February 2011: Market Commentary

The year is starting out fairly positively with multiple signs of improved economic activity and growing confidence across many areas. Economists surveyed by the Wall Street Journal reveal increasingly optimistic opinions regarding growth in 2011 and continued economic recovery. In a January 14th article, the Wall Street Journal reported that their 56 Economists surveyed predicted annual growth better than 3.2%. In addition, because the expected drivers of growth are domestic demand and rising exports, belief is high that the trend will continue.

Their growing confidence in the future of the economy continues a clear trend. Economists and various pundits are steadily growing more confident in our strengthening economy. Fourth quarter growth came in at a solid 3.5 percent annual rate which was higher than original estimates of 2.6% and even later revisions of 3.3%. The higher rate comes after a reasonable 2.6 percent pace in the July to September period.

Consumers are showing similar enthusiasm. U.S. consumer confidence improved more than expected in January to 60.6, the highest level since May. The jump was a significant improvement from December's level of 53.3. Perhaps as noteworthy, the index came in well above economists' expectations of 54.3 and appears to result from an improving outlook for employment and manufacturing as well as a sense the economy is now on a firmer footing.

Even the housing market has reported some good news. According to the Commerce Department, new U.S. single-family home sales in December rose to their highest level in eight months, and prices were the highest since April 2008. U.S. home re-sales also jumped 12.3% in December which was more than expected. Although the rates of increase are very strong, the actual numbers of homes sold is still relatively weak. Much of the cautious optimism regarding the housing market stems from the nature of this recovery that is based on real numbers untainted by various government programs. The principal barrier to recovery remains the large number of potential foreclosures that could keep prices from strengthening throughout 2011 and possibly beyond. As a result, overall housing price appreciation is expected to trail inflation for the next three years as the jobs market continues to struggle.

Corporations continue to sit on large amounts of cash and levels are still at or near records. However, there's various evidence that companies are starting to put capital to work. Merger-and-acquisition (M&A) activity is on the rise. After plunging in 2008 and again in 2009, 2010 saw a nice rebound. For 2011, experts forecast a record number of M&A transactions. While M&A activity may seem a bit removed from many people's lives, it's a great indicator of corporate health and transactions generate numerous benefits including increased profitability.

The banking sector is also recovering. JPMorgan Chase & Co reported a fourth-quarter earnings jump of 47 percent compared to the year earlier quarter, helped by narrowing losses on bad loans. Notably, strong earnings were also a result of sales increases rather than simply cost cutting or fewer losses. The sector is growing. The positive results were seen as a benchmark for the sector as a whole and created expectations of more outperformance. While there's still potential overhang from the mortgage problems as noted above given the expected foreclosures, more evidence of solid progress is welcome.

In addition, JP Morgan's reduction in loan loss reserves and aggressive investment in new retail financial services strongly indicates that JPMorgan believes the economic recovery is strong and sustainable and it is time to start investing again.

Other indicators in different sectors also provide reason for optimism. Mid-Atlantic factory activity is holding up well and factory jobs are showing net increases. An index of leading manufacturing indicators also surpassed economists' forecasts.

Jobs numbers are starting to see progress. Jobs growth is becoming more predictable and increasing in strength with new jobs created absorbing new job market entries and chipping away at unemployment. Surprisingly, manufacturing jobs growth continues to lead the economy out of recession even though it's just 11% of the economy. Gains are showing up in production of various durables ranging from cars to machinery as well as non-durables such as food and energy. The unemployment numbers will remain high, especially as discouraged workers re-enter the job search and push numbers back up, but employment numbers appear well positioned to continue higher for the foreseeable future, and should really start to pick up in the second half of the year.

As the economy continues to mend, sometime in the future, we're also likely to see at least one negative side affect – inflation. Commodity prices for all kinds of goods are rising such as cotton, copper, silver and oil, among many others. Gasoline alone increased 8.5% in December.

However, core CPI (excluding food and energy) rose only 0.1%. Comparing December 2011 to December 2010, the Consumer Price Index only increased about 2%. The year before, the increase was only 1.5%. And, 2011 target inflation projections are also very subdued. There are two major reasons for this.

First, there's still ample excess capacity in the economy including both manpower and other resources. Given the high unemployment rate, workers are not seeing higher wages and salaries. It will probably be 2012 before GDP and job growth are both strong enough to cause upward wage pressure. Second, housing costs account for 42% of CPI. The still weak housing market is unlikely to create much upward pricing pressure in 2011.

Instead, inflation is likely to stay very tame throughout the year and possibly beyond. One key factor that could start inflation upward sooner is international growth in emerging markets. Their demand for commodities could continue to push prices up and create significant upward price pressure. However, for now, inflation isn't a problem, but warrants close monitoring.

As we move into 2011, the year appears to be starting off well, and the slow recovery continues to gain more momentum. Business and consumer confidence are up, and profitability remains high. International growth is also contributing to the increasing strength. While we're still unlikely to see a robust recovery that normally follows a recession, at least we seem to be finally entering a solid recovery period. This should translate into continued recovery for various asset prices including stocks. Valuations are still reasonable, so hopefully the next year will reward investors in the US and internationally. Volatility will inevitably accompany any progress, but prospects for continued advancement appear promising.

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