



Copyright © 2010 Horsemouth, LLC. All Rights Reserved.
For the exclusive use of Horsemouth Member: **Barry Mendelson**
SEE BELOW FOR [IMPORTANT RESTRICTIONS ON USE](#).

Build Knowledge/Valuation & Analysis

How Different Economic Sectors Will Recover in 2010

By Barry Mendelson, CIMA
Jan. 21, 2010

As the economy emerges from the downturn, health and some consumer industries are showing early signs of growth. Manufacturing is also perking up, and home sales are rising. However, plenty of potential downside remains. Here's an overview of how the different economic sectors should fare over 2010.

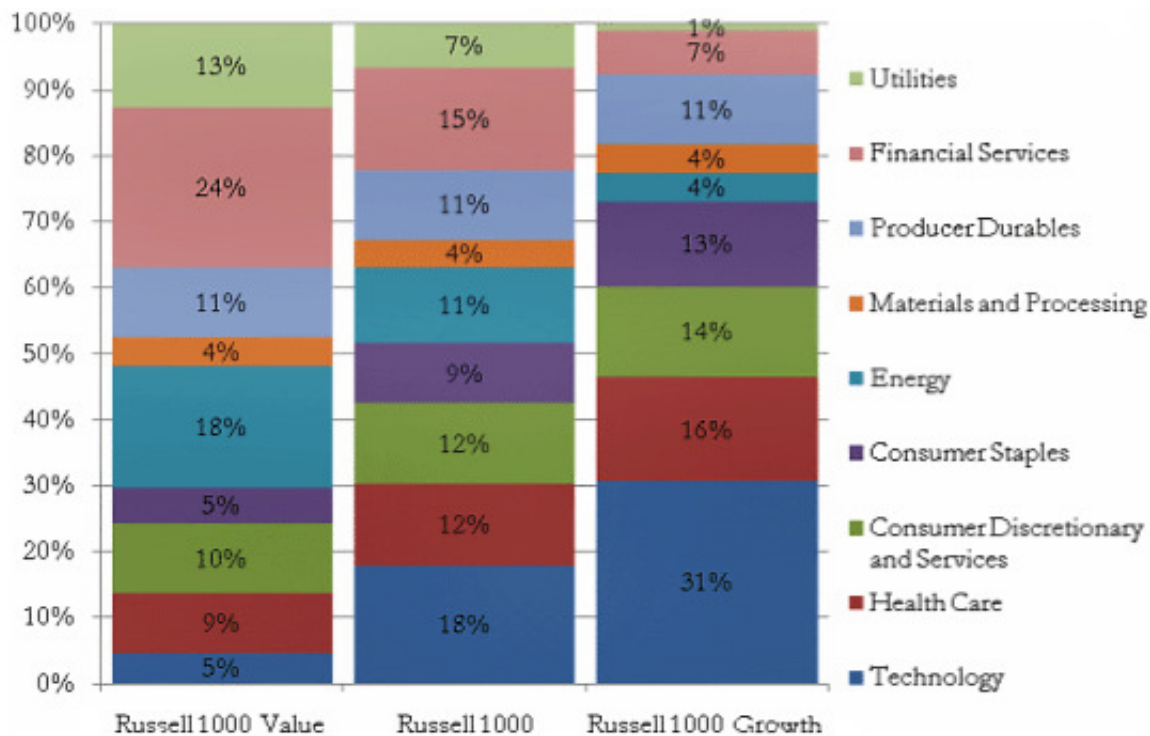
The recession's intensity is easing across the U.S. The entire central region, extending from Texas to the Dakotas, is benefiting from a relatively shorter and shallower recession, a more moderate housing cycle, rising energy and commodity prices since early 2009, and more stable household balance sheets. Much of the rest of the country is still struggling to emerge from the recession. Job losses are slowing, and industrial production is improving nearly everywhere. But housing markets have not definitively stabilized, and consumer confidence remains tentative.

In 2010, many industries, and the economy as a whole, will be in transition. The capital markets are already starting to discount these prospective changes. In short, real GDP will grow, but nationwide payroll employment will not expand before mid-2010. Consumption gains will be tepid, limiting industrial production growth once inventories are rebuilt to desired levels.

Economic sectors

Different economic sectors will react with varying speed to this transition. We review the various sectors, shown in the figure below, to determine which will benefit from improved conditions and how.

Russell Index Sector Weights (12/31/09)



Source: CMC Research

Health care

Health-related industries will lead the recovery. This sector experienced a very short and shallow contraction before resuming growth in the second quarter of 2009. This is typical: health care is a relatively stable recession-resistant industry that meets a vital need regardless of the economic cycle.

Given its mild downturn, we estimate health care returned to its pre-recession high in the third quarter. Provisions in the federal stimulus package to encourage automation in medical record keeping will also boost the performance of medical services and insurance firms. This should be a boost for domestic growth stock indexes, where health care is a more heavily weighted sector.

Financials

Financial services revenues should also be [moving off](#) their recessionary bottom. However, in this case, growth from a year ago does not indicate a return to health for these industries, but rather a lessening of their deep losses stemming from the financial crisis.

Restructuring is helping to stabilize financial services through considerable merger-and-acquisition activity. This has created larger institutions with more liquidity and greater ability to cope with risk.

Because of the deep losses suffered, financial services as a group will not fully recover in the next two years. This has the potential to be a drag on the performance of domestic value indexes, where financials comprise a significant weight.

Consumer

We also expect to see an expansion in consumer and business/professional industries in 2010. Consumer industries and business services are turning around, with rising demand and a slowly growing need for support services.

Amid a stagnant job market, tight lending standards, and poor household credit conditions, consumers will be circumspect in spending. Grocery and other retail spending will recover before more discretionary local entertainment and recreation spending. Though restaurant spending will show solid growth, much of this will be in less costly establishments.

The last segment to recover will be hotels and gaming. Business travel will remain subdued, with job losses continuing into midyear, and vacations will be low on consumers' budget lists. Access to credit is not expected to be as easy as before the downturn, although lending institutions will certainly ease lending standards from current levels. Credit constraints will continue to limit demand growth next year, especially for big-ticket items.

Technology

Investment in software and equipment will increase during the first quarter, but the pace of growth will be subdued for much of 2010. With recovery, some businesses will begin spending for necessary technology upgrades. However, initial output increases in goods and services can often be achieved with current equipment. Just as employment is not expected to increase until the middle of the year, it will take several quarters to fully utilize the technology on hand. This should benefit growth styles, as information technology is a significant weight in growth indexes but a modest weight in value indexes.

Industrials, energy, materials

Last to begin expansion will be the supply-chain industries: energy, commodities, manufacturing, and transportation. These will turn the corner in early 2010 as demand for goods gains traction in the U.S. and globally.

However, [commodities](#) and energy will not return to pre-recession revenue levels until 2012. Energy and raw materials demand is rising with industrial production but will receive even more of a short-term boost from rising commodity prices. Global and domestic industrial output will push energy prices higher in coming quarters. Although demand will come back and prices will move higher, new sources and a more measured pace of economic expansion will keep supply and demand more evenly balanced, thus containing price growth. These factors should be substantially offsetting to one another in terms of style index performance.

Real estate

The recent pattern of rising [home sales](#) will persist, with much of the increase attributable to foreclosures in the pipeline and accompanying low prices. Residential investment will slowly gain steam, accelerating in the second half of 2010.

In contrast, non-residential construction will languish, due to excess capacity in all segments of

commercial property. Vacancy rates are high for offices, hotels, industrial, and multifamily housing. Even retail, which is normally the tightest market, has more available space because of slack consumption. Demand for commercial space will increase, but it will take several quarters to absorb enough space to raise lease rates adequately for new construction to take off.

Thoughts on trade

Many industries are internationally oriented, and the pattern and pace of the global recovery will influence trade in both goods and services. Growth in China, India, Brazil, and other emerging markets is re-accelerating, and exports are slowly recovering. In addition, the [weaker U.S. dollar](#) is helping domestic firms gain a competitive edge in global markets. Canada, the largest U.S. trading partner, is still in recession, as are many European nations. As they recover, industries that produce the goods they import will benefit.

As demand for goods rises in coming quarters, excess capacity will be reduced, and slack in the labor market will diminish. This will put upward pressure on prices at all levels of production. Volatile crude materials prices will increase the fastest, increasing costs at subsequent stages of production. Nevertheless, rising demand will allow those costs to be passed through to the next production stage and ultimately to consumers.

Outlook

The recovery does not yet encompass all industries and regions and is not yet self-sustaining. The performances of regional, state, and local economies are tied to their industrial structures. Areas that relied heavily on manufacturing, housing, and financial services saw some of the largest losses during the recession. Health-related industries largely bucked the recession, and consumer industries, especially grocery retailers, faced only modest contraction.

Risks to the forecast are turning to the upside, as the government contemplates extending or increasing support via tax breaks and additional spending. Some short-term stimulus programs that were successful in reducing auto inventories and cutting excess housing supplies did not create self-sustaining demand, prompting extensions to the homebuyer tax credit. In addition, health care reform will increase demand for medical services and supplies, pharmaceuticals, and insurance.

While we welcome the first "green shoots" in economic activity, we are keeping a cautious stance, and we avoid reading too much into the first signs of cyclical improvement. A more optimistic outlook would require the fulfillment of a series of sequential steps: the quick rebalancing of supply and demand at the industrial level, a recovery of global trade, and a substantial improvement in the [banks' ability to lend](#). In turn, given the massive front-loaded job-shedding right after the Lehman collapse, a genuine recovery in demand could lead firms to resume hiring sooner than we currently expect.

Inflation fears have resurfaced on the market, spurred by signs of improvement in business sentiment and a more pronounced acceleration in oil prices. In order to have CPI inflation rising toward 4% over the next year or two, we need a shock on commodity prices very similar to the one seen in 2008, together with a substantial (and unlikely, in our view) instability in core prices through the end of 2010. Moreover, at this juncture the inflationary impact of massive liquidity injections does not overly worry us. We believe inflation will remain low.

Therefore, we remain confident in our long-held view that, over the forecast horizon, the risk of too-low inflation outweighs the one of excessively high inflation. We continue to believe that industries more heavily weighted in the growth indexes are likely to cause outperformance vs. value indexes.

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.

IMPORTANT NOTICE

This material is provided exclusively for use by Horseshmouth members and is subject to Horseshmouth Terms & Conditions and applicable copyright laws. Unauthorized use, reproduction or distribution of this material is a violation of federal law and punishable by civil and criminal penalty. This material is furnished "as is" without warranty of any kind. Its accuracy and completeness is not guaranteed and all warranties express or implied are hereby excluded.