

October 1, 2009

The Wall of Worry

The stock market tacked on a solid third quarter gain of about 15%, continuing the trend that started late in this year's first quarter. The last six months of trading has produced a gain of 32.5% in the S&P 500 index, it now stands a remarkable 56.3% above the closing low of 676 set on March 9th of this year. From our perspective it's hard, if not darn near impossible, to argue with results, and stock investors who stuck it out in the grim months prior to the recent rebound saw a nice uptick in asset values. The crocus bulbs of spring developed better than could have been expected, and it's nice to see patient investors rewarded when so much of the focus of the financial markets has been on short-term results. We feel it's well worth the effort to review some of the events that got us to where we are now, and more importantly, to look at the financial landscape for the months ahead.

Government stimulus programs have clearly had a positive impact on economies around the globe. Here at home, a number of programs have kicked in; \$787 billion of government spending, the \$8,000 tax incentive for first time home buyers, the now defunct \$4,500 auto cash rebate for clunkers, plus a host of lending programs targeting troubled sectors such as autos and banking. The just released final GDP (Gross Domestic Product) for the second quarter shrank a less than expected 0.7%, and as much as 3% growth is forecast for the just completed third quarter. Restocking of depleted inventories due to increased confidence of a return to growth by industry executives has been a major contributor to the GDP numbers. The closely watched Index of Leading Economic Indicators has now increased for the fifth consecutive month through August. Implementation of programs within the stimulus package takes time, and will be a tailwind to the economy in the months ahead. Further, there is discussion in Washington about extending or expanding programs aimed at helping residential housing, generally acknowledged to be the cause of the financial meltdown in the first place. It is widely expected that the recession that began in December 2007 will be declared officially over in the just completed third quarter.

With all the money being spent solving our economic problems, it's no wonder that the stock market went up. Investors so far have overlooked the huge increase in the budget deficit, instead focusing on the potential for a rebound in earnings. We believe investors have it right, and that when third quarter earnings are reported later this month, their optimism will prove correct as company's meet and perhaps beat analyst expectations. However, looking at earnings reports over the prior several quarters, it would seem that companies have squeezed just about all the savings they can out of expense control and reductions in employee headcount. Investors will now be looking more closely for revenue growth. At some point, corporate revenues must grow in order to provide sustainable long-term growth in earnings, the key to higher stock market valuations.

With the holiday selling season not that far ahead, retail sales will be closely watched for signs that the consumer is alive and spending.

Through the summer months, durable goods orders and retail sales, although not robust, were modestly higher and slightly above expectations. Auto sales near the end of the third quarter and for all of the fourth quarter will be sharply lower due to the expiration of the cash for clunkers rebate program, so any tailwind to sales from that sector will no longer exist. With unemployment approaching 10%, and the underemployment rate (the sum of those unemployed and those forced to work reduced schedules) almost 16%, retailers will be competing fiercely for consumer dollars. Although unemployment is a lagging indicator, we believe that any signs of a recovering jobs market will be well received by stocks.

Bull markets are said to climb a “wall of worry”, so before signing off, let’s fret for a few minutes. There is no lack of issues over which an investor can find concern; unemployment, budget deficits, health care reform, weak dollar, trade imbalances, high-energy prices, and high housing inventories to name a few. So there, we listed most of the concerns of the last year in just one sentence. For those still worrying, please reread the first two sentences of the first paragraph of this piece.

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Scoreboard through 3rd Quarter 2009

Dow Jones: +10.7%
S&P 500: +17.0%
Nasdaq: +34.6%



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