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Build Knowledge/Market & Economic Commentary

'Less Bad' First Quarter Boosts Investors' Expectations

By Barry Mendelson, CIMA
Jun. 9, 2009

The markets have seen a major rally in the first quarter, but without solid evidence of sustainable economic improvement, the trend could change. Here's a look at eight economic factors and their impact on the markets.

After improving noticeably over the last two months, the financial markets and U.S. economy have arrived at the same place: higher expectations. In early 2009, market participants found it acceptable that the U.S. economy merely stopped getting worse. Now, markets want to see real sustainable growth in the economy—not just less-negative readings.

Against this backdrop of higher expectations, the economy seesawed in May with some good news, some bad news, and some mixed news. The recession is gradually moderating, but economic data provide a reminder of how difficult the road to recovery will be.

Both initial and continuing claims for unemployment benefits increased, while retail sales fell unexpectedly. Manufacturing is contracting, but conditions are improving. Core inflation returned in April, but deflation risks are still present because of the tremendous slack in the economy.

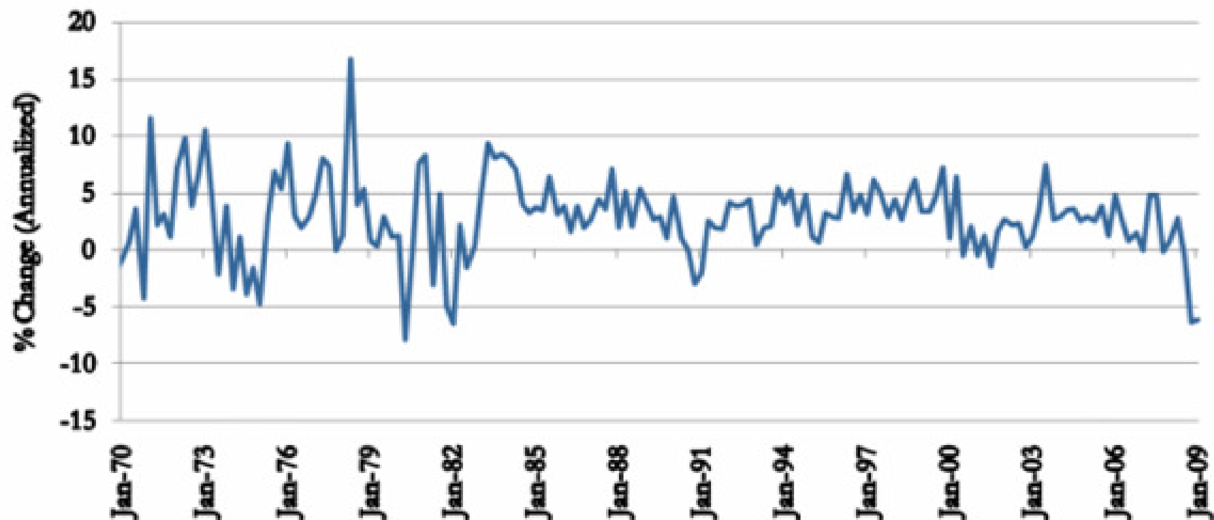
Improved consumer confidence is encouraging, but unless layoffs and house price declines moderate, sentiment will likely suffer. Recent oil price increases are also worrisome, highlighting the need for labor market improvement to offset this income and spending drag.

GDP

Real GDP declined at an annualized rate of 5.7% in Q1 of 2009 (see Figure 1, below). On an encouraging note, real domestic final sales suggest a recovery in demand, while profits from current production actually rose. Net exports and consumption contributed

to growth.

Real Gross Domestic Product



Source: CMC eResearch

Household balance sheets continue to suffer, as falling home prices, a deteriorating labor market, and tight lending conditions have conspired to erode household wealth and access to credit. This weak economic backdrop will remain entrenched in the second quarter. Although personal income rose 0.5% in April, the best gain since last May, spending has fallen for two consecutive months. We expect roughly flat consumption in the second quarter before very modest gains return in the second half of 2009, driven by the massive fiscal stimulus.

Manufacturing

April industrial production and surveys showed moderating declines, consistent with our forecast of mid-year stabilization in manufacturing and modest gains thereafter. Manufacturing industrial production declined 0.2% in April, following March's -2.0%. Further gains in manufacturing could be supported by improved financial market conditions and stimulus spending. Still, recovery will be painful as the auto industry's troubles ripple through the supply chain.

The spike in the index of leading indicators is a fair representation of how much the outlook has improved. Consumer confidence is drifting higher as Washington's policy response boosts disposable income amid more visible signs showing recession is moderating. A sustained improvement in confidence is a key for the economy to find its bearings.

Consumers

April retail sales disappointed, falling 0.4%. Retail sales excluding autos and building materials—as control retail sales—fell 0.5% following March's -1.2%. This drop, combined with no change in headline consumer prices, means real spending likely fell around 0.3% in April. Although the April decline in retail sales is discouraging, we still believe the worst declines in spending are behind us. Energy prices are below their year-ago levels, and households have received federal tax cuts, so consumers have some cash to spend. Another support is lower food prices. Still, spending will not come roaring back.

Housing

We interpret the new housing data as another sign that the government policies aimed at bolstering the housing market (e.g., tax credits, Fed buying Treasuries, and mortgage-backed debt) are beginning to help. Sales of existing homes were up 2.9% in April, to an annualized pace of 4.68 million, with increases in both the single-family and multifamily segments.

Existing-home sales continue to be driven by two forces: distress sales in a few states are driving sales up, while a weak economy is driving sales down across most states. While distress sales could rise further in the short term, they should eventually start to fall. Because they make up such a large chunk of existing-home sales, their decline could create a big drag on overall home sales. That said, fewer distress sales would help stabilize prices and reduce financial-sector losses, cushioning the decline in house prices.

Overall, we expect home sales to gradually increase throughout the remainder of this year as buyers take advantage of the tax credit, which ends later in 2009, as well as lower prices and rates.

Housing starts dropped to a new all-time low of 458,000 units. This was mainly due to a 46% decline in multifamily activity. Building permits showed a similar pattern, with the headline pushed lower by a big drop in multifamily activity.

The market for single-family homes, on the other hand, appears to be stabilizing. Single-family starts are more important for our near-term view of residential investment, and their improving trend sets the stage for a better GDP outcome as the housing slump fades.

Inflation

Inflation, as measured by the CPI, remains exceptionally tame. The overall CPI was unchanged in April and is now down 0.7% on a year-over-year basis, mainly because of lower energy prices, which have shown signs of firming more recently. Excluding food and energy, core CPI rose 0.3% in April, predominantly because of higher cigarette taxes. Overall CPI is the lowest it has been in more than 50 years, and core inflation will likely moderate for at least another year.

We forecast further moderation in core CPI, mainly because of import price weakness. One reason why the massive expansion of the Fed's balance sheet has not fueled inflation is the decline in the monetary multipliers and velocity of money. The slowing velocity of money implies that new money is being created more slowly. That said, once velocity returns, the Fed will need to act quickly to stifle inflationary pressures. This is an ongoing concern.

Employment

Continued consumer weakness will remain a key factor forcing employers to cut jobs, adding to the 5.7 million positions already lost. Even so, recent labor market data have shown some moderation in the pace of employment deterioration, and we expect this to be reflected in the May labor market statistics. Our projection is that non-farm payrolls declined by 500,000 in May. The losses are likely to be split between the goods and services sectors. As the pace of job destruction continues to outpace job creation, we expect unemployment to rise to around 9.2%.

Currency

The U.S. dollar has been range-bound against other major currencies for most of 2009. Fundamental factors favoring the dollar have offset the negative effects of aggressive U.S. monetary easing and fiscal expansion. However, the dollar's recent fall signals a new focus away from sustained global contraction and toward concerns about fiscal policy and inflation.

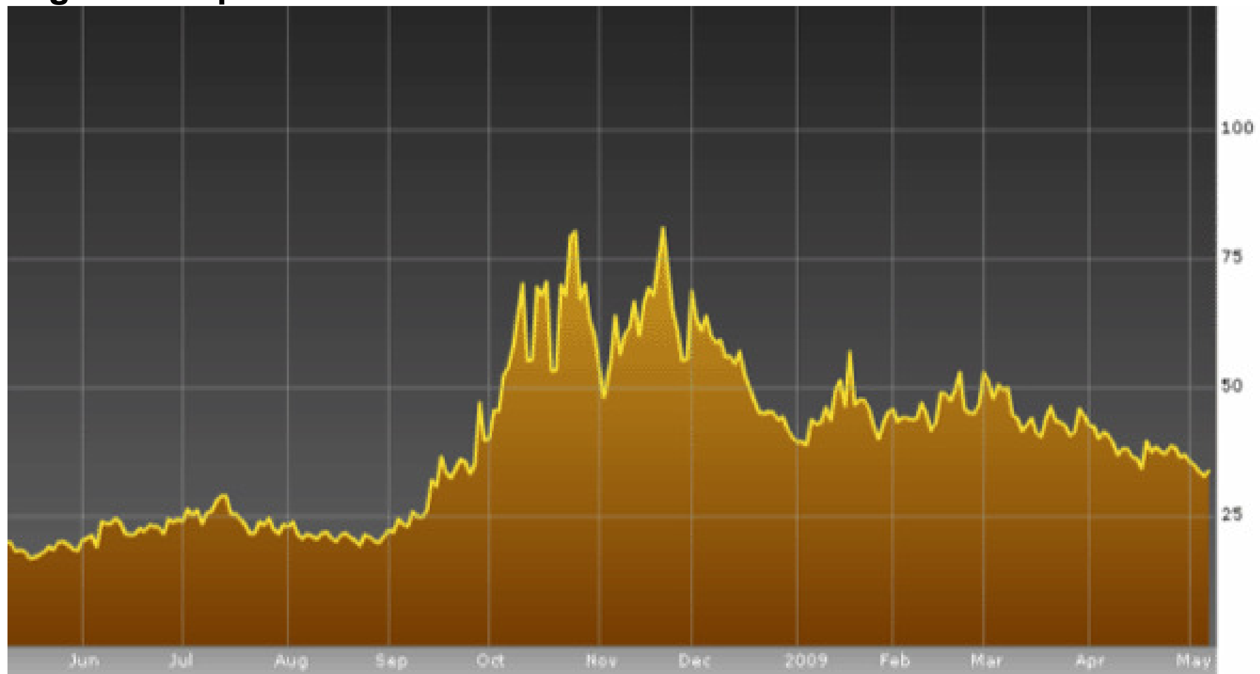
Signs of financial stability have lessened investors' desire for the dollar as a safe haven. Investors have increased their appetite for risk and discounted subdued global economic performance. This may explain the dollar's recent weakness, as well as higher Treasury yields.

Markets

Financial market improvement is encouraging. The VIX (a measure of market volatility) is close to 30 after peaking above 80 late last year (see Figure 2, below). Also, foreign purchases of U.S. equities have increased, which should be seen as a sign of greater

risk tolerance. Short-term interest rates are falling, and credit markets are beginning to thaw. The TED spread—the difference between what banks and the U.S. Treasury pay to borrow—stands at pre-credit-crisis levels.

Figure 2: Improvement in the VIX



Source: Bloomberg

The market rally that began in early March has resulted in a trough-to-peak advance of approximately 40% for U.S stocks. The upturn was dominated by lower-quality investments, with the highest-quality decile up barely 20% and the lowest-quality decile up 150%. That rally was based on a combination of oversold conditions, diminishing concerns about the nationalization of the banking system, the announcement of some new government programs, and, perhaps most significantly, a series of "less bad" economic data.

However, a continuation of the rally will soon require more solid evidence of an economic recovery. It is unlikely that prices will retreat to their early-March levels, but we could see a near-term decline as some profits are taken. Over the longer term, we expect that improving economic conditions will help prices move higher, and stocks will outperform bonds and cash over the next 12 months.

At this point, it seems clear that most investors are more optimistic about the global economy than they have been in some months. Policy makers have been diligent in fighting credit deflation, and we expect the Federal Reserve to continue to promote liquidity by expanding its asset-purchase programs, although we are concerned about

some legislative priorities in Washington. The rapid increases in deficits will become a problem before too long, and once the economy begins to stabilize, the likelihood of higher tax rates will increase. This scenario adds a growth- and market-unfriendly component to our outlook. On balance, we expect to see a slow and below-par economic recovery in the second half of this year, with growth accelerating modestly in 2010.

Despite historical tendencies for sharp recoveries to follow deep recessions, there are plenty of reasons to anticipate a slower process this time. Balance-sheet consolidation by households, businesses, and banks will take time. A huge overhang of unoccupied homes will prevent a cyclical recovery in homebuilding, while efforts to boost saving may slow consumer spending growth. Weaker consumer and manufacturing data also lower the chance that inventory building could push near-term growth higher.

Ultimately, though, the biggest hurdle to recovery is that firms are to slow to rehire, producing a labor market that does not mend fast enough to produce growth this year. If employment does not begin to show more positive signs over the next few months, the recovery may stall into 2010, when fiscal stimulus shifts to a drag on growth. The flow of benefits to consumers is set to peak this month, and further fiscal stimulus is unlikely at the moment. Many believe recent data suggests the need for more stimulus, and for now it will be up to the Fed to provide additional insurance for recovery.

Barry K. Mendelson, CIMA, is the managing partner of Capital Market Consultants, LLC (CMC), a specialized RIA that provides customized investment manager, mutual fund, and economic research as well as portfolio modeling advice to financial organizations and RIAs. CMC Unified Management Account portfolios, based on CMC manager research, are available to RIAs on all major independent custodial platforms.

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