

TWO SCHOOLS

There are two schools of thought about what is going to happen in our economy and the market. One is that the housing crisis and high energy prices will cause our economy and the global economy to enter a recession. This recession will cause the stock market to go down and interest rates to go down. Falling interest rates will provide excellent returns for bond investors. This school believes that we will not experience stagflation from oil and food price increases because the economy will slow down enough to keep this from happening. They believe we will experience deflation because insufficiency of demand will overwhelm inflationary forces. They point out that:

- a massive wealth loss due to falling home prices,
- a severe contraction of monetary conditions caused by the credit crisis,
- deteriorating global demand, and
- an enormous decline in consumer expectations

all point to a downward shift in aggregate demand, meaning lower inflation.

Aggregate supply and demand analysis can be confirmed by three different indicators—the unemployment rate, the manufacturing capacity utilization rate, and the output gap. Presently, all indicate that the U.S. economy faces insufficient aggregate demand, and consequently disinflationary pressures.

The unemployment rate has risen to 5.7%, the highest level since October 2004, while the manufacturing capacity use rate has fallen to 77.5%, the lowest since November 2004. Since 1949, manufacturing capacity utilization has averaged 81.1%. As such, there is an additional 3.6% of excess capacity. The output gap, which is real GDP less potential GDP as a % of real GDP, was an estimated -2% in the second quarter, the largest amount of economy wide excess capacity in five years.

The higher unemployment rate points to downward pressure on wages and benefits. This is clearly happening since wage gains have fallen to 3.4%, down 0.9% from their cyclical peak. The low rate of manufacturing plant use indicates that firms do not have pricing power. As such they are unable to pass through higher fuel and raw material costs, thus squeezing their profit margins. The negative output gap confirms the excess supply in the labor and production markets and also points to lower inflation. In such a disinflationary environment, intermediate and long term Treasury bond yields should continue to work lower.

The second school says that two-and-a-half years after the housing industry peaked, and one year past the start of the mortgage crisis, still no recession. However, recession forecasts remain as widespread as ever; they just keep getting rolled forward. Maybe a recession is still coming, but so far the economy hasn't caught up to widespread expectations of dread. Real GDP growth was 1% in the first quarter and 1.9% in the second quarter! Hardly a recession.

No doubt the economy has suffered a significant slowdown, but it is hardly (at least, yet) collapsing. What has collapsed? What is worse than the performance of the economy itself? Consumer confidence, investor sentiment and widespread generalized fear! The consumer confidence index recently declined to one of its lowest levels ever recorded. Currently, this index is about 10% "below" its worst reading during the 1982 recession—a recession widely recognized as the worst ever since the Great Depression! By comparison, in 1982, annual real GDP growth was -2.7%; the unemployment rate peaked at about 11% (today it is 5.7%); job losses from the peak amounted to 2.8 million jobs, or 3.1% of the job base; the core rate of inflation was above 10% (today it is 2.3%); and the 10-year Treasury yield was above 14% (today it is 4%)! The economy may or may not be headed for recession, but "economic feelings" are already in a depression!

Although confidence is not likely to get much worse, the question is how long before it begins to improve? This, of course, depends on when and by how much the economy shows undeniable signs of bottoming and recovers. They believe we are nearing such a point, both because most of the forces weighing on the economy in recent months (jobs, housing and oil prices) will likely lessen in intensity in the coming year, and because several positive forces for economic growth (policy stimulus, U.S. international trade and confidence) are likely to strengthen.

Although a more pronounced decline in the job market may still be forthcoming, there are reasons to be optimistic that job conditions could improve before the year is over. Renewed productivity growth combined with slowing labor costs should help revive job creation in the coming months. Most non-financial companies continue to enjoy positive profit growth, good liquidity and healthy balance sheets. What is lacking for most corporations is not the ability to hire, but rather the confidence. Should housing and autos begin to decline more slowly or bottom, the invisible undertow of net export growth could cause the manufacturing job market to recover surprisingly quickly! The slowdown in job creation, like much of the rest of the economy, remains highly concentrated among the housing and auto industries. Despite comprising less than 3% of total jobs, of the 438K payroll jobs lost since the start of this year, 219K or 50%, are directly tied to the housing and auto industries. Should the pace of collapse in these two industries simply diminish or cease, the aggregate job numbers could quickly improve.

Housing spending has been subtracting about 1% from real GDP growth during much of the last couple years. What if housing activity only trims 0.5% off real GDP growth in coming quarters rather than 1%?

Non-energy prices remain remarkably tame. In past oil crises, core inflation often surged, combining with energy prices to destroy household purchasing power. Today, the consumer is still

enjoying “deflationary electronics pricing,” falling apparel prices and lower new-sticker auto prices! Overall, the annual rate of core consumer price inflation is still only 2.3%.

They are hopeful that oil prices will soon peak and decline from record levels, that the job market may soon show signs of bottoming, and that the U.S. dollar may strengthen some relative to developed world currencies. Finally, if some of these positives emerge, consumer and business confidence may also improve.

For all S&P 500 stocks, the median one-year forward estimated price-earnings multiple is currently 13.6! This seems fairly attractive in a world where real GDP is growing, with a sub-4% 10-year Treasury yield and 2.3% core consumer price inflation rate, and where U.S. money market mutual fund balances have been exploding in the last year!

Conclusion

Both schools of thought make valid arguments as to what will happen in the economy that will affect the stock and bond markets. We believe that in times like this a neutral approach is the prudent posture. Just staying the course in terms of asset allocation is not prudent to us since we lean to the deflationary / recession scenario.

As you will recall in 2000 we suggested cutting equity exposure in half and increasing bond exposure. In 2004 we suggested adding direct energy, commodity, emerging market debt and real estate to our clients’ portfolios. In 2006 we suggested going to money market in the bond portfolio and we suggested going back to bonds when the Fed started lowering rates in 2007. All of these moves paid off well for our clients. We have just recently suggested trimming the equity portfolio and putting the funds in bonds.

Our thought process is that if energy drops back the rest of the equity portfolio will do well. If energy continues to go up the rest of the equity portfolio

will do poorly. The bond portfolio is currently yielding 5.40% (PIMCO Total Return) and interest rates will probably not go up. If they go down the bond portfolios will deliver excellent returns from yield plus capital appreciation. It is possible that the equity market moves higher, interest rates stay the same or decline slightly, and energy stocks move higher.

Energy Outlook

In July we talked to the energy managers. They expected a drop in the price of oil to around \$100-\$110/barrel. They expected a correction in energy stocks after the big run up in the second quarter. This correction presents a buying opportunity in their opinion because the fundamentals have not changed. Supply is shrinking and demand is growing. They point out that energy stocks have rarely been so inexpensive relative to oil and gas prices, estimated asset values and earnings. Oil service stocks look particularly attractive because their fortunes are not based on the price of oil but rather the capital spending by oil companies. In April for example, Exxon announced it would increase its capital spending to \$25-\$30 billion over the next few years, a 25% increase. A lot of the money will be paid to oil service companies. Historically, capital spending by oil companies peaks years after a bottom in spending. For Exxon the last bottom was 2005 and capital spending is expected to peak in 2012. As you may recall, we suggested over two years ago that our clients get out of commodity funds, and most used those assets to increase their exposure to energy stocks. We have not been comfortable in owning commodities for some time now because of the huge run up in prices caused by a weak dollar and speculation. Based on our discussion with the energy managers we remain bullish on this sector.

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