Economic Update

Thanksgiving Pie
November 3, 2010

It has been about a month since our last update, a little longer than what is typically the norm. I wanted to wait until this week to share my current thoughts since it would be a particularly newsworthy week. In addition to a winding down of the earnings season, we also had the mid term elections yesterday, the release of the national ISM manufacturing *and* service indices, and news from the Fed on its anticipated plans for Quantitative Easing (QE).

The markets have enjoyed a very strong October and now are just a hair shy of their April highs, the period which immediately preceded surfacing concerns over European economic contagion, the BP Oil spill, and a peaking of the ISM surveys, all of which ushered in the more difficult late spring and summer months for the stock market. Now that we're pushing back up against the year's earlier highs, the question is whether better news will push us through current levels to the upside or if more troubling news will surface, leading to a pullback and a continuation of the1040-1200 trading range experienced for most of 2010.

Before we share our current thinking on the coming months and year, it might be helpful to comment on those factors that may have helped the markets move beyond the contagion concerns that plagued it earlier in the summer. We believe that two factors have enabled investors to overlook these concerns in spite of ongoing riots in France over an appropriate minimum retirement age and a highly uncertain regulatory environment for many domestic industries. Clearly, the prospect for a more balanced form of government following the mid term elections has helped as has the prospect for possibly even lower interest rates as the Fed engages in the controversial and rare form of economic stimulus known as Quantitative Easing (QE).

While the midterm elections were highly anticipated and perhaps already discounted in the recent run up of the markets, it is worth noting that *the economy actually seems to be doing okay on its own* just as the Fed is gearing up its QE plans to stimulate it further. Third quarter GDP growth of 2% may not be great by historical standards, but it is still positive growth - albeit at so called "stall speed" - and a small uptick from the prior quarter's rate of 1.7%. Unfortunately, GDP growth of 2% or less sustained for more than four quarters in a row has generally been followed by a recession, spooking investors.

These remain unusual times. Corporate America has cut back to an entirely new level of productivity where earnings gains and now profits are at record highs even though revenues often remain below their 2007-2008 peaks. Curious to know where our portfolio stands in this regard, we discovered that our average holding has profits 20% higher and free cash flow 25% higher than the prior 2007 peak. As a reminder that the stock market is also a market of individual stocks, the market cap of our average holding is also back to its 2007 peak even though the S&P 500 index remains 20% lower. Given all of the cost cutting, the tight lending environment, and the heightened budget process, it is possible that an extended period of 2% growth without an ensuing recession may not only be possible but perhaps even likely.

The Fed's plan to manipulate interest rates even lower through Quantitative Easing came out about an hour ago and will involve the open market purchases of $600 billion in government debt securities of varying maturities from 2 to 10 years over the next eight or so months. The Fed has decided to take these additional moves in spite of the fact that the economy is growing – albeit at a slow pace – because of its dual mandate from Congress which charges them with maintaining monetary policy that promotes both price stability and full employment. While unemployment, at least politically speaking - remains too high at 9.5%, the Fed also made the very unusual comment recently that inflation may be too low, setting the stage for QE.

In my view, and I'm admittedly not the only one who feels this way, the Fed wouldn't likely be making these moves if it weren't for the dual mandate. They've referenced it many times in the past few months, which may somehow belie the notion that although they wouldn't ordinarily engage in such behavior, they must do so now, because it's the "law".

Frankly, I think the move may be a mistake, not simply because it may be unwarranted based on the economic fundamentals independent of the dual mandate, but because I question whether or not lower rates will even influence the lackluster economic fundamentals it is targeting, unemployment in particular. The household refinancing boom that often accompanies lower rates is not driving renewed consumption capable of generating 4% plus GDP growth as it has in the past. Instead, in spite of record low rates, most people are taking the savings in cash flow to reduce the principal value of their refinanced loans. Likewise, companies, rather than using their record cash flows to hire new workers, are instead returning it to shareholders through dividends and stock buybacks likely under the notion that spending it in other ways isn't likely to improve top line demand as much as it may done in the past.

So, what's our overall view? While I believe the Fed should stand pat and allow the economy to work itself out over time, it is clear as of today that they are not going to risk the historically unfavorable odds for a double dip especially in the face of the politically unpopular 9.5% unemployment rate. Although we may not be setting new records for GDP growth in a recovery, balance sheets are improving and with time growth in employment, loan demand and even inflation should follow suit. Quite simply, we're working through our problems the old fashioned way, by earning it. A year from now, I fully expect that the S&P 500 will have pierced the elusive 1200 ceiling it has bumped into on repeated occasions this year.

In the intense media focus over the mid term elections and the Fed QE frenzy, investors may be overlooking two interesting data points in recent weeks. First of all, unemployment claims made an important yet seemingly unnoticed downtick last week, falling roughly 40k to sub 450k levels where they have been mired for months. In addition, and perhaps more importantly, all of the regional purchasing managers' indices have been up in recent weeks and the National ISM index increased to 56.9, clearly in expansion territory. The new orders component also improved versus last month, an important sign.

From an investment perspective, we are neither bullish nor bearish, but instead believe things are just about right. The economy should continue to chug along from here - even if left to its own devices - and thus mend itself overtime. Hopefully, the Fed won't end up doing more harm than good in making inflation down the road a tougher monster to tackle, but time will tell. It will be interesting to see what the stock market does in the coming days and whether or not the "risk on" trade that has pushed the markets higher in recent weeks will hold.

Although our stock market has done well, the gains for foreigners have been virtually wiped out because of currency depreciation, suggesting that recent gains may be more nominal than real. QE may only worsen this trend. At the same time, it is an undeniable positive that the House has switched hands as the anti-business culture should moderate quickly. (Had the election been two months from now when small businesses were receiving their "revised" health insurance premiums, I suspect Republicans may have captured the Senate as well.)

While the bulk of the market's cyclical gains may now be in the rear view mirror, we believe patient investors can still do well from here by focusing on innovative companies less tied to the dynamics of the economic cycle and slower but stable growth companies that pay a nice and growing dividend. We do have an exposure to some cyclical areas of the market, but it tends to be in those companies and industries that are later stage in nature, which means they usually benefit from operating leverage only as the economy moves from its recovery phase to an outright expansion past the prior highs. In this category, companies that can benefit from stronger international economies are of particular interest.

Where might the unexpected upside come for investors? Two areas. As we've mentioned before, dividends may attract some money away from the gaga bond market as a source of yield, providing some relative capital appreciation potential for stocks. On a longer term secular basis, the emerging market consumer may also be worth paying attention to. As the wealth of overseas economies grows and makes its way into the hands of its citizens, a growing middle class should emerge with the same needs and wants that many of those in the United States have enjoyed for years. In many areas of the world, this trend is underway and could ultimately benefit U.S. exports.

In this sense, the end of the Cold War may start paying its best dividends just when we need it the most. With the changes in Congress, hopefully our leaders will spend more time figuring out how we can grow the economic pie rather than wasting time figuring out the fairest way to divide the "spoils".

As far as Thanksgiving pies go, a growing one always tops the list of favorites.

Kindest Regards,

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