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MARKET COMMENTARY

Challenges Continue

As expected, gross domestic product expanded at only a 1.5 percent annual rate in the second-quarter according to the Commerce Department. First-quarter growth was revised up by a tenth of a percent to a 2.0 percent pace putting average growth for the year at an annualized rate of only 1.75 percent. Growth for the year will probably continue at about a 2 percent rate. The level seems right on track for this anemic recovery.

Europe is making progress in resolving its major sovereign debt challenges, although struggling or shrinking economies across the continent continue to drag down global growth. Many of countries have slid into recession, and those that are growing are posting low numbers.

China's economy isn't helping. While their growth should still hit 8.2 percent this year, this remains well below prerecession double-digit gains. Their growth will likely be the slowest since the global financial meltdown of 2008. Since this level remains well above the 6 percent forecast some feared earlier this year, China's slowdown shouldn't have a major negative impact. But China's growth will not be high enough to propel the U.S. forward or significantly lessen Europe's negative influence.

In the U.S., Washington's troubles continue to plague the economy. Various fiscal challenges ranging from federal borrowing limits, automatic federal spending cuts, and uncertain tax rates continue to present businesses and consumers with incredible uncertainty. All of these challenges add to the uncertainty introduced by countless half-implemented regulatory changes that may or may not actually reach implementation.

Uncertainty Crisis

Nearly everyone with resources, whether consumers, small businesses, or large corporations will continue to hold back and delay unnecessary purchases. As a business owner, I know our firm has followed the same path of delaying investment until absolutely necessary because of incredible uncertainty regarding new rules and regulations.

Slow growth and ongoing uncertainty continue to inflict yet more pain on U.S. job seekers. New hires in June reached just 80,000 which isn't even high enough to support population growth. The official jobless rate will remain at 8.2 percent, although the method of counting, which excludes job seekers in many categories, means that the true unemployment rate is likely nearly double this level. Slower hiring and ongoing high unemployment continues to affect consumer spending.

Slower growth has lead many economists to expect the U.S. central bank to launch a third round of bond purchases when policymakers meet September 12-13. This speculation drove the market sharply higher on July 26th. This would mark a third round of quantitative easing. Yet, the Fed may not act because many others argue that the slowing is not serious enough to warrant action. Investors counting on action could be disappointed.

Growing Confidence

All this sounds pretty dire, and yet the market has slowly been moving up, not down. If you have read my recent newsletters, this should not be a surprise. Although current news remains uninspiring, the market has already incorporated much of this news into current valuations driving them below historical norms. Investors seem to be slowly moving past crisis-mode and are looking more realistically at circumstances and likely longer-term trends.

And there is good news out there, especially when looking at the longer term. Even if they're struggling now, European countries are finally taking real strides to work more closely together. A more unified banking system including central oversight by the European Central Bank takes affect by the end of the year. Progress also continues along multiple other areas including deposit insurance, plans for handling future bank failures, and global standards for capital requirements. Improvements should help Europe move forward, and greater unity and eventual increased strength of the continent is good for the U.S.

Current struggles with foreign earnings have lowered earnings growth projections to around 4 percent for this year, down from 8 percent last year. The recession in the euro zone combined with slowing global growth reaching only about 3 percent is contributing little to corporate earnings. Yet, corporate earnings have remained fairly strong (4 percent growth isn't bad), and next year's expected recovery should boost profits.

Possibly most encouraging, the housing market is really turning back up. Most indexes of house prices are rising, and home prices themselves are moving up in many markets. May sales exceeded April's by nearly 10 percent. The percentage of vacant homes also reached its lowest level since 2006. Inventories of existing homes for sale has fallen close to the normal level of six months worth of sales despite large inventories of foreclosed homes. Reduced inventory should prevent a future slump as has happened during past short-lived recoveries.

Inflation remains a non-concern. It's down 40% from February and sits well below the Federal Reserve's target. This could make another round of quantitative easing more likely, although political pressure on Bernanke to resist meddling pre-elections will make action difficult.

And, in spite of slow hiring, the number of job openings is up. New openings increased 17 percent, which likely points to increased hiring ahead. Since firms have waited so long to hire that many new openings differ significantly from eliminated jobs. It will take some time for the job market to adjust, but this indicator should signal a more permanent hiring upswing.

While many challenges obviously continue to trouble investors, the market's greater stability in the face of potential problems seems to signal that investors are increasingly confident that the economy will not implode. Investors appear less skittish, and almost seem to be expecting signs of optimism. The short-term will likely offer more fairly meaningless ups and downs with elections drawing closer, but I believe long-term fundamentals look attractive.

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