

INSIGHTS ON FRONT STREET



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FROM LESS BAD TO LESS GOOD

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The stock market sold off strongly in May (down almost 8%) but was able to hold on to the February lows of 1040 on the S&P 500 Index. That amounted to a correction from the April highs of a little over 12%. Those investors and market strategists who use technical analysis to forecast the market's future have taken solace by the fact that the stock market had put in a "double bottom", which is a bullish price pattern. This means, according to them, that the bull market has resumed. We remain skeptical about these bullish forecasts because we have seen many signs that the economy has gone from being "less bad" to "less good".

As we have stated many times before, we believe that the 82% rise in the S&P 500 Index from the lows in March of 2009 to the highs in April was way overdone when considering what has actually been going on in the economy. The rally in the market began when the economic news became *less bad* from *very bad*. Even as the stock market peaked in April only a few of the economic indicators were considered to be good and they were primarily in manufacturing.

While the economic numbers were obviously much better than they were in the depths of the recession they were surely not describing a strong recovery. And that was with the tremendous amounts of fiscal and monetary stimulus programs put into action over the last 20 months.

Now in the last month or two we have seen economic indicators that are less good. Some of the weaker numbers have to do with the government stimulus programs coming to an end. Others are related to the high unemployment rate and the fact that personal income continues to increase at less than the inflation rate while credit lines are still being cut. Consumer confidence in the economy is still at recessionary levels despite the improvement.

What we find most disconcerting about the outlook for economic growth over the next six to twelve months are the declines in two major leading economic indicators. The Economic Cycle Research Institute's (ECRI) Weekly Leading Index has declined to where it was last June, a 47-week low. This same pattern occurred coming out of the last recession in the second half of 2002, which was not a good time to be invested in stocks.

The managing director of ECRI, Lakshman Achuthan, recently stated that "U.S. economic growth is set to start easing in fairly short order". David Rosenberg, the Chief Economist with Gluskin Sheff & Associates, who closely follows the ECRI Weekly Leading Index, says that this Index is now forecasting a dramatic slowdown in real U.S. GDP growth to only 1.5% in the second half of this year.

The Conference Board Leading Economic Index (LEI) declined .1% in April, the first decline in more than a year. That is very rare in the first year of a recovery. Its six-month growth rate has moderated since December, which is also suggesting that the economy's growth rate will decline over the next six months.

While the latest Institute of Supply Management's (ISM) Purchasing Managers Index showed that manufacturing was still strong in May, it was down from the prior month. We think this Index will show that it has also peaked in April and that manufacturing will be slowing as inventory building subsides.

Outside of manufacturing, the ISM non-manufacturing index also looks like it has topped out at a level that suggests only moderate economic growth of about 2.5%. That is significantly below consensus expectations for 3.5% real GDP growth in 2010.

The government's \$8,000 and \$6,500 tax credits for first time and some repeat home buyers helped boost existing and new home sales in March and April as the program came to an end. However, we believe that the tax credits pushed future sales forward and that we will see significant declines in sales in May and beyond. In fact, mortgage applications for new purchases have fallen to a 13-year low, down over 18% in May alone.

There have been reports that home prices have found a bottom and are increasing in certain areas of the country. That may be but there are also reports that the number of foreclosures is increasing as many people *choose* to stop making their mortgage payments (aka, strategic defaults). We will also see more defaults from the resets of the option-ARM and Alt-A mortgage loans over the next year. This will cause banks to bring more of the "shadow inventory" of homes on the market, which we think will drive real estate prices lower.

Retail sales were stronger than we expected in the first quarter of this year but there are signs that consumer spending may be less in the second quarter. The managements of many retail companies have commented in their first quarter results that their customers are still being very conservative in their spending, especially for the lower-end mass merchandisers. Sales for May were recently described as "tepid" for many retailers despite the comparison to depressed sales a year ago.

Automobile sales increased in May but that was only because the federal government ordered a large number of cars from their very own General Motors. That is one way to help GM payback the loan to the taxpayers.

Although exports are a relatively small part of the U.S. economy, we will feel the economic effects of a severe slowdown in the European community. Most

countries in Europe are taking steps to cut their deficits by decreasing spending and raising taxes. The real concern is whether or not China will be experiencing as much of a slowdown as their leading indicators are suggesting.

The United States will be experiencing its own fiscal tightening over the next few years in an effort to reign in the exploding budget deficit. Higher taxes and spending cuts will reduce growth next year and beyond. As a result of this global fiscal tightening, we think most companies will be more conservative with their future hiring and investments into new plant and equipment.

Besides the concerns of the sovereign debt issues in Europe and the massive and ongoing oil spill disaster in the Gulf of Mexico, most investors are focused on the monthly employment reports. While the companies are hiring again, the numbers are nowhere near high enough to put all of the 8.5 million people who lost their jobs in the Great Recession back to work in the next 5 years. The employment report for May was very disappointing and supported our outlook for a weak economy in 2011.

With short-term interest rates already close to zero and American voters' growing hostility towards trillion dollar deficits (and towards the politicians who vote for the spending that causes them), it is very troubling to think of a double-dip recession in 2011. It brings the fear of deflation to the forefront of our list of worries.

Obviously if the leading indicators, slowing retail sales and low job growth are harbingers for much slower growth in 2011 then the stock market is vulnerable to the eventual realization that corporate earnings will be much less than expected in 2011. Stock market returns tend to be less than exciting when the economic indicators become less good. They become outright dismal when deflation becomes a reality and not just a fear.

While we have used the recent volatility in the stock market to add some new equity positions to the portfolios, we are still focused on dividend income, strong balance sheets and low stock prices as part of our defensive strategy. We have also maintained our hedges to keep the net exposure to the stock market at very conservative levels as we wait for a much better buying opportunity.

