May 2010 Market Commentary

As the weather continues to warm up, the economy is doing the same. We're now in the midst of a full blown recovery, although it's still a somewhat tepid version. Across the globe, nearly every asset class is going up providing a very desirable, remarkably broad recovery of asset values. Whether it's stocks, high yield bonds, commodities, private equity, or even real estate, asset prices are heading up.

Obviously, this is largely due to a strong recovery in the business cycle. Various drivers are in place that continue to propel the economy forward. Consumers are feeling more comfortable and businesses are spending more. If we look primarily at US stocks, I like a particular model that essentially breaks down the analysis of drivers of stock values into more easily understandable categories. I'll also credit Bruce Johnstone, Managing Director at Fidelity Investments, with introducing this model to me several years ago. Looking at the three pillars of the stock market, they all look pretty good.

First, corporate profits are way up with a nice majority of firms outperforming expectations. Given the extremely strong correlation between corporate profits and stock prices, a rising stock market is not a surprise. Obviously, during a recovery in the business cycle, it's expected that corporate profits would be up, and this time is no exception. In addition, as of April 1, US businesses were sitting on a cash trove of $2.8 trillion excluding financial firms with 15.7% of their total financial assets held in very liquid investments. With the exception of a brief span after the corporate governance scandals of the mid-2000s, it's the highest cash share in 23 years, and the highest ever if financial companies are included in the tally. All this cash should help power the economy forward as the recovery gains momentum.

Second, inflation and interest rates continue to remain very low. Capital for larger corporations remains very inexpensive. In addition, the yield curve (simply the graphical display of interest rate levels over time) remains very steep with extraordinarily low short term rates. Historically, steep yield curves are great for corporate profits and thereby stocks. In addition, liquidity for most publicly traded companies is ample, even if it's still fairly restricted for small and medium companies. Most likely, this situation will stay the same or improve over the next year.

Third, valuations are still reasonable. While stocks are not cheap, valuations haven't raced ahead. Stock prices versus profitability are very near historical norms. The combination of rising profits, easy access to capital and reasonable valuations likely mean the next year should be pretty good for the markets. Of course, anything can and will happen, but a standard analysis seems to signal that we're heading in the right direction for the immediate future.

Most of the above analysis provides the good news. Unfortunately, there are many issues which are likely to be a drag on the economy. Some of these also have the potential to create much longer term challenges. Housing will take a while to recover, Europe is struggling with sovereign debt issues (Greece was just "resolved", but more could follow), fiscal stimulus will diminish over the next year, interest rates will move up off the floor at some point, health care costs will rise with the new health plan, consumer wealth is still woefully damaged, bank capital is tight for most medium and small business, consumers are over-leveraged, and there's obviously much more.

Longer term, there's really two major issues, consumer health and vastly expanded government. First, the consumer. Given that around 70% of the US economy is driven by consumer spending, weakness in consumer spending creates very real problems. And the US consumer is going to be hurting for a while. This issue goes well beyond current unemployment. The average US citizen has too much debt and not enough equity. For instance, 25 years ago, the average homeowner with a mortgage enjoyed an equity holding in his or her house of 50%, obviously owing the bank the other 50%. At the end of 2009, this number had dropped to below 0%. Savings rates almost certainly will be forced to increase which in turn will decrease spending.

However, as dire as this sounds, other dynamics could offset this issue. For instance, in recent years, emerging markets have exploded and nearly half of the world's population has become consumers over the last 20 years. Currently, over half of the revenue of the 30 companies that comprise the Dow Jones Industrial Average is generated overseas, and the percentage is growing. The possible impact of these countries is hard to predict, but it's clear that their economies are continuing to expand rapidly. In the first quarter of 2010, China's economy expanded 11.9% from a year earlier and Singapore grew 32% in the first quarter on a seasonally adjusted annual basis. By contrast, economists were pleased with US growth in the first quarter of 3.2%. How the continued growth of these economies and their consumer base may help or hurt the US has yet to be determined, but there's strong sentiment that their growth provides substantial opportunities for our industries.

The other major issue is government. Government spending as a percentage of GDP is now higher than at any time in US history other than the war years of 1944 and 1945. This is before taking into account the government's recent takeover of healthcare or the new financial regulations put in place that give the government unprecedented control of our financial services industry. (While most financial professionals would agree that the financial services industry regulations desperately needed an overhaul since they were largely created in the 1930s, no one likes the current proposal which is more a punishment than a reform. It may play well on TV, but it's very poor legislation.) These trends are not encouraging.

However, the current trends in government spending and regulation are likely just bubbles like the stock market, debt market and commodity market bubbles of the previous decade. As with most bubbles, I believe the best question to ask is when will it pop, rather than if it will pop.

When that happens, we're likely to experience some very unexpected changes. It could be very positive for the economy like the economic changes instituted in the early to mid-1980s, or it could be much more destructive. Regardless, while many look at the hole we are digging ourselves and proclaim that the US is done for, I'm more optimistic that we'll see positive change over the medium and longer term. The US has shown a tremendous ability to adjust – quickly – to perceived problems. I believe this will happen again before the doomsayers prophecies come true. Furthermore, betting against the US has proved to be a very bad idea in the past, and is likely to be unwise in the future. And, at least for the immediate future, a relatively strong business cycle will give us some time to make adjustments.

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