U.S. Market Report

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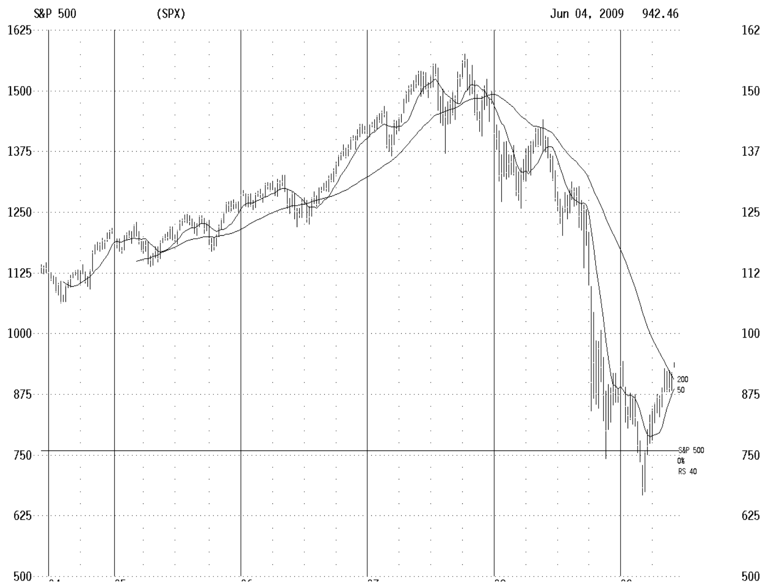


S&P 500 Price (5 Jun.'09): 942.46

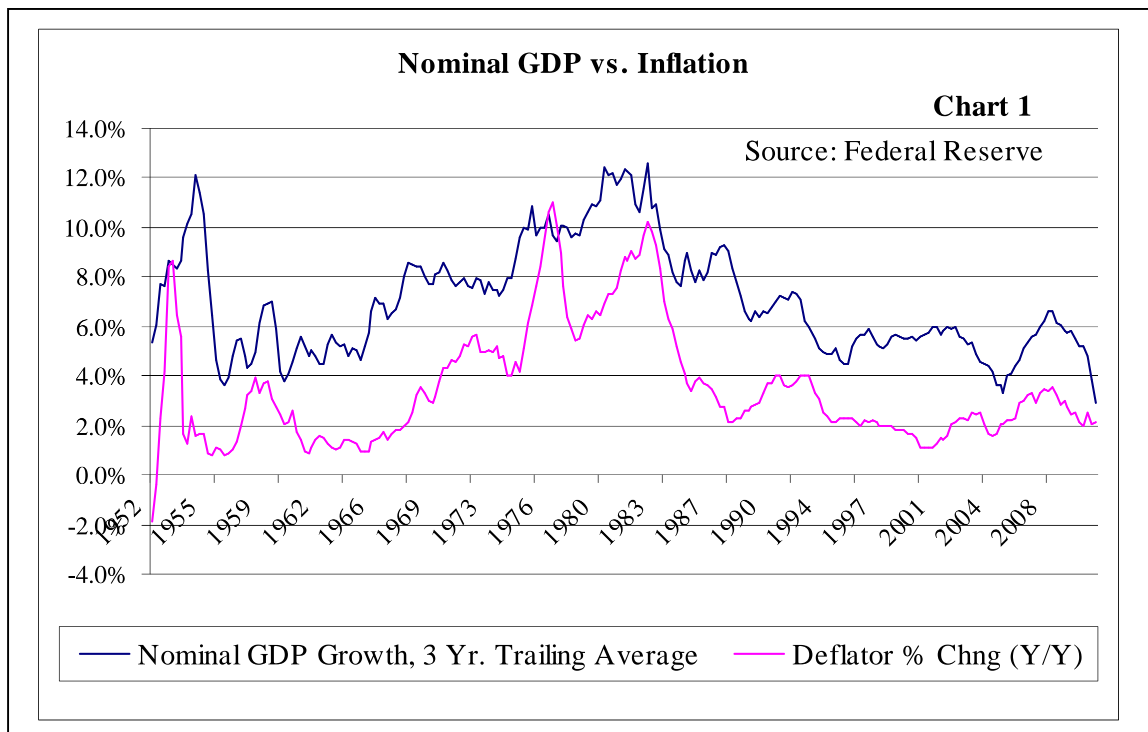
Dividend Yield: 2.9%

	2008	**2009e**	**2010e**
Operating Earnings	68.63	64.52	75.73
GAAP Earnings	14.88	44.21	60.82
Book Value	520.16	453.91	487.99
Price / Oper. Earnings	13.7	14.6	12.4
Price / GAAP Earnings	63.3	21.3	15.5
Price / Book Value	1.8	2.1	1.9

The US Economy & the Great Recession of 2008-2009

The recession is nearing its bottom. Real GDP fell at an annualized 5.7% in the 2009 first quarter, following a 6.3% decline in the fourth quarter of 2008. On a year-over-year basis, real GDP has contracted 2.5%, the worst performance since the third quarter of 1982 when GDP was down 2.7%. The severity of this recession reflects not only a sharp decline in business investment and inventories, which is common during recessions, but also because of a decline in consumer spending. The decrease in motor vehicle output alone reduced real GDP by 1.36 percentage points in the first quarter and 2.01 in the 2008 fourth quarter. With real estate and stock prices down sharply, Americans are feeling much poorer and have cut back their spending. Nonetheless, there is increasing evidence that conditions are at their worst and the Fed's accommodative monetary policy is beginning to work its way into the system. For example, disposable income and new orders for durable goods have started to turn upward. Real GDP growth is expected to be slightly negative for the 2009 second quarter—down at about a 0.5% annualized rate, but positive growth in the 1.0%-to-2.0% range is expected during the second half of the year.

Inflation is not an issue—for now. There has been a lot of talk about the risk of inflation because of the Fed's accommodative monetary policy. The Monetary Base, which consists mostly of bank reserves, has more than doubled, and the M2 money supply is up 8.5%, year-over-year. The growth in M2 has been due largely to investor preference for safe, government insured bank deposits—and US treasuries--during the recent turmoil. Despite these figures, which are alarming to some, money has to be spent in order to be inflationary, and that has not been the case. Furthermore, a high level of spending has to be sustained for a considerable period in order for inflationary pressures to build. Take a look at Chart 1 below. The GDP Deflator is the broadest measure of inflation, and Nominal GDP growth is the broadest measure of current dollar spending. As shown in the chart, spending over a trailing three year period correlates very highly with the year-over-year change in inflation. When nominal spending rises, so does inflation. But notice: nominal spending has all but collapsed, down 5.8% in the 2008 fourth quarter and 3.1% in the 2009 first quarter. Even on a trailing three year basis, nominal spending has grown at an average rate of only 2.9%. People have hoarded money, not spent it. The Fed has merely been trying to accommodate the tremendous demand for safe, liquid assets. The 2.9% growth in nominal spending over the past three years is consistent with ZERO inflation, not hyperinflation. That said, it will be very important for the Federal Reserve to start to withdraw nearly all of the bank reserves it has created over the past nine months once spending resumes in the second half of 2009. If they don't do this, we can then start worrying about inflation coming down the road.

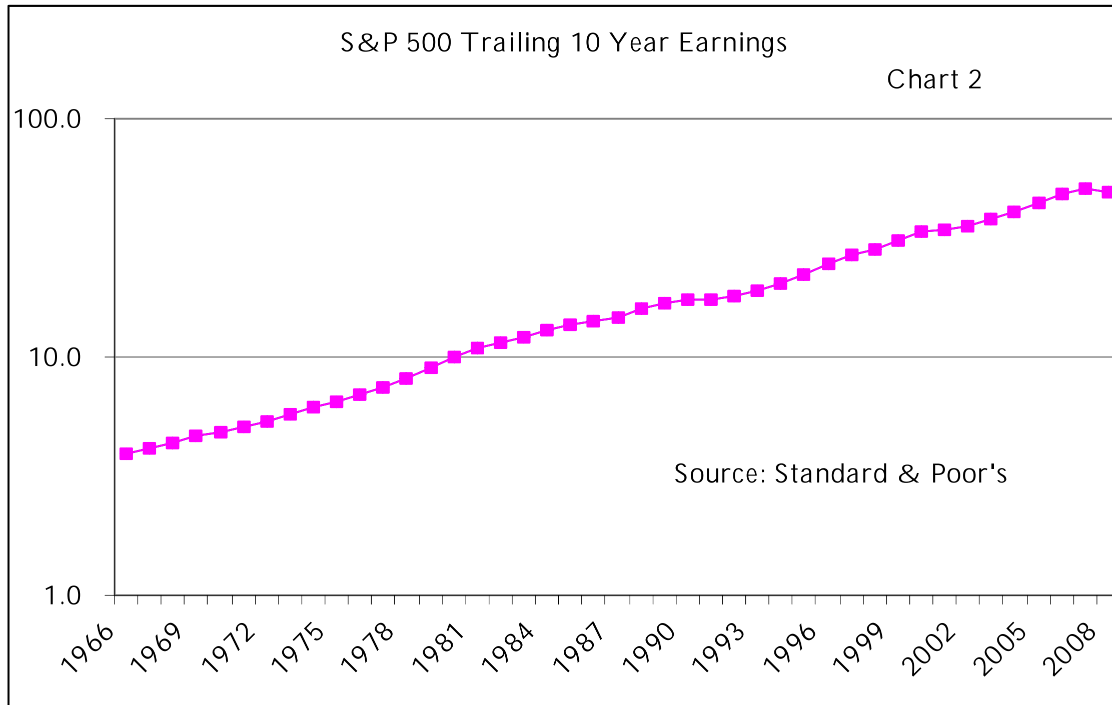


Interest rates are likely to be heading higher this year. Since about September 2008, the Fed has more than doubled bank reserves through its policy of low interest rates and "quantitative easing." As already discussed, fear played a part in this phenomenon since people have hoarded money by transferring funds out of stocks and other risky assets and into safe bank deposits which are counted in the M2 money supply. However, we have begun to see a reverse of that trend. Fear is gradually giving way and money is finding its way back into the stock market and other risky assets. Expect business and consumer spending to soon rise as well. As previously noted, the right thing for the Fed to do as spending rises is to increase interest rates and gradually withdraw bank reserves. Thanks to pressure from the Chinese, who hold a trillion dollars of US government securities, as well as pressure from the currency markets, we expect that the Fed will do the right thing and start raising interest rates later this year. A recent speech by Chancellor Merkel which was critical of the Fed and other central banks was an unexpected and very positive development. Public pressure like Merkel's will help insure that interest rates rise as spending rebounds. Not only are short term interest rates likely to rise later this year, but we expect long term bond yields to rise. We especially expect US treasury yields to rise as investors unwind the safety trade. Over the past few quarters a tremendous quantity of capital has poured into US treasuries because people wanted capital preservation even if it meant receiving very little interest income. That trend will reverse.

The balance sheet of the United States is worsening, but it is still much stronger than most other countries. At the time Obama became president, federal debt held by the public was at about 45% of GDP, which is well below the government debt levels of Germany, Japan and many other industrialized countries. The stimulus spending this year will push the budget deficit up to 13% of GDP and debt will rise similarly. However, budget deficits are expected to contract thereafter. Perhaps more importantly, the US population is still growing and it does not face a public pension debt bomb of the same magnitude as many other industrialized counties which will have declining populations. The US can grow out of the current fiscal problems.

Foreign exchange values are notoriously difficult to forecast, but we suspect that the dollar will begin to strengthen in the second half of 2009. As growth resumes in the US and interest rates start to rise, the dollar should benefit. European and Asian business cycles tend to lag behind the US and interest rate differentials are likely to widen as it will be some time before the ECB starts to raise rates. Also, the current global recession is partly due to the imbalances which occurred due to the US consumer being the global spender of last resort. This has come to an end. US real imports were down at a 34.1% annualized rate in the first quarter and the trade deficit has been sharply declining. It has become increasingly clear that US consumer spending is likely to revert back to its historical proportion of about 65% of GDP, versus spending at a rate of more than 70% of GDP during the period after 2001. It seems very likely that spending on housing and automobiles will remain subdued for an extended period. The coming US recovery will be lead more by business fixed investment and net exports, and much less on consumer spending. The US treasury secretary was recently in China encouraging the Chinese to rely more on domestic demand to stimulate growth. That's probably good advice for other exporting countries that have relied on the US consumer. The dollar's fundamental value is its purchasing power and on that basis it should be trading somewhere between $1.15-to-$1.20 to the Euro. It is possible that the f/x rate could approach that range by sometime next year.

Earnings for the S&P 500 will be up this year because of the huge write-offs in 2008, but will still be far below the recent peak. We prefer to use Generally Accepted Accounting Principals (GAAP) earnings because they are conservative and include the special charges many analysts take-out to arrive at "operating earnings." For the S&P 500, net earnings were a mere 14.88 last year, largely because of the huge write-downs in the financial sector. This compares to the cyclical peak of 81.51 in 2006. Earnings this year are forecast to come back up a bit to 44.97. However, it is important to realize that earnings, while highly cyclical, tend to move in a fairly straight (logarithmic) line upward over long periods that include entire business cycles. Therefore, in order to model the S&P 500, we use a trailing 10 year average of actual earnings (see Chart 2). In this way we can smooth out the "noise" of the earnings cycles and derive a "normalized" earnings level. Also, this method is conservative as it does not rely on estimates, only actual earnings. On this basis, normalized earnings for 2009 are 72.00.



Stock prices have run up sharply over the past few months and a minor pull back is possible, but we suspect that the overall trend will remain upward. The S&P 500 has risen nearly 40% since the low in early March 2009 and is looking overbought according to a number of technical indicators. Therefore, it is entirely possible that there could be some correction in prices before an upward trend resumes. However, we would not count on a major pull back in order to put cash into stocks. It has been reported that the value of cash mutual funds now exceed the value of equity mutual funds. Three years ago the value of stock mutual funds was several times the value of money market funds. In other words, there is a lot of cash on the sidelines that could flow into stocks if fear continues to wane. Furthermore, the S&P 500 index is still about 30% undervalued based on our fair value model which incorporates the 72.00 earnings level described in the previous paragraph, and also takes account of inflation expectations, which is the primary driver of normalized P/E ratios for the index. Stocks are still cheap, especially compared to the meager returns available for most fixed income securities. Investors who have a tolerance for volatility and a long term time horizon should have stock exposure. We suspect that in three or five years equity investors will look back with a smile about the equity investments they made during the Great Recession and Great Market Decline of 2008-2009.

Banks stocks have rallied sharply since the lows of March, but we remain underweighted the financial sector. The Fed's easy monetary policy is certainly giving the banks an opportunity to repair their balance sheets internally by keeping the yield curve, and bank net interest margins, reasonably positive. However, the risk appears high that there will be an elevated level of loan losses during the next year even if there is an economic recovery. The government's so-called stress tests comforted many investors but we are skeptical. Dilution to common shareholders is likely as banks raise capital and some preferred and fixed income securities are converted into common equity. Also, as we've already mentioned, interest rates are likely to be heading higher in the year ahead. Repair of the bank balance sheets may be slowed if the Fed has to quickly start increasing short term interest rates.

The consumer discretion sector has also strongly outperformed the market since the March lows, but we remain underweighted there as well. Our thesis is that US consumer spending is now in secular decline. Consumer spending rose to more than 70% of GDP this decade as people pulled equity out of their homes to purchase cars and other big ticket items. With the housing implosion, consumer borrowing is in decline and unlike to recover anytime soon. We remain doubtful that the housing or auto industries will make a lasting turnaround. More than likely, these businesses will be laggards during the recovery.

The technology, energy, materials and industrial sectors have good prospects for future growth. These groups should benefit from higher prices and positive operating leverage as the economy rebounds. Also, the current weak dollar should help these businesses with their exports, as well as ease domestic competitive pressures from foreign firms. The U.S. trade deficit could worsen over the next couple quarters as the U.S. economy starts to pull out of the recession ahead of Europe and Japan. Nonetheless, the longer term trend is likely to be to the relative advantage of US exporters. Since neither real estate prices nor consumer spending is expected to rebound to previous levels anytime in the foreseeable future, growth in consumption is likely to remain modest. Businesses dependent on domestic consumption are likely to be at a disadvantage to those that can take advantage of the strong growth in Asia that is likely to continue.

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