

## *Market Zigzags on Inconsistent Data*

The second quarter of 2011 started out on a strong note. The Dow Jones Industrial Average reached a recent high of 12,810.54 on April 29<sup>th</sup>. The quarter started out with definitively strong data. During March and April growth in the U.S. manufacturing sector was hitting levels that have not been seen since 2004. The Institute for Supply Management (ISM) said its index of national factory activity had reached 61.2 in March and 60.4 in April. Those readings had topped expectations. A reading above 50 indicates expansion in the manufacturing sector, while a number below 50 means contraction. The unemployment rate for March (that is reported in April) had dropped below 9 to a rate of 8.8%. The Federal Open Market Committee (FOMC) statement released on April 27<sup>th</sup> was also somewhat optimistic stating that “the economic recovery is proceeding at a moderate pace and overall conditions in the labor market are improving gradually. Household spending and business investment in equipment and software continue to expand.” So it looked as if the economy and the markets were starting to gain some traction. However, by June 10<sup>th</sup> the Dow had slipped to 11,951, a drop of almost 7%. How quickly things had changed. What did the market miss? How could attitudes change so quickly? The list of factors is obvious but also not new. So it is somewhat troubling to see the market move so quickly to news that is not necessarily a surprise. Some of the economic data turned less positive, but the big driver of negativity was the Greece debt crisis and a fear of default contagion spreading around the globe. Other contributing factors included: the end of the Fed’s quantitative easing program on June 30<sup>th</sup>. The market and the public have been well aware that the Fed is no longer going to buy long dated government bonds in the open markets. Over the last 6 months this strategy has successfully kept long term rates near 3%. It is a given that longer term rates will start to move up. The ISM index dropped 8 points to 53.5 in May. This was a surprise. According to the S&P/Case-Shiller Index, housing prices, which had a recent peak in September of 2010 continued to slide back to levels that we saw in May 2009 and then you have to go back to 2003. Then, on June 22<sup>nd</sup>, the FOMC did not help matters with their less than optimistic press release. “Information received since the Federal Open Market Committee met in April indicates that the economic recovery is continuing at a moderate pace, though somewhat more slowly than the Committee had expected. Also, recent labor market indicators have been weaker than anticipated. The slower pace of the recovery reflects in part factors that are likely to be temporary, including the damping effect of higher food and energy prices on consumer purchasing power and spending as well as supply chain disruptions associated with the tragic events in Japan. Household spending and business investment in equipment and software continue to expand. However, investment in nonresidential structures is still weak, and the housing sector continues to be depressed. Inflation has picked up in recent months, mainly reflecting higher prices for some commodities and imported goods, as well as the recent supply chain disruptions. However, longer-term inflation expectations have remained stable.” Then, out of nowhere, the market decided it was time to stop worrying so much. The start of a 4 day rally

of about 12,500 on the Dow. This level can be maintained but probably won't go much higher until unemployment levels start to fall below 8%.

### Pros

The ISM Index – Has not been below 50 since July of 2009. The manufacturing sector has been strong thanks to a weak US dollar and the Fed's reluctance to increase rates. Historically, the manufacturing sector has led a sustained economic recovery.

Continuing Claims/Unemployment Insurance – The number of continuing claims for unemployment has dropped dramatically from March of 2009. It peaked at that time at 6.5 million and is now down around 3.5 million. The labor market is improving but obviously some of those continuing claims have dropped because of limits on the length of benefits. However, new claims have been dropping in lock step. This is a good sign, but a slow one.

Federal Funds Rate – The Fed has chosen to keep short term rates at near 0% for the foreseeable future. In their opinion, long term price instability is not a risk. As the short term rates stay low, so do rates on prime rate adjustable loans as well as the billions of dollars of adjustable rate mortgages in the system. Lower rates on these consumer loans keep the consumer spending.

Consumer Balance Sheets – A widely followed consumer metric is the financial obligations ratio, which compares consumer financial payments to income. Obligations measured include mortgages, rents, car payments, lease payments, credit cards, and other loan payments. This ratio peaked at almost 18.9% of income in 2007 and has subsequently dropped to 16.4% for the first quarter of 2011, its lowest level since 1994 and below the 30-year average of 17.2%.

### Cons

Oil – Oil prices remain painfully high, although off their recent highs. Oil has been hanging around \$95 a barrel which equates to about \$3.75 at the pump. Historically, gasoline under \$3 a gallon has been stimulative for the economy as consumers have more discretionary dollars to spend on items other than gasoline.

Long term Interest Rates – The end of QE2 (The Fed bond buying program) is here. The 10 year US Treasury Note went from 2.87% on June 24<sup>th</sup> to 3.20% on July 1<sup>st</sup>. Yields jumped 1/3 of a percent in a week! The effect on housing is obvious. The result will not be instantaneous, but will merely keep housing depressed for the near future.

Housing - As noted above, home prices reversed the short uptrend they were experiencing from the March 2009 lows. As interest rates go up, it is all but certain that housing will remain stagnant. The biggest economic impact of stagnant housing is the lack of available easy credit for consumers from home equity lines of credit.

### Outlook

Our investment philosophy is to find quality companies that are exhibiting earnings momentum and are priced at a level that allows for growth in share price. When you break that down, our job is to identify companies that have proven track records but are still innovative enough to find new ways to grow on a consistent basis. The tricky part is identifying those companies that have not already been bid up to levels that do not make it possible for further gains in share price based on the current information. With that said, our analysis of the equity markets as a whole leads us to believe that a current equilibrium is around 12,500 to 13,000 on the Dow. "Current" is only good for today and the very near future. If second quarter corporate earnings come in strong or stronger than expected; we could see at least 5% upside on the stock market. We feel strongly that this upside is still limited by job growth. There is not a silver bullet anywhere that can fix job growth. The reality is that it will just take time. Current economic conditions suggest that job growth could reach 200,000 new jobs per month. At 200,000 per month, we could see the unemployment rate under 8% by the end of next year. We see the biggest risks for the slow and steady growth scenario coming from inflation and a severe slowdown in China. The Fed is confident that current inflationary pressures are transient. Most economists agree that China is headed for a "soft landing" which implies a gradual and healthy slowdown. We will vigilantly monitor these situations with a sharp eye towards domestic job growth. Given these factors, our stock market forecast for the next 2 years is an average growth of 10% per year with moderate volatility.