8%, much better than expected, according to Bloomberg as of July 29. Of course, earnings improvements are largely the result of cost-cutting rather than growth and you can't cut costs forever.

The rate of U.S. credit card defaults showed signs of stabilizing in July which seems to signal that U.S. consumers are in better financial shape than feared by many despite job losses and the housing slump. Bank of America Corp reported credit card defaults dropped in July after several months of a steep deterioration, and JPMorgan, Citigroup, and Discover Financial Services all reported that bad-loan levels fell in July.

In other parts of the world, late July data showed a bigger-than-expected rebound in euro zone industrial new orders which further buoyed market sentiment. **Japan's economy** returned to growth in the second quarter, pulling out of its longest recession since World War II. The growth was mostly in line with forecasts and added to evidence that Japan was clawing back after being the hardest hit among the major economies due to its reliance on exports.

No interest rate increases are expected until late next year at the earliest despite the recovery. If the recovery is tepid and unemployment remains high, the Federal Reserve could even wait until 2011. And, any eventual rate increase will likely be small as the Fed is likely to remain extremely cautious.

The declining popularity of the current government initiatives, namely Cap & Trade and Universal Healthcare Reform, is also being credited with helping July's market performance. There's a growing belief that many of the programs viewed by economists, business leaders, and small business as hostile to economic recovery and growth may not be implemented, or at least will be scaled down.

There are also a couple major issues that could be either bad or good depending on your perspective.

US companies are sitting on record levels of cash as of late August, which signals caution regarding the economy's and Washington's future. While increasing cash levels appear to add to evidence of a further improving economy, corporate America's unwillingness to spend doesn't help a recovery. Companies have yet to show any major signs of rehiring or spending. Adding to consumers' hoarding cash at near record levels, companies' unwillingness to spend may further slow a recovery. Earnings growth and spending could surge once consumers and businesses gain confidence in the economy. However, to date, companies continue to remain very cautious.

Very low and worsening sentiment of small business owners is possibly the most troubling major indicator that refuses to improve. Small business proprietors have become more pessimistic as their worries grow about whether business conditions will improve in the next six months according to the non-profit, non-partisan National Federation of Independent Business (NFIB).

Small businesses produce half the private GDP, employ the bulk of the private sector work force and generate most of the new jobs created in the U.S. Given their importance to the economy, small businesses' lack of confidence could signal more problems ahead. According to NFIB, small businesses face a plethora of proposed taxes: unemployment, gas, cap and trade, and health care to name a few. Given that small business creates most of the new jobs in the U.S., pessimism in this major area bodes poorly for a quick or near-term employment recovery. This, in turn, could pose a drag on the economy.

A couple Observations: As summer draws to a close, we're continuing to see more and more positive signs in spite of some lingering problems. And, with policies believed by many to be hostile to the U.S. economy facing increasing resistance, optimism is growing that changes may not be as draconian or punitive for business as feared. This in turn, should translate into greater future profitability and higher equity markets. Of course, current optimism has been incorporated into stock prices resulting in equity prices that are likely much closer to reasonable levels given challenges still facing the economy.

However, in order to see continued economic and market gains, confidence in the economy and resulting growth will need to return. Opinions on the timing and strength of the eventual return to strong growth vary tremendously ranging from very near term to much more pessimistic predictions of many years.

While I don't claim to have an answer, I believe the future path lies more in the middle of general forecasts as is usually the case. Fears of a complete economic meltdown and a total breakdown of the capitalist system were largely overblown. Similarly, concerns that the government was going to ruin a capitalist system built up over hundreds of years in just a few months also seem very pessimistic – although this has yet to be decided.

I believe it's more likely that corporate profits will eventually improve as adjustments continue. Credit markets will continue to heal. Clarity regarding policy issues will eventually come from Washington which in turn will provide business and individuals the information they need to make spending and investing decisions. And, innovation will continue with the U.S. leading in this field – at least for the immediate future. While no path is certain, it appears we've moved past the Great Panic and are slowly returning to more normal conditions.

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