JULY 2010: MARKET COMMENTARY

At the half way point of the year, corporate America continues to perform well, consumers are recovering but don't feel like it, and government incompetence continues to worsen economic problems on multiple levels. This messy combination creates numerous contradictory signals. Yet I believe there are various reasons why risk assets, such as stocks and other investments that reward risk, likely represent the best investment opportunity.

Corporate profits continue at record levels in spite of tepid economic growth. Corporations also hold record levels of cash and have greatly reduced their leverage. Maintaining financial flexibility is an obvious emphasis. New hiring and investment will likely remain cautious in the near future, or at least until both sentiment and confidence improve. Corporate America doesn't want to get burned again.

Consumer sentiment also refuses to budge from lows not seen since the early 1980s. Looking back 30 years, sentiment was terrible given the awful economy of the 70's and early 80's. Even the movie soundtracks of the time were depressing. So, similar sentiment levels really are bad. It's easy to understand why. Unemployment refuses to significantly improve and housing keeps heading south.

Normally, three years after the depths of a recession, employment levels bounce back to pre-recession levels. Now, we're barely off the lows and badly trail every other recovery post WWII. While official unemployment for college graduates is below 5 percent, the level is still roughly double pre-recession unemployment – not good. Everyone knows someone unemployed and even many employed workers are frustrated at their lack of options. If you've got less education, times are really tough.

In addition, housing refuses to recover hitting individual finances hard. Usually, stock market increases produce a desirable wealth effect which leads to greater spending as total asset values rise. During the stock market's doubling over the past couple of years, the wealth effect has been muted by housing struggles. This will likely continue until housing convincingly improves.

Yet consumers are getting healthier. Consumer debt service levels are nearing 1980 levels and housing affordability is the best in 40+ years, or ever by some accounts. Low interest rates help, but consumers have made notable progress in building a better financial base. Savings levels are also up. If consumer sentiment were to increase significantly, consumers have much more capacity to contribute to the economy. Both consumers and corporate America are building up significant dry powder.

So, what's the problem? Well, there are many, but two stand out. Recessions resulting from financial crises tend to be more severe. Deleveraging and confidence building take time. Yet, this recovery is exceptionally anemic by any standard. The addition of awful government policy seems to have put this recovery solidly in the slow lane.

Business and consumers face a toxic combination of unprecedented policy uncertainty and ill-conceived, burdensome regulation. Whether it's healthcare, tax policy, environmental rules, financial regulation, new legal precedents, government spending, brazen (and legally questionable) union promotion, government debt levels, potential government default, etc., etc., the rules of the game are uncertain and all moving in the wrong direction from an economic perspective.

Yet, given all these issues, forecasts aren't as dire as might be expected. A double dip recession remains extremely unlikely for numerous reasons. Manufacturing and retail sales have stabilized. Various chains are expanding again. Corporate America has adjusted to the hostile environment and profits should remain strong. Even as the economy has slowed again in the second quarter, stock analysts have increased profit estimates. Stocks have often been significantly undervalued during the two year rally because many investors confuse the news with the state of corporate finances. And expectations of Washington are so low, that any progress will likely buoy expectations.

On the international front, Greece's recent acceptance of austerity measures should keep the Euro zone progressing in spite of numerous problems. The vote also raised hopes that Europe will effectively deal with inevitable future challenges. Even the socialists are waking up to economic realities – eventually, you run out of other people's money.

The nearest major policy issue U.S. markets face is debt negotiations. The S&P ratings agency has warned of severe consequences if the U.S. defaults on its debt. Washington needs to adjust to a new reality. Global competition is much greater and the bureaucracy created during WWII is an economic drag. Other countries, particularly emerging markets, are growing increasingly competitive. Government spending at levels only seen previously at the height of wartime can't be sustained.

For these and other reasons, politics will likely be a major factor affecting future economic progress. During the next 18 months, we'll likely see more of the same. Corporations will cautiously invest and expand, unemployment will drop slowly and consumer sentiment should drift upward. A major domestic or international crisis could untrack the slow recovery, but probably won't because corporations and consumers have dramatically increased reserves.

Longer term, 2012 elections will have a major impact. If President Obama is re-elected, expect more of the same, but a likely stronger Republican presence in both houses will slow the regulatory tidal wave and reduce uncertainty. If a business friendly Republican is elected President, the economy could improve much faster.

Regardless, Washington will be forced to make major changes to address debt and growth challenges. They've tried borrowing, quantitative easing (2 times), bank nationalization, foreclosure moratoriums, TARP, Increasing spending, debt forgiveness, cutting taxes and more. Cutting spending is the obvious solution. It's always worked, and is the only long-term fix, but it's politically difficult – not a Washington strength. Most likely, the U.S. will try a combination of printing money, entitlement reform, and tax increases through broadening the tax base (i.e., removing tax exemptions). While entitlement reform will be tough, even AARP has acknowledged its necessity. It's a matter of when, not if.

From an investment perspective, the more important issue could be the printing press. For numerous reasons, the government will likely devalue the currency. Assuming this happens, maintaining purchasing power will be critical to investors. Risk based assets tend to perform well during inflationary periods and remain the only real option for maintaining purchasing power. Real, tangible assets in particular perform well. Bonds offer little upside and provide downside protection only as long as interest rates remain low – probably another two years. Regardless of Washington's actions, investors will likely be forced to hold significant levels of performance based assets during a very uncomfortable economic climate. Diversification across different asset classes is wise and could help investors achieve greater performance for a given level of risk.

More simply, Armageddon seems unlikely, but so does Nirvana. Don't bet against America, but she's a wounded champion right now saddled with a heavy load. It's going to take a while to unshackle her and nurse her back to health. But progress remains likely even if slow. At least the nation seems to be acknowledging the need for major change. America will come back, but recovery will be unpredictable.

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