June 2010: Market Commentary

As we move into summer, the economy, stock market, assets values, and indicators can't seem to agree regarding the strength of economic growth. This seems to be the major theme of this recovery. First quarter GDP reports reached 1.8% while expectations were 2.2%. Personal Consumption declined to 2.2% from original projections of 2.8%. Personal Consumption Expenditures were revised down to 1.53% from 1.91%. Inventories increased to 1.19% from 0.93%. Yet the stock market remains fairly stable, most asset values keep increasing, and corporate profits maintain near record levels.

Originally, economists predicted that first quarter weaknesses were temporary and the U.S. recovery would quickly revert back to its slowly improving trend. Optimism appears to be lessening. Manufacturing, a leading area of economic strength, appears to be cooling. April's slight dip in the capacity use rate, a measure of factory utilization levels, followed 22 months of expansion. The housing market remains weak – more below –, and consumers refuse to jump back into the economy.

The softening of an already weak recovery is leading economists to reduce growth forecasts. No surprise there. Corporations are following a similar playbook announcing that they expect second quarter numbers to be lower than first quarter numbers. The usual GDP explosion following a downturn refuses to materialize. Instead, the uninspired recovery keeps trudging along in the face of unending government uncertainty.

The good news – we're moving forward. The bad news – picking up any real speed still appears unlikely.

First, the Good News: Corporate profits remain near record levels. Since corporate profits drive stock market values, solid profitability will likely keep stock prices reasonably steady. Even as areas of manufacturing slow a bit, many parts of corporate America are only beginning to get back on track. The U.S. auto industry is enjoying a renaissance and the banking sector continues to strengthen. Previous economic dislocations are still sorting themselves out.

The Federal Reserve also continues backing its commitment to drive up asset values. While their policy approach has been denigrated by many as shortsighted, it has produced results. The stock market has doubled over the past couple years and many parts of the economy are at peak performance.

Furthermore, the Fed's actions have been very bullish for any risk asset, and their commitment appears as strong as ever. While the probability of QE3 (quantitative easing, round 3) remains low, strong beliefs persist that we would see another injection of funds if the economy slows too much. The policy approach remains clear. Keep interest rates near zero so any asset providing nominal returns becomes more attractive. Approximately 15% of companies in the S&P500 (ex-financials) pay a dividend higher than the 10 year treasury rate. This ratio usually hovers around 4%.

Consumer health is also improving. Household debt service levels have declined to levels around the early 1980s. Personal savings rates have returned to early 1990s levels common before consumers started using their homes as piggy banks. Home affordability levels are much better than at any time in the past 40 years which is all the data I have.

Lastly, stock valuation levels remain fairly conservative. Whether using 12 month trailing price to earnings ratios or forward price to earnings ratios, both measures fall almost at historical averages. In spite of the run up in stock prices, there's little evidence of the market getting ahead of itself. Market increases have basically tracked profitability. In fact, many believe that market prices are actually discounted because of widespread uncertainty created by Washington.

Yet bad news refuses to fade. The flip side of the Fed's easy money policy is, well, too much money. Inflation concerns are growing. Some projections put gas at $5 per gallon by summer's end. Higher gas prices crimp the economy and will likely further depress poor consumer confidence levels. Some food prices have already ramped up. Corn prices, a key link in the food chain, tripled in the past year. In spite of the recent pullback in commodities, prices are climbing. A trip to the grocery store quickly confirms this trend.

Even salaries are heading up. Recent increases in charges for temporary workers likely signal future salary increases for permanent employees. The data point to an approximately 2% increase in the Employment Cost Index by the end of the year, which would be the biggest gain since the first quarter of 2009, according to BNA. The Labor Department data posted a 1.6% year-over-year gain according to the ECI, a broad measure of compensation. While salary increases help workers, they slow the economy.

In spite of labor cost increases, unemployment remains high. Three years after the bottom of recession, employment levels normally reach pre-recession highs. Now, we're just coming off the bottom. This explains much of the consumer sentiment doldrums. The salary increases mentioned above are unlikely to alter these levels much.

And the housing market refuses to rebound. Sales of foreclosed homes remained astronomically high in first quarter comprising 28% of homes sold— a share nearly six times higher than what it would be in a healthy housing market. Unfortunately, the backlog of distressed properties likely means any housing recovery is a long way away as much more restrictive regulations and cautionary bank lending will likely weigh heavily on this market for the foreseeable future. Long term, it will force the U.S. away from leverage, but near term adjustments will slow growth.

The combined factors likely mean more of the same with the economy, corporations and consumers slowly moving forward while the Fed does whatever it takes to keep the train on track. The big wildcard is probably government – both here and abroad. European struggles with country crises will probably continue. The Middle East probably won't stabilize for years. Emerging markets will continue to emerge – a process that's always messy.

In the U.S., many, including me, would argue that the government is at the heart of our economic problems. Uncertainty regarding regulations, energy policy, taxes, national debt etc. creates a nearly impossible planning environment for small and big business. The government has made this recession much worse that it should have been. While all these issues will likely be with us for a while, the economy's direction creates some hope for better times. Current asset values appear to account for uncertainty. Good policy changes and improved clarity could create unexpected benefits. Regardless, for now we believe that the positives will continue to overpower the negatives like poured honey slowly overtakes a muffin. The progress may not be fast, but it continues barring major interruption.

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