

AUTOS, HOUSING, FINANCIALS & ENERGY

The American auto industry, the housing market and the financial industry are experiencing very difficult times while the energy industry is booming. The economy is not in a recession, in spite of what you hear on CNBC. There are prognostications all over the place that say we are already in a recession. That is just not true through the first quarter of 2008. We are in an economic slowdown. We may or may not enter a recession. The stock market is a leading indicator of what to expect and it is saying no recession. The Dow touched 13,000 again in early May. The S&P 500 approached 1,400 and the NASDAQ approached 2500. The Dow is off 3.0% YTD, the S&P 500 is off 4.8% YTD and the NASDAQ is off 7.6% YTD. No disaster.

As James W. Paulsen, Ph.D., Chief Investment Strategist at Wells Capital Management says:

“The issue for the financial markets is how long and how deep will the current slowdown/recessionary growth period prove? The economy did possess more momentum coming into 2008 than suggested by the headline real GDP number. Through February, real personal consumption was on track to rise about 1% annualized pace, business spending should be about flat, and as it has in recent quarters, the drag from lower construction spending should be nearly offset by continued international trade improvement.”

Has the Job Market Really Cratered???

Central to the outlook for the economy is just how much has the job market weakened? The unemployment rate stands at 5.0%. It peaked at 6.1% in the last recession. The four-week moving average of weekly initial unemployment claims remains below 380,000, not a recessionary level. The SurePayroll small business employment national hire index suggests small company job creation rose at almost 4% annualized pace in the first quarter. A broad array of labor market indicators suggest job creation more likely has

suffered a significant slowing as opposed to a widespread contraction. If people have jobs they will spend money.

Is Housing Activity Finally Bottoming?

A full blown recovery in the housing industry is still some time off and will likely be slow to develop when it does emerge. National housing prices will also likely continue to decline until 2009. Even if housing doesn't bounce much or soon, a simple bottom will “add” considerably to quarterly real GDP growth rates.

Stimulus Comin!!!

Disposable personal income will rise by a double-digit pace in the second quarter, bolstered by tax rebates. Much “economic medicine” has been applied to the patient in the last year and every policy official is fully and myopically focused on “job one”... getting the economy moving again. It is a good bet that they will be successful by the second half of the year.

How Bad Is the Credit Destruction?

Total U.S. bank loans plus commercial paper was rising at about 12% annual growth rate prior to the crisis and has since slowed to about a 6% pace. Although briefly stalling immediately after the crisis last summer, total bank credit creation plus commercial paper has accelerated again and has risen at about a 6% annualized pace in the last six months.

Financial Crisis Calming Down?

Every financial crisis has two components — fundamental balance sheet/income statement problems and “fear”. The current crisis is no exception. It consists of a record-setting collapse in housing and auto industries, massive sub prime mortgage loan losses, and pervasive and widespread fears. This crisis appears more “fear-based” than financial. Fundamentally, the economy may not have much to fix. Today, 95% of all who want a job have one. 95% of all home

mortgages are being paid on time. Household net worths are near all-time record highs and household liquidity growth has risen close to 10% in the last year. Non-financial companies have been coining profits for a record-setting consecutive string of quarters (i.e. S&P 500 non-financial earnings were up 13.5% in the fourth quarter). Non-financial corporate balance sheets are stronger today than at anytime in the last four decades with corporate cash flow to capital spending ratios near record high and with inventory levels near record lows.

Currently eight out of the ten economic sectors within the S&P 500 are expected to have positive year-over-year profit growth again in the first quarter of this year! Policy officials have dumped a ton of stimulus into this economy during the last year, aimed at reviving the epicenter of this crisis – housing, banks and perhaps retailers. However, this stimulus is also hitting many sectors which simply don't need it! For these sectors, perhaps eight out of the ten, the stimulus is comparable to dumping gasoline on a fire which is already lit! Strong companies with strong earnings are getting stronger!

Energy?

We expect that the worst of the housing problem is over and/or already reflected in the market. The real problem going forward is high energy costs

that serves as a tax on consumers and slows down the economy. In every problem there is a silver lining. We have recommended for four years an allocation to energy managers, and we are still bullish on this sector.

Conclusion

Our position at Monroe Vos is to stay the course.

The stock and bond markets have all the negative expectations factored into their prices. Even though the economy is now showing signs of faltering, the financial markets appear to be looking forward to an eventual economic recovery. The combination of excessive investor fears, massive policy stimulus, a significantly cheaper stock market relative to bonds and the belief the economy is likely to outpace expectations in the second half of this year, paints a bullish picture for stocks.

The U.S. dollar could rally short-term. This could bring short-term selling pressures to bear on commodity prices and basic material stocks. Long-term, it is expected that the dollar will weaken, especially against emerging world currencies.

As James Paulsen says, “Don't get caught sitting on a sidelines when Wall Street finally decides the King after all does have clothes!”

We look forward to seeing you at our next meeting.

Jamison Monroe, CIMA
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