April 2010 Market Commentary

During the month of March, the Healthcare debate and passage has certainly received the greatest media attention of any recent event. I'll address this topic first as it's the 800 lb gorilla in the room.

Obviously, this contentious takeover by the government of approximately one sixth of the U.S. economy will have far reaching effects. I'll leave the social issues of healthcare for others to discuss and instead focus on areas that I understand. From an economic standpoint, countless unknowns still exist which make predicting the ultimate impact very difficult. However, in spite of the uncertainty, there are still some projections that can probably be made fairly safely.

The healthcare debate and controversy will likely be with us for quite a while – this is probably a gross understatement. In the short term, the effects will not fundamentally alter medical care or even much of the greater health system. However, companies will start seeing the impact much sooner than individuals as firms are forced to deal with various new and often ill-defined requirements. Unfortunately, the healthcare bill will further slow or delay corporate hiring as costs of compliance will be substantial.

Unfortunately, costs will be incurred well before any potential benefit. AT&T has already written down $1 billion due to healthcare with many other companies following suit. The consulting firm Towers Watson estimates that costs will reach nearly $14 billion this year for large company write-offs only. Government will also incur numerous new costs such as the IRS' estimation that they will need to hire 16,000 more agents to deal with added complications in tax filings.

Possibly most punitive – at least from a jobs perspective – is that the tax increases and penalties primarily target small and medium businesses. Small companies in particular will be forced to pay for the majority of the new programs. As one small business analyst said, the healthcare bill was really a tax bill in a healthcare wrapper. Additional taxes and penalties will further strain resources that could have been more productively applied. From an economic standpoint, in the opinion of nearly all economists (including myself), not only is the healthcare bill a horrible piece of legislation, the timing of the healthcare bill is dreadful.

All that said, the combination of the costs and changes **will not be enough to tip the economy back into recession.** Rather changes will "only" create a drag on current and future economic activity. Most likely, we're going to see more of what we've been seeing – a gradual economic recovery with moderate expansion and a painfully slow recovery in the jobs market.

Blue Chip Economic Indicators, which polls about 50 economic forecasters every month, reports that **not a single one of its respondents expects a second dip back into recession** for the economy in 2010 or 2011. The group believes various growth factors across the private sector are too strong to allow a reversion back into recession. This same consensus from Blue Chip Economic Indicators estimates annual growth running about 3% in 2010 while Barron's projects around 3.5% growth for the year.

Like many past recoveries, many of the expected factors that have contributed to strong recoveries after past downturns are in place. The S&P500 companies reported good fourth quarter results with 75% of companies beating earnings estimates and 10% meeting them. For the past three quarters productivity has grown at a torrid 7.3% annual pace. While increases of this size won't continue, they're expected to last longer than during past recoveries because many companies are still learning how to employ new equipment with newer technologies. After seven straight quarters of stagnant business investment, spending on equipment and software is finally picking up.

Even the jobs picture is getting some good news with more temp workers transitioning to permanent positions. More managers are also becoming convinced that business will improve resulting in an increase of hiring of good temp workers across various industries. Consumer confidence indicators rose in March while a closely watched housing index showed home prices rising in January for the eighth straight month although significant weaknesses remain.

Given all these positive factors, it's notable that **few economists expect a robust recovery.** While many factors are in place for robust growth, two key components are missing. First, small business is not participating in the recovery. The National Federation of Independent Business (NFIB) has been compiling their Index of Business Optimism since the mid 1980s. The Index measures their member's sentiment and plans regarding various business related variables.

The February 2010 reading is still stuck at 88 – a measure which is consistent with a recession, not expansion. Until this number rises above 100, widespread growth and a jobs recovery will remain very weak (in the U.S., net job growth comes from small companies, not large companies which tend to shed workers as they acquire organizations and increase efficiency).

Unfortunately, NFIB Chief Economist William Dunkelberg doesn't see the return of credit helping with the problem. Rather, he sees the problem as lack of demand for credit. He attributes much of the cause for weakness with small business on the "the Washington agenda, which remains a nightmare for small-business owners." Understandably, given his viewpoint, Dunkelberg projects recovery in 2010 to average less than 3%.

Another factor which makes a robust recovery unlikely is the lack of consumer confidence. Strong retail sales suggest that real consumer spending will increase at 3% or better in 2010. Consumers have begun to return partly due to increases in consumer confidence and partly because of a release of pent-up demand. As a recent example, on March 25th, Best Buy, the top U.S. electronics retailer, beat Wall Street's view for profit and sales in its holiday quarter and forecast stronger-than-expected earnings in the current year.

Unfortunately, the 3% increase, while good, contrasts with the 6.1% increase recorded in June 1983 at a similar point in the recovery. Increased consumer spending is good news, but the pace isn't. And, unlike past recoveries, other factors such as the weak housing prices and a very slow decline in unemployment are likely to slow spending recoveries.

Adding all these factors up, unlike past vibrant recoveries after deep recessions in the 1970s and 1980s, **an exceptionally strong recovery seems very unlikely.** Yet, at least tepid growth seems assured as we slowly move beyond the past recession. So, while a very strong recovery may be desirable for many reasons, it looks increasingly likely that we'll get a lukewarm and slow strengthening over time. While not great, it's also much better than reverting back to the painful panic of the recent downturn.

Daniel Wildermuth and the Kalos Team
CEO/Money Manager

Investment Advisory Services offered through Kalos Management, Inc., an SEC Registered Investment Adviser.
Parkside Terrace West, 3780 Mansell Road, Suite 150, Alpharetta, Georgia 30022
Phone: 678.356.1100, Toll Free: 866.525.6726, Facsimile: 678.356.1105, ClientServices@KalosFinancial.com