

# INSIGHTS ON FRONT STREET



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## **LESS BAD IS STILL NOT GOOD ENOUGH**

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Despite the largest industrial bankruptcy in U.S. history and another government takeover (General Motors), “hope springs eternal” on Wall Street. The stock market rally continues to be fueled by various economic numbers that are “less bad” than the numbers we were seeing when the economy fell off a cliff in the fourth quarter of 2008. Still, less bad news is just not a strong enough reason to put our clients’ money at risk at this time.

The S&P 500 Index is now above its 200-day moving average and that has some investors convinced that this is a new bull market. We would like to believe it but our analysis of current economic conditions and our forecast for very slow growth going forward lead us to think that the upside potential from here is limited and the downside risk substantial.

While the stock market has risen about 40% from its bottom in March, the S&P 500 Index is only up about 4% year-to-date. We’re very content with having avoided this roller-coaster ride and continue to focus on providing a much smoother experience.

This current rally in the stock market was not totally unexpected by us but the magnitude was a surprise. As we had mentioned in our March newsletter, we knew it was possible that the stock market would react positively to “less bad” economic reports. In fact, we debated about increasing our clients’ exposure to stocks at the market bottom in early March. However, we decided not to because of the downside risk we still saw based on historical precedents in previous bear markets.

The fact that we have seen a number of “green shoots” or economic statistics that show a slower rate of descent was to be expected. Our economy and those in many other countries around the world were in a free fall in the final quarter of last year. Credit had frozen up and consumer spending was in rapid descent. The stock market was crashing to new lows and home prices were showing no sign of bottoming. Trillions of dollars of wealth were evaporating and people in or near retirement were scared to death about their ability to fund their current lifestyle.

Through massive bailout programs for the largest institutions in our financial services industry credit has started flowing again. People and companies with good credit scores and documented abilities to pay back loans can get them although there are a few more hoops to jump through. Credit lines are not as generous as they use to be but are adequate in most cases. This alone has made economic conditions *less bad* and in some instances even better than they were six months ago. However, let’s not get carried away with this less bad news. It’s not yet good news. We still have a lot of serious problems to contend with.

For instance, housing prices are still falling, having declined by 19.1% year-over-year in the first quarter of this year according to the Standard & Poor's/Case-Shiller National Home Price Index. There is 10 months of supply of homes on the market unless you have a home priced over \$700,000 in which case there is 40 months of supply currently on the market. Real estate experts believe that many banks have homes that they have foreclosed on that have not yet been put on the market so these inventory figures are probably low. Home prices surely have further to fall.

The employment numbers are still heading south even if the monthly job loss is less bad than it has been. The U.S. has lost over 6 million jobs since the recession began in December 2007. That is the biggest decline in history. The unemployment rate was 9.4% in May and will soon be over 10%. Those of us living in Michigan could see its unemployment rate peak at 20%. Rising unemployment means little if any income growth unless unemployment benefits keep getting extended.

Consumer spending, which represents 70% of the economy, is still falling compared to last year as the consumers react to the massive decline in their personal wealth as well as actual or potential job losses. Their sources for credit like credit cards and home equity lines have been cut back or eliminated in many cases.

Their savings rate rose to 5.7% in April from 4.5% in March and could approach the 8 -10% range in the not so distant future. People have learned that depending on the price of their homes and the stock market to make up for their past half-hearted effort to save was a serious mistake that may cost some retirees a comfortable retirement or the ability to actually fully retire. They will continue to spend less and save more in the future.

Besides our concern about a substantial long-term slowdown in consumer spending, we worry even more about what has happened to America's capitalist economy. In their combined efforts to save the financial system and jobs and to try to keep interest rates low, the federal government and the Federal Reserve have taken the concept of "bailouts" to a whole new level. They are throwing around trillions of dollars as if they were "only" billions and *guaranteeing* almost everything

in sight. The government (and that is us) now owns a majority of General Motors (a.k.a. Government Motors), AIG, Fannie Mae, Freddie Mac and has numerous large holdings of warrants and preferred stock in several banks like Citigroup. Although the Obama Administration says they don't want to interfere with the day-to-day operations of these businesses we can all expect more regulations going forward.

The massive multi-trillion dollar budget deficits that are expected over the next five years or more are currently wreaking havoc on the value of the U.S. dollar and causing longer-term interest rates to rise. The weak dollar has caused the prices of oil and other commodities (that are priced in dollars) to rise. Gas prices are climbing again. The federal and state budget deficits will also bring about various taxes increases in the not to distant future.

The "bond vigilantes" (active bond investors) are nervous about the trillions of dollars of U.S. Treasury notes and bonds that will have to be sold in the market to fund these deficits. They are even more concerned about the rising risk of future inflation. The Federal Reserve has been printing a lot of money to provide adequate liquidity and to keep interest rates low. At some point they will have to figure out how to take that money back when the economy improves without jeopardizing what little economic growth there is. That won't be easy.

So with all of these serious problems confronting the economy and the stock market now and into the future, we are treating this rally as if it is possible the bear market is still alive and well. We are focusing on earning income with bonds and dividends for our clients until we see a better economic environment for growth or much cheaper stock prices.

