# December 2009 Market Commentary

**As the economy slowly creeps back toward more solid footing**, it appears more likely that we've entered a period of extended recovery that is unlikely to be derailed. Adding to the encouragement is growing confidence that we will not suffer a double dip recession, but rather continue to move forward albeit at possibly a more tepid pace than past recoveries. Inevitably, there will be continued reports of bad news with an on-going focus on key current issues such as unemployment. However, if we look past the current near-term issues, there is ample evidence for continued optimism with regard to the economy, corporate profits, and ultimately, future stock prices.

**Corporate profits and stock prices** are very closely linked and this likely represents good news for the future of stocks. Since World War II, corporate profits have increased by 63 fold while stock prices have risen 71 fold. The well documented correlation between corporate profits and stock prices is the primary reason that the market watches and reacts so sharply to increases and decreases in corporate profits. In fact, many – including myself – believe that the market often overreacts to corporate profits in the short term.

**The link between long term profits and investor benefit** provide significant reason for optimism for a several reasons, but there are two that I believe are particularly interesting at this time.

**First, corporate profits will likely rise substantially** over the course of the next few years – even if the economy is very slow to recover. Firms have been adjusting to a new environment, and profitability increases will follow. While various news outlets decry job losses and inventory reductions, companies take these steps to improve the bottom line. In addition, in recent months, we've also seen tremendous productivity gains which also positively contribute to corporate profits.

An obvious immediate example is Wall Street's rapid return to profitability. While many individuals may resent this sector's return to profitability given the damage that its collapse and ensuing bailout caused the economy, the good news is that the financial sector's recovery has nearly always been a precursor of the rest of the economy's recovery. The sooner Wall Street begins excelling, the better for the rest of the country.

**The second positive correlation** resulting from the link between corporate profits and the stock market results from a presently very steep yield curve. Don't let the term confuse you as it's very simply a graphical depiction of the relationship of different yield rates for bonds of different durations. (As a simple example, a 3 month CD pays a different amount than a 5 year CD. The graph of this relationship is a yield curve.) When short term rates are low and long term rates are high – like they are now – the yield curve is said to be steep.

Historically, a steep yield curve is exceedingly good for corporate profits because corporations can borrow very cheaply and use leverage to increase profitability. In the summer of 2003, the 3 month Treasury Bill rate was 340 bps (3.40%) below the 10 year Treasury Note. This was a post Depression record. In the ensuing three years, corporate profits skyrocketed and the market followed with tremendous gains. Unfortunately, during the past couple years, corporate profits have rapidly decreased resulting in a terribly performing stock market. However, the yield curve once again provides reason for optimism.

The current spread, or difference between the 3 month Treasury Bill and 10 year Treasury Note has been hovering around 350 bps (3.50%). This is an even greater spread than occurred in 2003, and now is the highest spread in 75 years. While this guarantees absolutely nothing, a high spread between short and long term borrowing has been an exceedingly positive indicator since the Great Depression indicating future corporate profit increases and thereby, the direction of the stock market.

While this is only one factor among many, it's a very important one which further supports claims that the market is likely to continue to move in the right direction during the next few years.

**Further good news** can be found in recent global trade figures. Both exports and imports have seen strong recent growth. Most analysts believe that the recent figures indicate that global trade is returning to normal. While the U.S. is still a large enough economy to lead a recovery on its own, evidence that a global recovery is underway further supports the belief that the economy will continue to heal itself and increase stability.

**Manufacturing** in parts of the United States is picking up steam as data for this November demonstrated and a major gauge of business optimism was at its highest in more than three years, an industry report showed. The Institute for Supply Management-Chicago business barometer grew faster than anticipated in November, rising to 56.1, which is above the 50 mark which divides expansion from contraction. This Monday's data "is all consistent with a gradual to moderate economic recovery," said Scott Brown, chief economist with Raymond James & Associates in St Petersburg, Florida.

**As always, there are still some disappointing factors and trends.** Unemployment will continue to be a problem for the immediate future. While the major media spends a lot time on this issue, this is a very predictable result of an economic slowdown. During nearly every recession, unemployment continues to increase even as the economy picks up again. This time has been no different. However, I believe predictions that unemployment will stay terminally high are also unrealistic. While it will likely be many months before we see a jobs recovery, there's no real reason to believe that this turnaround will be completely different from every other turnaround. Jobs will return, but it will take time. One complicating factor in this instance is the all the uncertainty that Washington is contributing to the system resulting in companies hoarding cash and slowing decisions.

**Banks now have more than 1 trillion** (yes, TRILLION) more dollars on their balance sheets than they are required to carry. This is 500 times the level of excess reserves that banks carried on their balance sheets before the credit crisis. This excess should be flowing back into the system, but isn't to date. Banks are uncertain on what and how they can lend given all the market and political instability they've recently gone through. Corporations are following the same pattern and have the highest levels of cash on the balance sheets since the mid 1950s. However, all this will pass – but it will take time.

**Other sectors such as commercial real estate** will likely continue to suffer in the near term. However, the rebound in financial markets is having a positive impact signaling that projections of future pain may not be as dire as suggested. In fact, if one reads through most articles on commercial real estate, the articles generally discuss what could happen rather than what has happened. As an example of investors who have benefitted from the recent market dislocation, purchasers of bankrupt US mall owner General Growth Properties (owners of Boston's Faneuil Hall Marketplace and Honolulu's Ala Moana Center) have reaped incredible profits as values have dramatically recovered. This recovery may be very indicative of future gains made by investors willing to risk their money to buy discounted assets.

**Overall, the economy continues to develop more momentum** and expectations for a slow steady recovery are growing. While we are certain to face continued difficulties on the path forward, we remain confident that the long term trend will be positive.

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