FVCM

U.S. Market Report

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9 October 2009

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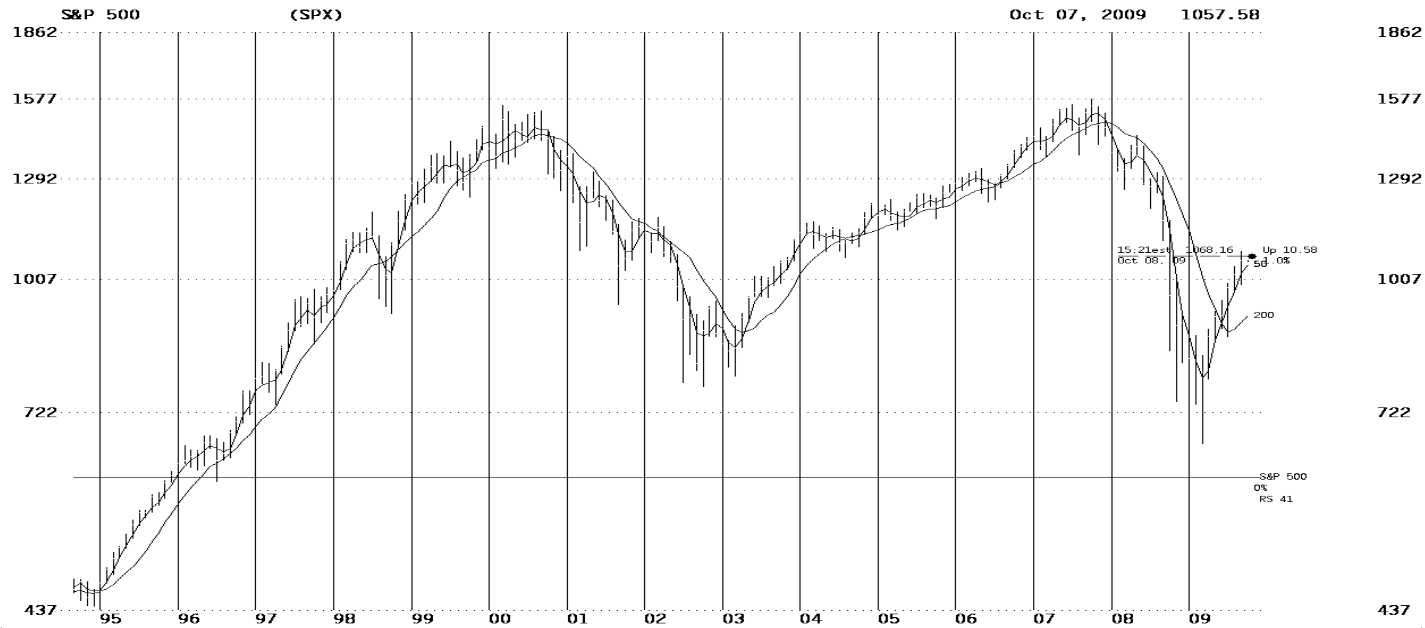
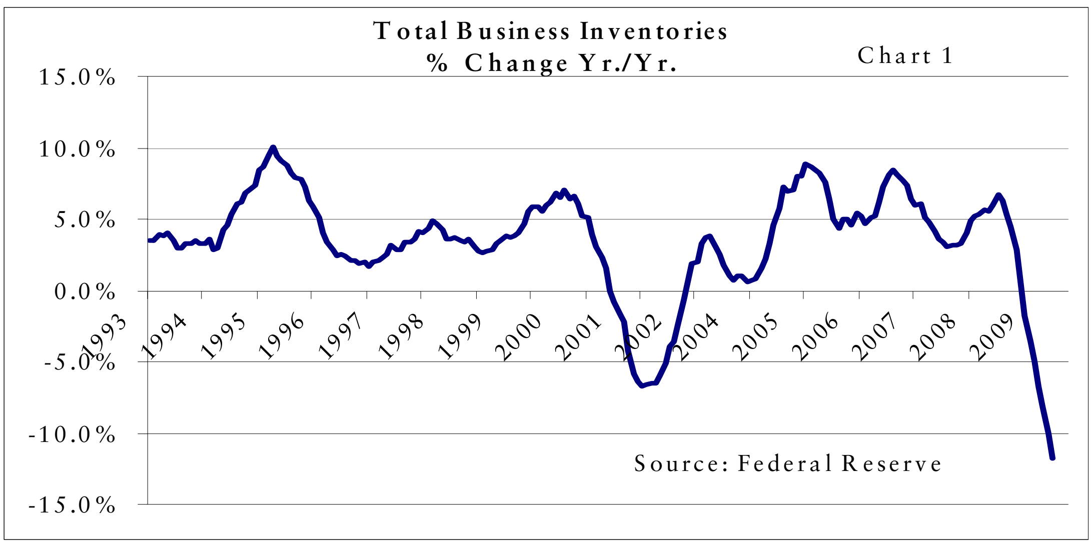


The Great Rebound of 2009

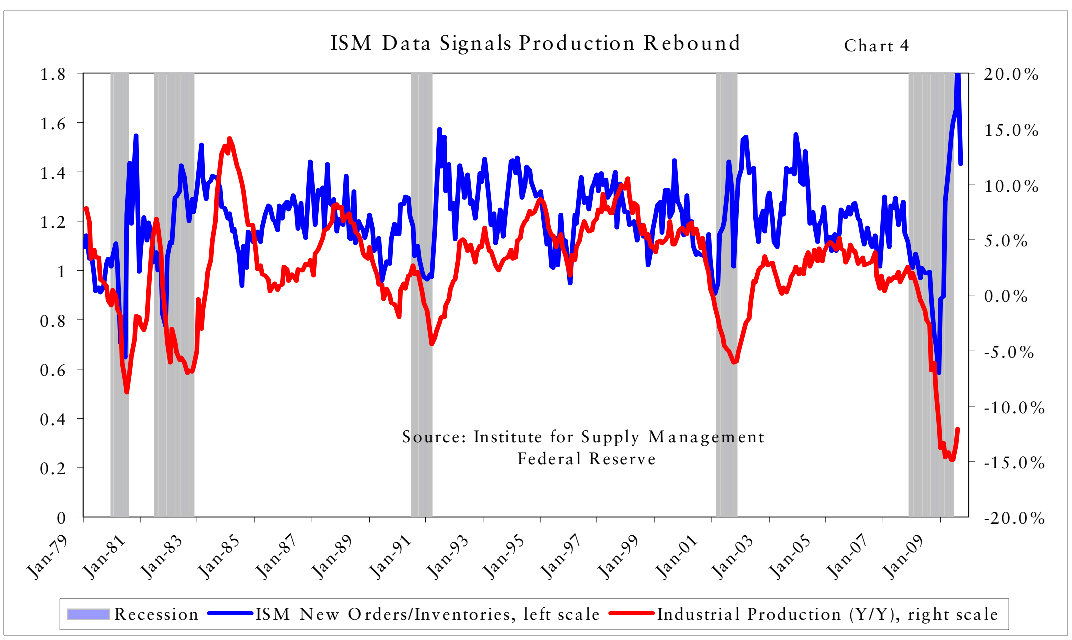
The gains in stock prices this year may be only the beginning of a new bull market. We expect further gains to come. Since hitting bottom at 666 on Friday March 6, 2009, the S&P 500 has rallied more than 50% to the current level of more than 1000. Nonetheless, the S&P is still well below the peak of more than 1500, which was hit twice: once in March 2000 and again in October 2007. Whether you think stock prices are high or low, in part, depends on your perspective. Compared to the recent low in March, stocks look like they're up a lot. From the perspective that stock prices are still more than 30% below the peak of 10 years ago, prices still look amazingly depressed. Stepping back and looking at the big-picture fundamentals, we think shares have further room to rise for the following reasons:

Global growth will not be slowed for long because of the U.S.-based financial crisis. As we all know, over the past couple decades more than a third of the world's population (China, the former Soviet Union and Eastern Europe) has emerged from the darkness of Marxist totalitarianism to achieve the greater freedoms of a market-based economic system, if not everywhere western-style political freedom. Furthermore, another billion people in India have been slowly achieving greater access to international trade and investment thanks to liberalization. The case for market-economics over central planning has been won throughout most of the globe. It is hard to overstate the impact that this shift is having on global growth and wealth creation. The volume of human ingenuity and resourcefulness now at work in the global markets is unprecedented. Gains in productivity and wealth were tremendous in the last century, but the gains will likely be even greater during the current century. These forces for growth will re-exert themselves as the current financial excesses are unwound. A rising tide lifts all ships.

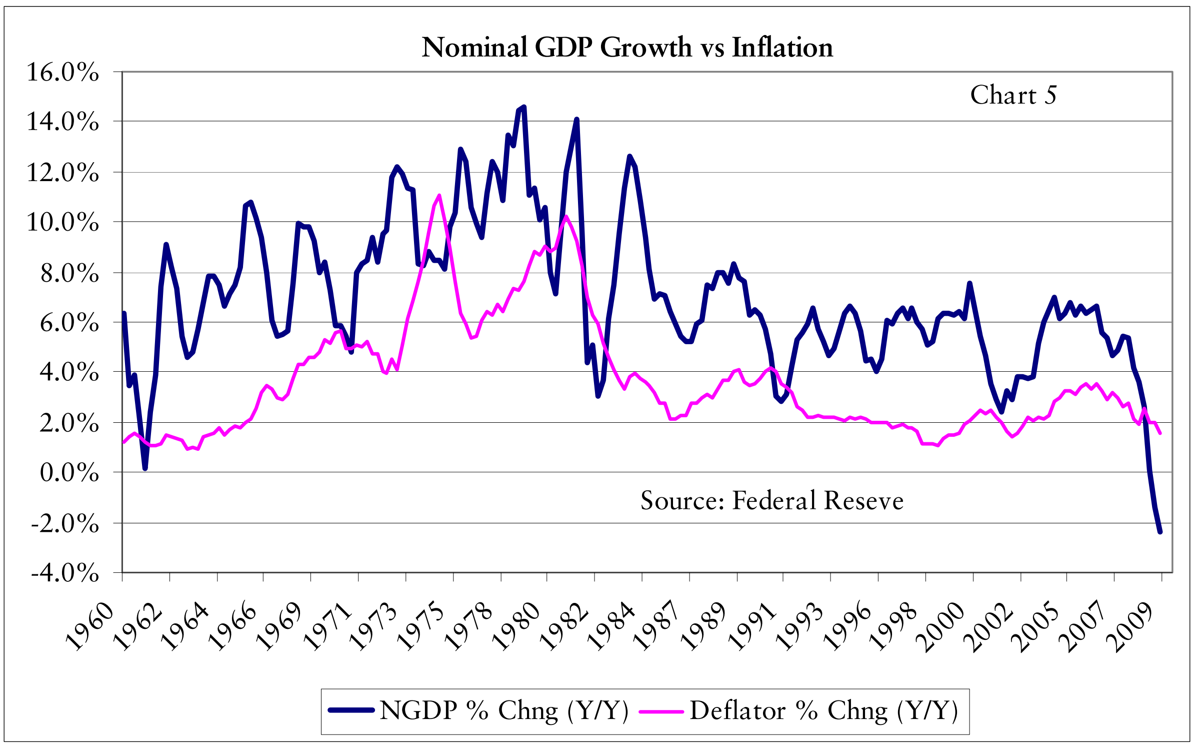
U.S. businesses have reacted to the most recent financial storm with the "flexibility" for which the U.S. is well known. Businesses have reduced production very rapidly in response to declining orders, and have even cut production enough to reduce inventory levels. As shown in Chart 1, inventory growth has gone deeply into negative territory. What is rather amazing, business productivity was still up 1.9%, year-over-year, as of the second quarter of 2009. How can productivity rise when actual production is falling? Businesses have been cutting jobs at an accelerated rate. Production is down, but labor is down even more so output per unit of labor is actually rising. The unemployment rate hit a low of 4.4% in March 2007 at a time when the downturn in the real estate markets and spending was becoming apparent. Businesses started cutting jobs by mid-2007 and the unemployment rate has rapidly risen to the recent reading of 9.8% and could go higher (see chart 2).



The sharp decline in inventories and improving order trends is likely to fuel stronger real growth than anticipated by most economists. All business cycles change directions, and the snap-back is often a matter of how businesses reacted to the downturn in the cycle. As discussed, businesses are now very lean in terms of labor and inventories. This will likely result in a sharper than expected rebound as companies are forced to quickly change direction as the cycle turns. As seen in Chart 3, the ISM Manufacturers New Orders Index has already snapped back sharply from depressed levels. Chart 4 shows why a sharp rebound in industrial production looks to be on the horizon. The blue line is the ratio of new orders to inventories—so when the line is rising, new orders are accelerating faster than inventories. The red line shows the year-to-year change in industrial production. As indicated, the blue line has already moved sharply higher while production has yet to catch up. Economists (and analysts) are susceptible to the same shifts from exuberance to despair that effect most investors and other people. The decline in business conditions in 2008 and 2009 caught most economists off guard and estimates had to be cut. We think the opposite is about to happen and earnings estimates will have to be increased.



Real economic growth is coming but inflation is not. The Fed has been very aggressive at untying the knots of the financial system. Not only have short term interest rates been kept near zero, but the Fed has been purchasing mortgage backed securities, commercial paper, U.S. treasuries and other securities which have had the effect of boosting liquidity throughout the system. These efforts are reflected in the money supply data: M1, which is mostly cash in circulation and demand deposits, was up 18.5%, year-over-year, as of August; M2, which includes savings accounts and some time deposits, was up 7.8%. As we went into more detail in a previous report, this growth in the money supply is not building inflationary pressure because people have been essentially hording the extra cash and not spending it as they repair their balance sheets. Money has to be spent in order for it to be inflationary and, even then, the impact on inflation is typically after a lag-time of two years or more. To help clarify the point, please note the relationship between U.S. nominal GDP growth and inflation in Chart 5. When the growth rate in spending accelerated in the 1970s, the inflation rate rose with a lag. When the growth rate of nominal spending fell in the 1980s, inflation fell with a lag. In the most recent quarter, nominal spending contracted at an annualized rate of 2.4%! It is almost certain that inflation will continue to decline in the year ahead because of this dearth of spending.



A critical point is that monetary policy impacts real economic activity relatively quickly, but inflation only with a much longer lag time. The growth in money and an improving tolerance for risk is now having the effect of getting people to spend and return nominal GDP growth back into positive territory. As money starts to get spent, the first order effect will be higher real economic growth. This is indicated in the rise in new orders shown back in Charts 3 & 4. Manufacturing capacity will start to be utilized at a higher rate, employment will begin to rise again and only some years from now, *IF* spending is allowed to grow at a high sustained rate, would inflation become an issue.

With the Euro approaching $1.50, the currency markets are signaling that either the U.S. is facing inflation or there will be further contraction and deflation in Europe. The fundamental value of a currency is its purchasing power. At present, one Euro can purchase a basket of goods that would take about $1.17 in the U.S. This (1 Euro = $1.17) is known as purchasing power parity (PPP). With the currency markets pricing the Euro at nearly $1.50, the Euro is significantly overvalued on a PPP basis. Therefore, there are two possibilities. Either the dollar will rise in the currency markets in the coming years, or the dollar's purchasing power will deteriorate very significantly relative to the Euro. As we have argued in the previous section, the decline in nominal spending in the U.S. tells us that inflation will be very low, and perhaps zero, for a considerable period. The logical extension of this, if we assume that the *relative* purchasing power of the Euro is to increase, is that the Euro would have to rise in terms of its purchasing power, i.e., deflation. One possible conclusion is that the ECB will be forced to become more accommodative in the quarters ahead in order to help stimulate growth. This would reduce the upward pressure on the Euro.

The economic environment we expect for the year ahead—accelerating real growth and low inflation—is ideal for the equity markets. Inflation is corrosive to equities as well as bonds, just to a lesser degree. P/E ratios rise in times of low inflation and fall in times of rising inflation. With inflation below 2% by all major measures and falling, stock valuations should remain high. Therefore, the expected rebound in earnings in the year ahead should be a main driver for higher stock prices. Just as economists were too optimistic with their estimates of economic growth last year, analysts were too optimistic about corporate earnings. Estimates had to be reduced. However, as seen in Charts 6 & 7, consensus estimates for the S&P 500 have bottomed out and are now starting to rise. Chart 6, for example, shows that the consensus estimate for 2009 earnings was 92.9 back in November 2008, but were cut to a low of 52.9 this past August. Since then, the consensus estimate has moved back up to 57.5. Chart 7 shows the trend in the consensus estimate for 2010, which was 97.1 back in November 2008 and is now 71.2. Whereas analysts were too optimistic back in 2008, they look too pessimistic now. Our 2009 and 2010 estimates are 65 and 83, respectively.

Chart 6 Source: Thomson Baseline

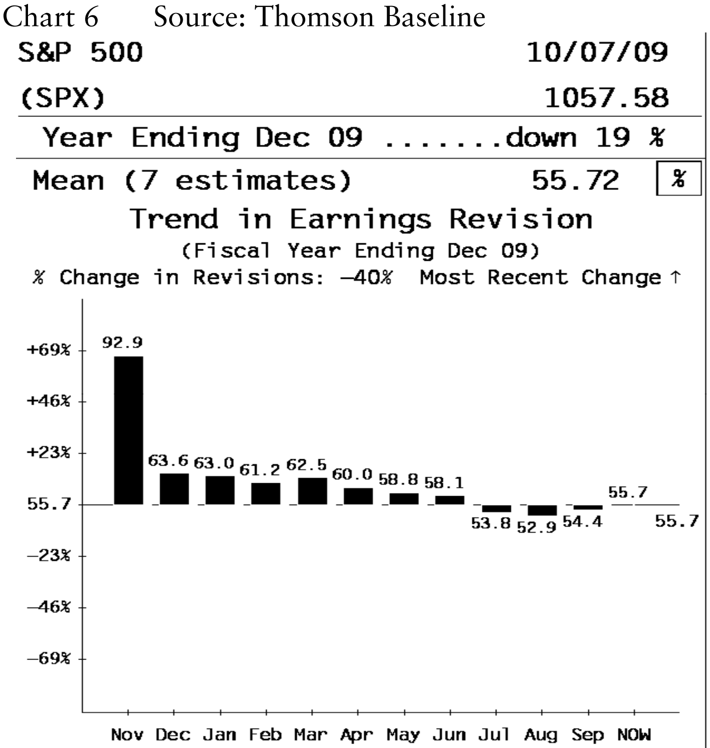
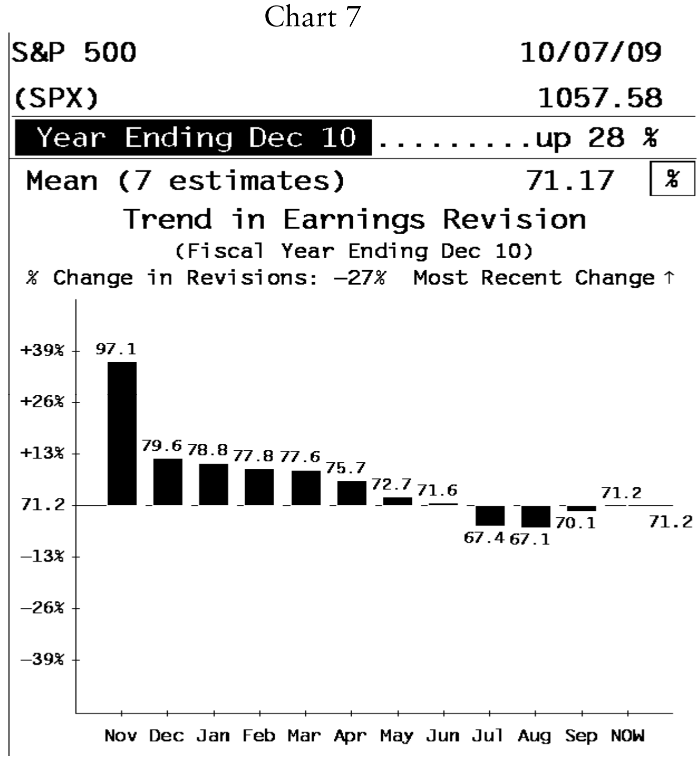


Chart 7



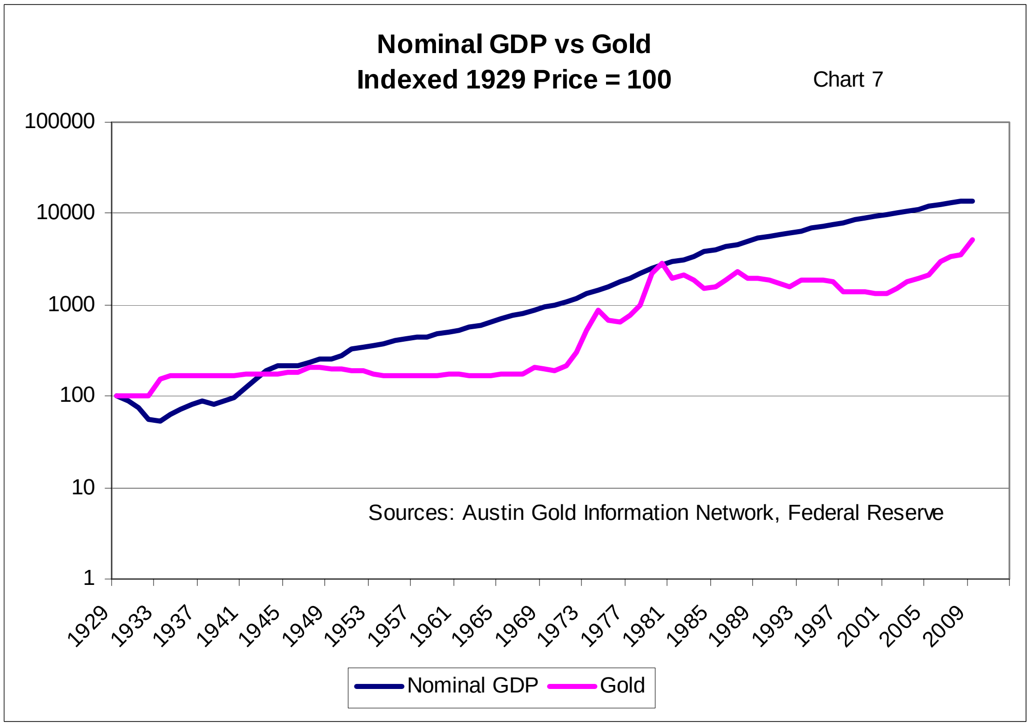
Fixed income is likely to be entering a period of underperformance at the same time equities are moving toward strength. Both U.S. treasury and higher-quality corporate bond yields are near historic lows. Although we expect inflation to stay low during the year ahead, it is unlikely that yields will decline further or even stay at their current levels. US treasury yields have been in a secular declining trend for more than 25 years and yields are expected to increase a bit as the recovery takes hold. Furthermore, weakness in the dollar and worries about the accommodative monetary policy will likely lead the Fed to raise short term rates sometime in the year ahead.

We are bullish on Gold despite our expectation that inflation will stay low. This business contraction, unlike other cycles of the past 50 years, has been driven by a simultaneous reduction in asset prices and debt. The last time there was a similar contraction was in the 1930s, as was described by the famous economist Irving Fisher:

> "…..at some point of time, a state of over-indebtedness exists; this will tend to lead to liquidation, through the alarm either of debtors or creditors or both. Debt liquidation leads to distress selling and to contraction of deposit currency as banks loans are paid off, and to a slowing down of velocity of circulation. This contraction of deposits and of their velocity, precipitated by distress selling, causes a fall in the level of prices, a still greater fall in the net worth of business…"

The contraction in velocity that Fisher mentioned reflects the increasing desire for liquidity and the tendency of people to horde money during such financial contractions. Unlike in the 1930s, the Fed is now properly creating money to accommodate this rise in demand for dollar liquidity. However, the Fed can not add to the global supply of gold! Therefore, this increase in the supply of money, while the gold supply is essentially steady, results in the depreciation of the dollar versus gold. In other words gold prices rise. Does this mean the increase in the money supply causes dollar inflation in the sense that consumer prices rise? Not if the increase in dollars is the result of rising demand for liquidity and the dollars are mostly horded. As long as nominal spending remains slow, as is the case now, so should inflation. Is there any evidence of this phenomenon is not just some wild ass theory? Yes. Back in the 1930s the price of gold was pegged by the Fed. Even though the peg for gold was raised 69%, consumer prices fell 18.7% between 1930 and 1940.

Contrary to popular opinion, there is little relationship between changes in gold prices and changes in the price level (inflation). For example, between 1980 and 2000, the consumer price level in the U.S. rose 124%. During the same period, gold prices fell more than 50%. Gold prices and inflation can and do move in opposite directions for long periods, just as the demand for money moves up and down over long periods. Furthermore, from a theoretical standpoint, gold prices should rise more inline with nominal income and spending, rather than just inflation. One can easily imagine, for example, why demand for gold in India or China would rise more in-line with incomes rather than just inflation. As people have higher incomes, even if inflation is zero, they purchase more gold for both jewelry and for a store of value. Take a look at chart 7, which is on a logarithmic scale. In the chart both U.S. nominal GDP and the price of gold has been converted into an index where the 1929 level equals 100. The relationship between gold and income is clearly very loose. However, if the asset/debt contraction continues and the demand for money & gold rises further, it is not inconceivable that gold prices theoretically could rise to a point where it is at the same index level as nominal GDP (as it did back in 1980). In order for the gold price index shown below to rise to the same level as nominal GDP, the price of gold would have to rise to about $3,000 per oz., versus the current price of about $1,000 (keep in mind, because of the long periods involved it was necessary to use a log chart, which can be deceiving to some).



In spite of being in uncharted waters, we have the analytical tools to help point the way. As noted, the business contraction--that now appears to be coming toward an end—has been characterized by a simultaneous reduction in asset prices and debt, just as was the case in the 1930s. But this cycle is very different from the 1930s for a number of reasons including federal insurance on bank deposits, which has helped prevent the bank runs, bank closures and the collapse in the money supply that occurred in the 1930s. And, importantly, the Fed has vastly expanded its balance sheet to offset the contraction in private debt and to provide the liquidity being demanded by a newly risk adverse population. Every crisis brings opportunity. In our estimation, this second major decline in equity prices this decade has likely set a generational low in stock prices. Volatility has not come to an end and there will be corrections. However, the Fed learned the lesson of the 1930s and has properly managed the change in financial conditions. From our perspective, the current direction is a resumption of growth, a rebound in corporate profitability and higher stock prices.
