

# INSIGHTS ON FRONT STREET



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## HOPE IS NOT AN INVESTMENT STRATEGY

AUGUST 2010

Just to frustrate the bears one more time, the stock market broke down to a new trading low (down 16% from the April high) on July 2<sup>nd</sup> only to turn around and rally up 9% into the first week in August. Investors concerns about a “double-dip recession” faded away with better than expected corporate earnings announcements for the second quarter. Those better earnings did not sway bond market investors as they remain concerned about future economic growth as evident by the sub-3% ten-year U.S. Treasury yield. We believe these stock market rallies are based on hope, not the reality that we see. Hope, as you know, is not an investment strategy.

Over the last nine months the stock market seems to be suffering from a manic-depressive illness or bipolar disorder. It seems that these investors are either giddy with excitement about hopeful signs for a better than expected economic recovery or they are depressed at the thought of a double-dip recession. There is no in between. But through all of that volatility the S&P 500 is only up about 1% year-to-date.

On the other hand, bond market investors have earned about 7% this year as they have remained consistently skeptical about the sustainability of this economic recovery. In addition, bond investors are growing more concerned about the real possibility of deflation as the core rate of inflation (excluding food and energy) gets closer to zero.

This so-called recovery has been much weaker than past ones despite the depth from which it started and the huge stimulus programs by the federal government and the Federal Reserve. Had it not been for the rebuilding of inventories and the significant increase in business investment in equipment, this recovery in GDP growth would have averaged closer to 2% than 3% and unemployment would have been significantly higher.

Speaking of unemployment, the July employment report was another disappointment for the bulls. Private payrolls (excluding the census workers) were only up 71,000 in July and that was after 31,000 in May and 51,000 in April. The only reason that the unemployment rate remained at 9.5% was that an additional 181,000 people gave up and left the labor market. Over the last three months the labor market has declined by 1.2 million people.

In a normal economic recovery people who were previously discouraged and not looking for a job re-enter the labor market as companies begin to hire. Had that happened in this recovery the unemployment rate would now be around 12% or higher.

The actual unemployment rate that includes discouraged people and those working part time but wanting full time rose to 16.8% in July. The percentage of the unemployed who have been looking for a job for over six months is around 45%. Many of these people are over 45 years of age and are falling behind in their skills. That will make it even more difficult for them to find a job at a similar pay level to the job that they lost.

We have to admit that on the surface it is difficult to reconcile the economy as we see it and the strong recovery in corporate earnings that we have seen over the last year. It is understandable that the bulls have grabbed on to that news to rationalize their positive views of the market. The fact is, however, when you take off the rose-colored glasses and dig a little deeper into finding out the sources of the revenues and earnings growth, you begin to question the very optimistic estimates going forward.

Most of the better than expected growth in the top and bottom lines of the companies' income statements was due to sales to faster growing economies in Asia or South America or to sales of capital equipment or other materials to replenish inventories. There are now indications that inventories are back to desirable levels and that these faster growing economies are now also beginning to slow.

The higher the targeted customers are up the income stratum the better business was in the U.S. However, many companies commented that their customers were much more discerning about their purchases. *Need* seemed to be trumping *want* as the motivation to buy no matter what the income level was.

The obvious answer as to why corporate earnings have been so strong is because of gains in productivity and continued cost cutting. The disappointing employment numbers are proof that companies are hesitating to add to their payrolls despite the improvement in business conditions. We don't see how this recovery can be sustained at a 2% to 3% growth rate without a significant pickup in job growth.

Many companies, including banks, have said that demand for their goods or services remains below levels that would give them confidence in the sustainability of the economic recovery. They are "cautiously optimistic" about the recovery but are not yet ready to invest their cash to expand their operations. The fact is that most industries still have a considerable amount of excess capacity.

Because it represents 70% of the economy, the future strength of this economic recovery is closely tied to the future strength of consumer demand. The strength of consumer demand is depended upon higher income and/or wealth, which are depended upon job growth and higher asset values, especially financial assets and real estate.

With weekly jobless claims rising again, we do not see the job market getting stronger anytime soon.

Other leading indicators of job growth are also suggesting that employment growth rates are peaking. For example, temporary hiring actually fell in July. If, in fact, job growth remains below normal after 8.4 million people lost their jobs in the Great Recession, it will be 5 years or more before those people are reemployed. That is not encouraging for future demand.

As consumers keep paying off credit card debt and the availability of debt continues to decline, we don't see how consumption can grow to the levels that are assumed by the Wall Street analysts' earnings estimates for the next year. Consensus estimates expect 12-15% earnings growth next year, which we think is a very high hurdle to achieve.

Last but not least, we believe that real estate prices will continue to decline for some time based on the supply of real estate currently on the market and the number of properties that are in or near foreclosure and will be on the market in the years to come.

Laurie Goodman, a Senior Managing Director with Amherst Securities recently published a paper in the Financial Analysts Journal entitled "Dimensioning the Housing Crises". In it she stated that there have been about 1.5 million homes liquidated through foreclosure and short sales since 2006. During that time home prices fell 20 to 35% nationally. Her analysis leads her to believe that another 11 to 12 million homes will be liquidated over the next few years. If that turns out to be even close to what actually happens housing prices have much further to fall, which would continue to be a severe deflationary drag on the economy.

In addition to all of these factors, the leading economic indicators that we have been following still point to a significant slowdown in the economy going forward. As long as that is the case we will be forced to remain in a protective mode and focused on income generating investments.

In our opinion, to be bullish about the stock market at this point when the actual data are as troubling as they are and the leading indicators are still pointing down, requires a lot of hope that the economy will actually turn out better than the indicators suggest. We need more than hope to put our clients' money at risk.

