FVCM

U.S. Market Report

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REVIEW & OUTLOOK

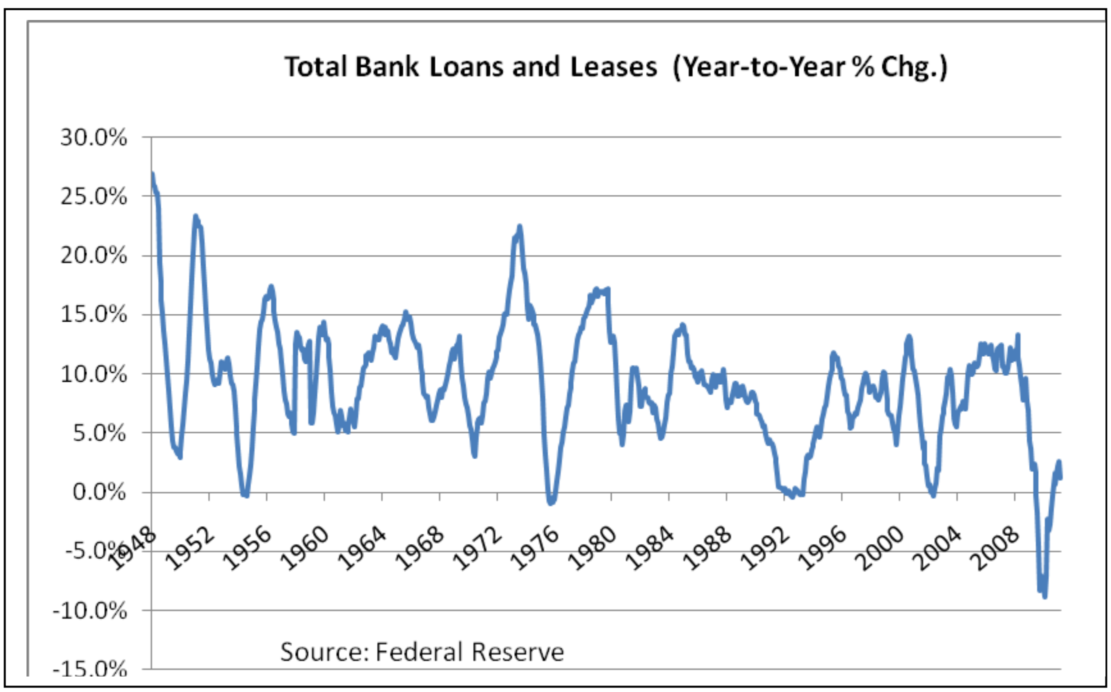
The U.S. economy and corporate profitability continues to emerge from the deepest recession of the past 50 years. Many headwinds remain, but the economy appears to have achieved the point of a “self-sustaining” expansion. The U.S. consumer continues to deleverage and the housing market will likely remain flat for years to come, but jobs growth has begun to accelerate and spending growth is expected as a result of new employment and income, not borrowing. Also, U.S. businesses are generating high and rising cash flows and corporate balance sheets are strong. With confidence gradually beginning to pick up, we are seeing rising demand for capital goods. Furthermore, exports are reaching record levels, thanks in part to the weak dollar, and manufacturing production is rising. The world remains unpredictable and events in Africa and Asia have proven that volatility is the rule, not the exception. But, investors capable of withstanding volatility and risk are likely to be well rewarded in the years ahead.

BUSINESS AND ECONOMICS

Below we make some general comments about the major subjects affecting the general economy and the prospects for growth in production and profitability. Many people are now very cautiously revising their emotions from extremely negative to only modestly gloomy. But there is still a long way to go before the economy fully rebounds from the Great Recession. We believe there is still a lot of time ahead before emotions are back to elation and euphoria (at which point we'll be worried).

Inflation

Consumer price inflation has recently surged to over 2% thanks to rising fuel and food prices, but we expect those price pressures to unwind. The Fed's QE2 program has been a fuel that has enticed speculators, both professionals running hedge funds and retail investors, to pile into commodities because of the belief that inflation is on the way. In a sense, the speculators ability to drive commodity prices upward has led to a self fulfilling prophecy. However, we do not believe the fundamentals are in place for a sustained upward run in inflation. Bank lending collapsed during the financial crisis in 2008 and is now only slightly positive on a year-to-year basis (see chart below). The Fed, with QE2, has essentially been the lender of last resort because the commercial banks are not lending. And while the Fed's balance sheet has expanded sharply, the larger M2 money supply is up a fairly modest 4.6% year-over-year. Furthermore, because businesses and individuals have continued to hoard money, nominal spending is up only 3.9% on a year-to-year basis. There simply cannot be significant inflationary pressure without aggregate spending growth well above current levels. We suspect that consumer price inflation is likely to recede below a 2% rate in the months ahead.



Commodities

Growth in world consumption of basic commodities is almost certainly going to keep prices on an upward track for years to come. However, prices of oil, copper, grains and other commodities (especially silver) are coming off a tremendous rally and could remain in a short term correction.

There has been significant speculation in commodities through exchange traded funds (ETFs) by retail investors, and hedge funds have been active in commodities as well. We've seen some of these levered bets recently being unwound. The CRB Index (see Chart 2 below), which includes seventeen commodities including energy, grains, metals and livestocks, is a broad measure of commodity price trends. The CRB fell nearly 9% in the first two weeks of May as sentiment quickly shifted against commodities. We do not anticipate a crash of any sort, but an additional 6% - 7% decline to just below the 200 day moving average would probably be enough to flush the shaky legs out of the markets and establish a base for future gains.

It almost seems that central banks are now conspiring to take some of the air out of commodity prices. Because of inflation in China (rising food prices in particular are causing political discomfort there), the Chinese are allowing their currency to appreciate slightly, bank reserve requirements are rising, and they are using numerous other ways to try and cool the economy. Brazil and other large emerging economies are experiencing a similar situation. Furthermore, the bias in Europe is toward monetary tightening, and now the Federal Reserve is ending its QE2 program at the end of June. These combined monetary forces increase perceptions that global growth could cool a bit.

Chart 2
Source: Thomson Baseline

US Federal Budget

There will be progress on reducing the U.S. budget deficit, but it's likely to stay wide by historical standards. Last month Standard & Poor's reduced the outlook on U.S. sovereign debt to negative, just days after President Obama gave a speech in response to the budget proposal by Republican Paul Ryan. Obama's speech was particularly critical of the Ryan proposal and he went so far as to ridicule it. Obama's caustic attack, which lacked any budget specifics of its own, was interpreted as an opening salvo to the 2012 elections and raised the possibility that a budget agreement would be impossible before the elections. S&P apparently decided that the political atmosphere was poisoned by Obama. However, there are a significant number of Democrats in Congress that are also running in elections in 2012 who are under pressure by their constituents to achieve progress on the budget. And, there is the issue of the debt ceiling.

By law, the U.S. treasury cannot issue debt in excess of an amount set by Congress—the debt ceiling. This debt ceiling includes all Federal debt, even the debt still held by the government and not sold to the public. The debt ceiling, which was last raised in February 2010 to $14.3 trillion, exists because originally Congress had to approve every time the Treasury issued debt. But the high cost of World War I led Congress to grant the authority to the Treasury to issue debt at its discretion as long as it was not above the "ceiling." Now, it is a political tool. The Democrats used to threaten not to raise the ceiling when Bush was in office, and now the Republicans threaten not to raise it with Obama in the White House. And it is not as important as Timothy Geithner, the Treasury Secretary, has made it to be for political reasons. In fact, the official debt ceiling was reached on May 16th after a government bond auction. Does this mean the government can't pay its bills? No. Firstly, the U.S. still collects about $2.5 trillion in tax collections per year. Second, the treasury holds positions in U.S. corporate equities, corporate fixed income securities, sizable real estate holdings and other assets that can be sold. The debt ceiling will have to be raised at some point—perhaps by late August—but this is a political issue.

The Republican's have threatened not to raise the debt ceiling unless substantial and specific cuts in spending are made. If the debt ceiling is not raised eventually, there are government workers and others who likely would not be paid right away. Holders of U.S. treasury debt would almost certainly collect their interest out of tax collections. It will be a battle of nerves. Our guess is that a compromise will be reached that will lower spending during the next fiscal year, which begins October 1st and that the deficit will decline substantially over the next two years. Spending is now at a near record 25.4% of GDP. Part of our optimism rests on the observation that tax collections, which are now running at a depressed 16% of GDP, are likely to rise back toward the 20% of GDP seen during most recoveries even without any action.

<u>Real Growth</u>

The economy expanded at a disappointing 1.7% annualized rate in the 2011 first quarter, and growth is now expected to average only about 2.5% to 3.0% this year. Real personal consumption expanded at a moderate 2.7%, equipment and software rose 11.6% and real exports were up 4.9%. However, real government spending fell a sharp 7.9% in the first quarter. These numbers are not final and the individual parts tend to jump around a lot. But the figures do give a reasonable sense of current conditions and the direction in which the economy is moving.

Consumers continue to deleverage, but payroll employment is on an upswing. There were 244,000 new jobs created in April, net of job losses, which was more than expected. Also, prior months were revised upward. The net gains in February and March were 235,000 and 221,000, respectively. These figures are below the job growth levels seen in past recoveries. The slow expansion of jobs probably reflects an unwillingness of businesses to hire in the U.S. because of what is perceived as a hostile political environment. Nevertheless, new job and income growth should be enough to keep consumer spending rising at a moderate pace even as consumer debt continues to shrink.

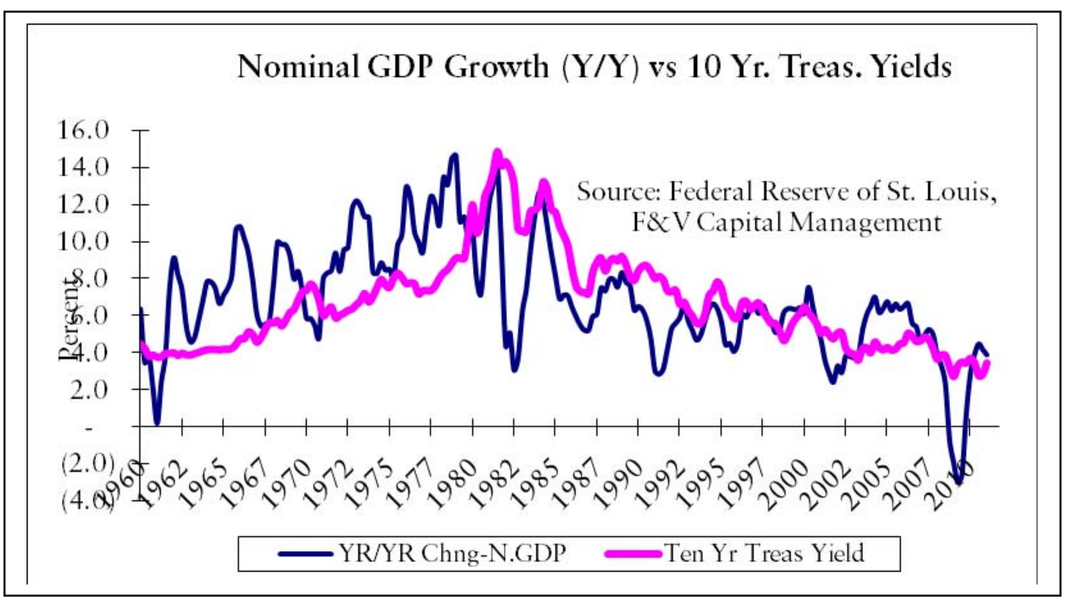
The outlook for private fixed investment remains good from a cyclical perspective. As recently as the 2010 first quarter, private investment was only 11.7% of GDP, the lowest level in 50 years. Businesses have lots of cash but have been unwilling to expand spending until recently. Total private fixed investment was up 7.2% in the first quarter and further gains likely lie ahead as the economy moves forward in this "self-sustaining" recovery off the depths of the recession. Clearly, business investment and the willingness to hire new workers have been negatively affected by the huge volume of new rules and regulations being implemented during the past two years. This is one reason we no longer expect a sharp rise in hiring and investment. But a cyclical rebound in investment is underway for sure.

Corporate Profits

U.S. corporate sales and earnings have been expanding at a very healthy pace and further gains look to be ahead. Thanks in large measure to strong foreign demand, sales for the S&P 500 rose 7% in 2010 over the previous year and were up 10%, year-over-year in the first quarter of 2011. Furthermore, profit margins have remained high and earnings are expected to increase at least 10% this year, and another 8% next year. In fact, these figures are probably low as margins will likely widen more as existing capacity operates at higher levels. Furthermore, globalization has provided U.S. consumers a chance to buy a wide variety of products manufactured at low prices, but it has also put downward pressure on labor rates, particularly at the low end of the skill level, because of competition from foreign labor. This trend is not likely to end soon. A slow rate of wage growth should help keep corporate profit margins high and rising as the economy continues to expand. The consensus estimates for S&P 500 operating earnings for 2011 and 2012 are 95.30 and 103.16, respectively. The FVCM estimates for the more conservative GAAP earnings are 83.70 and 90.52 for 2011 and 2012.

Fixed Income Securities

Long term interest rates have been in a declining trend for 30 years, and we would not predict a major break out to the upside. Our guess is that bond yields will stay low for an extended period. As shown in Chart 3, bond yields tend to move along with changes in nominal GDP growth. As we have already discussed, bank lending is stagnant, money growth is moderate, and nominal spending is growing at a modest pace as people and businesses continue to hoard cash. It seems implausible to us that nominal spending growth is going to significantly accelerate. Consequently, it is difficult to believe that bond yields will rise sharply. Some people have argued that the rise in government debt could cause yields to rise, but this seems unlikely as well. Net Federal debt in the US is about 70% of GDP. But, Japanese net debt is twice that level and yet bond yields are less than 2% because nominal spending growth is paltry. Even the end of QE2 may not cause yields to rise as some expect if investors simultaneously grow concerned about nominal spending growth. For us, the most probable outcome is that yields will stay in a trading range for a considerable period with 10 year treasuries yielding between approximately 2.5% and 3.9%. Corporate bonds can add incremental yield to portfolios, versus treasuries, and probably make sense since yield spreads are at about the long term trend level. With corporate cash flows improving, yield spreads could decline further. The bottom line is that bonds offer conservative investors a reasonable place to diversify investments, but the total returns will likely stay in the low single digits.



Equity Securities

The S&P 500 is already up about 7% this year on top of the 15% return achieved in 2010. With valuation levels still low and earnings on the right track, we continue to expect equities to provide better investment return than bonds, real estate and other asset classes. We are increasing the target we made last January for the S&P 500 from 1500 to 1600. Even at the 1600 level, our model indicates that the S&P 500 would be slightly undervalued. Stock valuations, like bond yields, are directly affected by inflation. Given our expectations of low inflation, bond yields should be low and P/E ratios high. At 1600, the S&P 500 would be trading at 17.7 times our forward estimate of the conservative GAAP earnings, and 15.5 times the consensus estimate of operating earnings. These figures are reasonable based on the historical relationships with inflation.

Even though we think 1600 is a reasonable target for the S&P 500, the human condition would lead us to expect a sizable correction at that point. Because the 1500 to 1600 level represents the major tops reached in 2000 and again in 2007, we wouldn't be surprised to see a correction at that level as people nervously take profits from this Bull Market. Base on our experience, it seems natural that people would look at the long term charts, see the market at the old highs and decide to take money off the table. However, our expectation is that such a correction would be a buying opportunity as we think the market will ultimately break through to new highs beyond those that were first achieved more than a decade ago.

Sector Rotation

There has been a lot of talk about sector rotation, but the real difficulty is in stock selection. Recently, energy and material stocks have declined in line with lower commodity prices, and there has been some strength in defensive consumer staples, healthcare and utility stocks. This sort of movement may continue for a bit, but if the global expansion remains underway, many of the more cyclical energy, industrial and technology stocks will likely retake the leadership role. And in any case, the markets have been punishing companies, regardless of the sector, that disappoint investors with bad quarterly earnings reports or if management makes big acquisitions, which is often seen as a squandering of shareholder cash and value. Punishment for stocks that disappoint has been swift and severe. The real difficulty is not just finding good values that will likely payoff someday, its finding good values that won't have any bumps in the road in coming months. Volatility will remain high for stocks of companies that don't simultaneously offer value, growth and seamless execution of a focused strategy.
