February 2010 Market Commentary

Economic improvement seems to be the continued theme. As usual, signs regarding the economy are mixed, but advancement, still slow and often albeit unpredictable, continues. Fourth quarter produced better than expected growth with GDP expansion averaging a 5.7% annualized rate. This was well in excess of expectations in spite of weak retail spending and uninspiring housing numbers. Other good news includes increases in manufacturing inventories and significant increases in various economic indicators ranging from services to manufacturing to consumer sentiment to investor confidence.

In addition, firms are no longer laying off large numbers of people. In fact, in November, the economy actually added 4,000 jobs. While December produced a drop of 85,000 bringing unemployment to 10.5%, this pattern of slowly and unpredictably adding jobs after a recession is normal. While continued job losses and slow hiring generate great sound bites and continue to feed the fear which maintains news ratings, it's normal. More positively, not only are job losses slowing, but temp hires are increasing which is precursor to employment rises.

Several other issues indicate that the economy is gaining strength. Expectations of "bull-whip" in certain sectors are growing. This occurs when companies start to ramp production back up after they have depleted inventories. The bull-whip occurs when firms not only must buy enough supplies and materials to meet current production, they also must increase purchasing to meet growing demand AND to replenish depleted inventories. The rapidly increased demand tends to send a jolt to the system because their suppliers have also cut back on production and inventories. This is the exact reverse of what we saw last year when all production stopped with little warning as companies rid themselves of as much inventory as possible. While the resulting rapid demand increase can be disruptive, the good news is that this is another sign of a recovery that is likely to continue.

The major conclusion from the combination of these and many other factors is that a double dip recession is growing increasingly unlikely. While the economy is recovering slowly and recreating lost jobs will take time, more and more signs suggest that we'll keep moving forward even if the pace is sluggish.

So, what does the future hold? The broad based recovery continues to be tepid largely because of two major factors. Probably the most obvious and widely reported factor is the severe financial crisis that precipitated this recession. In the past, recessions related to or caused by problems with the financial or credit system are the most severe and are normally followed by the slowest recoveries. In this recession, not only was the confidence of consumers badly shaken, but bankers and venture capitalists have also been forced to severely retrench. It will take years for various parts of the financial system to recover from the turmoil of the past couple of years. Access to credit and investment funds are the lifeblood of the economy. Decreased access will continue to slow recovery and growth.

In many cases, parts of the system will have to be rebuilt as various financing and funding mechanisms haven't simply declined, they were eliminated. In addition, consumers are going through a challenging financial retrenchment. The average American was overextended in debt and many people were using their rocketing home prices as an ATM. In addition, stubbornly high unemployment will also slow a recovery.

The second factor may be less obvious to some people, although those with strong political opinions will say otherwise. When Liberal Democrats won a major victory in the 2008 elections, they interpreted this as evidence that a large majority of Americans wanted major reforms in the economy, health-care and many other areas. So in addition to continuing and extending the Bush-initiated bailout, Congress and President Obama stridently announced their intentions to introduce major changes in policy, regulation, taxes, health-care, government spending and so on.

After the ill-conceived and horribly implemented "stimulus" package, virtually every move, discussion, idea or proposal from Washington over the past year has been hostile to business and the economy, and particularly to small businesses. And, unfortunately, given the ambitious nature of this new administration, the long list of government proposals has created tremendous uncertainty and introduced hard to quantify risk for businesses and investors. Unfortunately, when faced with a highly uncertain policy environment, the prudent course for business leaders, and investors is to stop or delay costly commitments that are hard to reverse. The result has been very predictable. Banks are reluctant to increase lending despite huge excess reserves. Businesses are reluctant to make new capital expenditures or expand work forces. Households are postponing major purchases.

As a result, businesses and corporate America have vastly reduced their risk profile. At the beginning of 2010, corporations had more cash on their balance sheets than they had since the early 1950s. Other evidence points to continued extreme caution by businesses and households. A regular survey by the National Federation of Independent Businesses (NFIB) shows that recent capital expenditures and near-term plans for new capital investments remain stuck at 35-year lows. The same survey reveals that only 7% of small businesses see the next few months as a good time to expand. Only 8% of small businesses report job openings, as compared to 14%-24% in 2008, and 19%-26% in 2007. All this sounds terrible and could be cause for pessimism.

However, I believe, there continues to be reason for optimism. While I agree with most economists and pundits who have been highlighting the many dangers of planned initiatives, I continue to believe that most predictions overestimate the damage that Washington will inflict on our economy. This is not because I believe that the current policies are not dangerous. Rather, I have great faith in America's ability to correct bad decisions, even if there is substantial cost involved.

The recent defeat by Republican Scott Brown of Democrat Martha Coakley by a margin of 52-47 percent in an overwhelmingly democratic state to win Ted Kennedy's (a Kennedy no less) vacant Senate seat is a great example of how quickly expectations change. If you were personally in favor of the Democratic agenda, you will view this defeat as a monumental lost opportunity. If you were part of the large majority of Americans who don't view the current trend toward vastly expanded government favorably, the shift will be welcome. Regardless, it's more likely that the many planned policies believed by nearly all economists as severely detrimental to the US economy will be curtailed or abandoned.

Obviously, none of us know the exact future. However, as I've said many times during the last year, I believe that much of the hype is vastly overblown. Admittedly, we have problems, some of them very severe. And, unfortunately, government has been a contributor to the problems rather than a provider of solutions. However, assuming that this will continue indefinitely is myopic. The economy is growing again. It appears likely to continue to grow, albeit slowly. The government has been adding to the problem, but correction in this area, much like the stock market a year ago, also appears to be on its way. It may take longer and unfold less cleanly – it is politics after all – but I believe the most realistic expectation is that we will continue to see movement away from the current destructive policies to less problematic plans to possibly even pro-growth policies in the longer term.

If you're invested in stocks, your time frame should be one that allows for at least one presidential term and hopefully, two or more. As expectations and policy initiatives become clearer, greater certainty is very likely to boost growth. I strongly believe the appearance of all of these is only a matter of time, and the events of this year have very possibly accelerated the timeframe. While nothing can be certain, momentum appears to be building in a more positive direction from an economic perspective.

Daniel Wildermuth and the Kalos Team
CEO/Money Manager