

INSIGHTS ON FRONT STREET



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THE WALLS ARE MORE THAN WORRIES

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It is fair to say that we are perplexed by the huge stock market rally off the March bottom. The bulls believe the market is just “climbing the wall of worry” as it always does. The “walls” we see are more than just worries. These walls are long-term structural problems in the economy that will not be easy to climb over and should hinder economic growth for years to come. We think that makes stocks very risky assets at current prices.

We respect the fact that bull markets normally do climb a wall of worry coming out of a recession or a sudden and severe financial crisis. The stock market rises on the relief that the actual economic data turned out to be better than what investors were worried about.

Today’s bullish investors argue that this is what has happened this year. The market had crashed to the March lows based on fears that our economy (and the global economy for that matter) was heading into a financial abyss. By avoiding the abyss through the use of massive amounts of government spending and guarantees as well as some accounting tricks by the banks, the stock market has recovered about half of its decline from its peak in 2007.

We get it. The economy is better off than it was a year ago. We would expect to see some improvement with the banking industry back up and running and those stimulus programs encouraging people to spend. And with the Federal Reserve keeping savings rates near zero, they are doing their part to entice people to do something else with their money than put it in a bank.

But how much better is the economy? How sustainable is this growth? Is it enough to justify a

65% rally from the market bottom? Are these worries of ours as unimportant as the market makes them look today? Have we really missed the start of a new secular bull market? We still don’t think so.

The bulls believe that while the recession was a bad one, it was just a recession. Therefore, using history as a guide, an economic recovery is right around the corner. Businesses will invest, consumers will shop and corporate profits will grow. It is just that simple.

Having friends and family members who have hit their own personal walls of financial difficulties from this Great Recession we would like to believe that scenario. However, the so-called recovery we have seen so far is not suggesting that will be the case. Let’s look at the data.

Job growth (and higher wages) is one of the biggest hurdles that we will have to overcome to get this economy on a higher and more sustainable growth path. Since the stock market started to rally in March the United States has lost over three million jobs and the unemployment rate has climbed to 10%. We would expect to see the unemployment rate actually rise in the months to come as more people re-enter the labor market.

While the number of job losses has substantially declined from the extremely high numbers a year ago (a favorite "less bad" statistic for the bulls), we see little hope for large gains in the job market anytime soon. In the month of November there were almost 48,000 fewer people hired than in October, which was the worst in over two years, according to the Challenger, Grey & Christmas Employment Survey.

The bulls believe that companies were too severe in the number of people they fired this past year. They will have to rehire many of them as production is increased to replenish the inventories of goods that have been depleted. That may be the case but there is another wall to overcome before that new job is created.

There are currently 9 million people working part-time who want full-time jobs. Also, the workweek is at a low 33.2 hours. Therefore, companies will first increase the workweek and then put part-time workers back to full-time before they hire new workers.

The bulls will also point out that existing and new home sales have been strong over the last few months. Once again we have our government to thank for that good news because of the tax credit for first-time homebuyers. The question is, did that government program create new sales or just take from what would have been future sales. We shall see in the next few months, especially with the FHA looking to tighten their lending standards.

Unlike the bulls, we think that falling home prices are still a major obstacle for future growth. We believe the studies that show that there is a large "shadow inventory" of homes that banks have foreclosed on but have not put on the market to sell. And to make matters worse, over the next couple of years there will be another wave of foreclosures as Option ARM mortgages that were so popular on 2005 through 2007 begin to reset at a higher payment levels and mortgage balances that are much higher than the appraised values of the homes.

Lastly, the bulls point to the better than expected corporate earnings as a reason for this rally. While earnings were better than expected, revenues were disappointing. In fact, revenues were down by a substantial amount. In order to achieve the earnings expectations next year we are going to have to see revenue growth of close to 10%. Good luck with that.

Like it or not this will not be a typical economic recovery because we are coming out of a different

type of recession. Normal recessions are caused by rising inflation and interest rates and excess inventories. Once the inflationary pressures recede, the Fed cuts interest rates and production increases to meet rising demand and the economy is back on track and growing again. The worries are easily resolved.

The Great Recession was caused from the bursting of the real estate bubble that was the result of a decade of easy credit. Our economy expanded on the ability of almost anyone with a pulse to be able to get credit, whether from multiple credit cards or home equity loans. Those days are over.

We are in what we think will be years of credit contraction, and therefore, deflationary pressures on assets, especially real estate. The credit lifelines have been pulled from many people and severely reduced for others. That has limited their ability to quickly recover from the financial strains they are currently experiencing. Many more people are going to hit their personal wall of financial stress or ruin before this economy is on more solid footing, in our opinion. The timing of that will depend to a large degree on the government lifelines that continue to be extended.

Speaking of our government, the largest wall that we as a nation will have to confront with in the years to come is the debt we are accumulating at over a TRILLION dollars a year. Even using the Obama administration's estimate of a 4% annual economic growth rate (which we think is too optimistic) we will still be looking at \$10 TRILLION of additional debt in ten years. State and local governments have some sizable walls (budget deficits) of their own to overcome over the next two years.

We think these walls are real obstructions to our economy's growth over the next few years. The exact timing of their effects is not clear. However, they will be a drag on our economy as we make our way over them. We don't believe that current stock prices reflect this risk, which is why we remain in a protective mode.

Maybe it will turn out that we are too pessimistic about this recovery. Maybe we can borrow, tax, and spend our way into prosperity. Maybe our walls are just worries that we will easily be able to surmount. We should know the answer to that soon.

