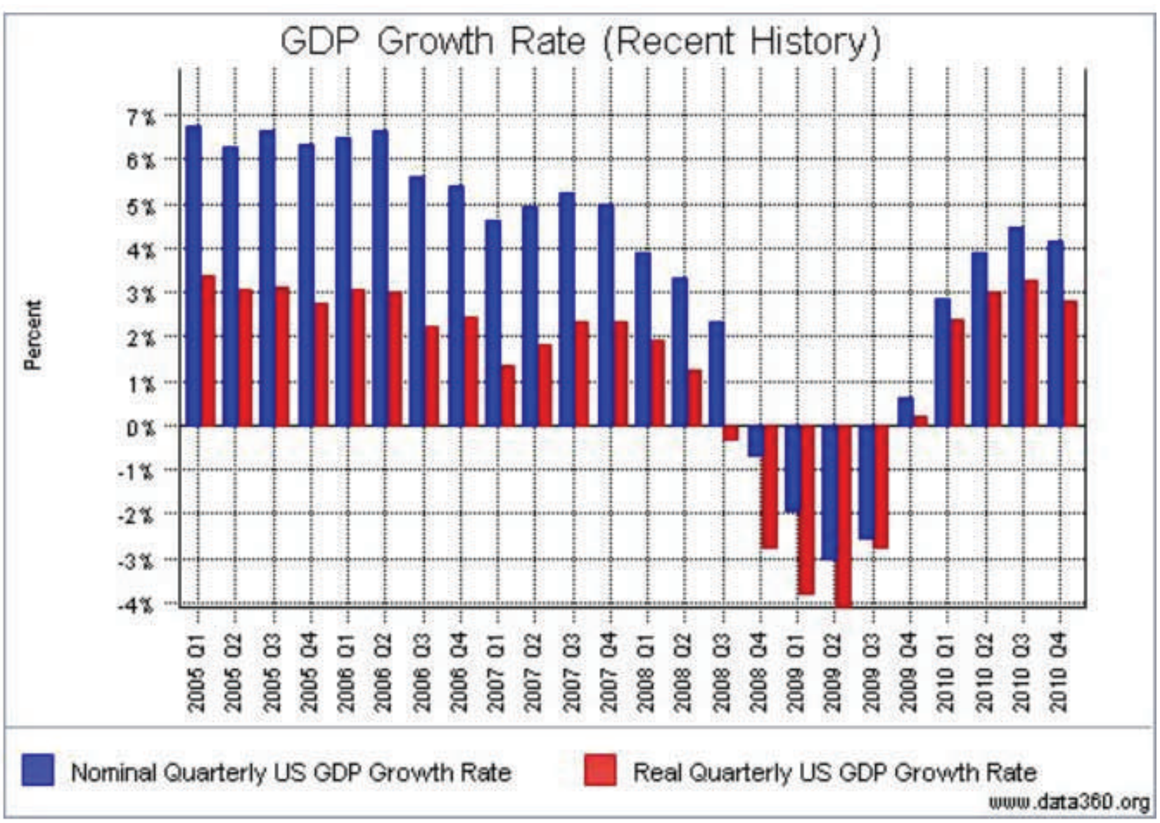
TROUBLE EVERYWHERE ... AMID *RISING* MARKETS?

Over the last few weeks, a number of clients have wondered why the capital markets would be advancing in the face of acute unrest in Egypt, Libya, and Syria, not to mention the two-part disaster that has befallen Japan. The supposition is generally that additional military conflict, oil disruptions, price shocks, and other supply disruptions could derail the recovery.

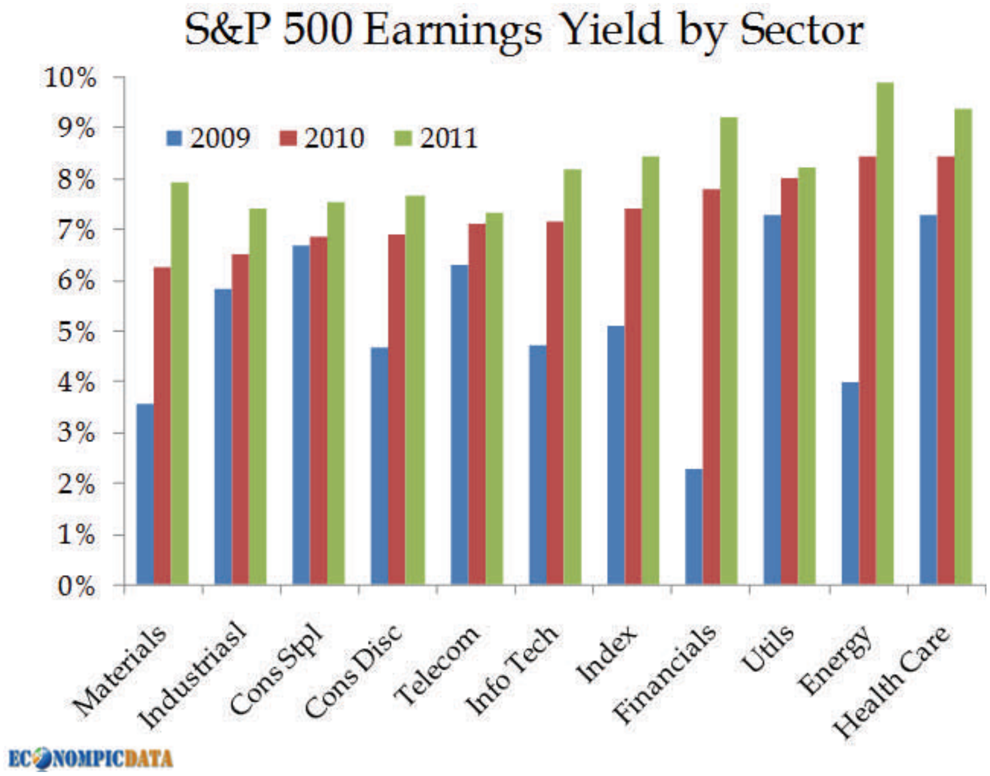
Since equity values have been advancing, investors, who vote their collective conscience with actual money, apparently believe (at least at this point) that the economic recovery is sustainable. Let's look at the state of the recovery.

THE RECOVERY IS INTACT

Over time, stocks tend to follow the growth of the economy. Whether you look at the growth of nominal GDP or real GDP (which is GDP adjusted for inflation), the U.S. economy *is* growing, although that growth began to slow in the fourth quarter of 2010.



The earnings yield of the Standard & Poors 500 in the graph that appears below provides a more granular view of the U.S. recovery. If you're technically inclined, the earnings yield is the reciprocal of the price-earnings (P/E) ratio. Otherwise, think of the earnings yield as a fraction where the numerator is the sum of the annual, per-share earnings of the 500 companies that constitute the S&P 500 stock index and the denominator is the sum of their respective share prices. All else being equal, the higher the earnings yield (or the lower the P/E ratio), the more attractive (or "inexpensive") the stock market would be considered.



Corporate earnings have rebounded dramatically after being eviscerated in 2008. Zacks (an investment researcher) figures earnings rose 45% in 2010 and expects them to advance another 15% this year. In general, economic rebounds tend to behave like coiled springs. The more severe the recession, the more dramatic the recovery. Thus, it is not surprising that earnings growth is slowing as the recovery progresses. Our researchers expect further growth during 2012, but they universally expect the rate of that growth to wane as stimulus measures fade.

Corporate earnings do not grow in lockstep with GDP, but the two certainly are correlated. Before moving on to other issues, let's take a look at a few lessons that lurk within this graph.

Since the financial sector was at the epicenter of the meltdown, it makes sense that earnings from these companies contracted and rebounded most dramatically. In contrast, companies that produce consumer staples such as groceries and household necessities were much less affected by the downturn because demand for those goods tends to be fairly inelastic (stable). Demand for telecom, utilities, and healthcare services sectors is similarly inelastic.

Companies in the consumer discretionary sector tend to produce larger ticket items and luxury services. Often, the purchase of large ticket items (e.g., a new car) can be postponed or substituted with less expensive alternatives. In the case of luxury services, they too can be substituted with less expensive alternatives (e.g., going to a movie rather than taking a vacation) or in more extreme cases, they can be eliminated altogether. These attributes combine to make earnings from the consumer discretionary sector more volatile than for more defensive sectors.

The energy and materials sectors are even more volatile. Less economic activity results in less demand for energy while manufacturers often preserve cash by working existing materials inventories to lower levels. Therefore, materials suppliers have to endure the twin insults of reduced demand *and* deferred orders.

The information technology sector also tends to be cyclical, but somewhat less so than the energy and materials sectors. Since technological advancement is often seen as a means of increasing operational efficiency, demand for goods and services offered by this sector tends to be somewhat more stable than might otherwise be the case.

Assuming these relationships persist, it would then make sense to favor relatively defensive sectors prior to an economic contraction and relatively more cyclical industries prior to the ensuing recovery. The trick, or course, is knowing where you are within a given cycle.

JAPAN ... HORRIFIC, BUT TOLERABLE (TO INVESTORS)

Although the human toll stemming from the disasters in Japan is catastrophic, investors have so far shrugged off the economic impact even though the costs could amount to some $300 billion. Historically, physical disasters tend to wreak less economic havoc than do financial shocks.

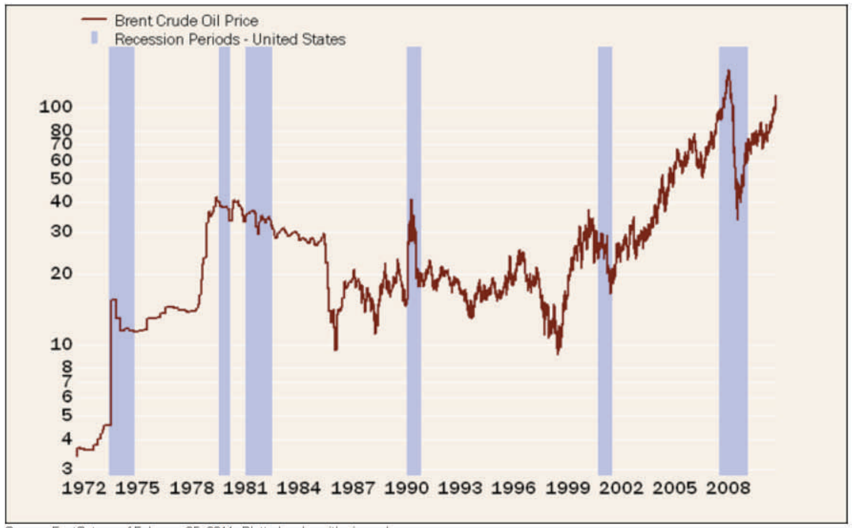
Here's why:

- Natural disasters tend to directly impact only a localized region whereas financial shocks tend to reverberate through many regions and economies.
- Natural disasters destroy physical capital, but they do not directly impact economic output. Although output typically falls in the short run, the perverse result is that GDP tends to rise in the long run as the wounded country rebuilds its stock of capital. There is no such "upside" from financial shocks.
- Speculative forces, which are often an element of financial shocks, typically cause asset prices to swing wildly. However, this element is rarely present in physical disasters.
- Financial shocks are generally complex and tend to create a great degree of uncertainty with respect to how large the tab will be and who will foot it. In contrast, the costs associated with physical disasters tend to be easier to calculate and the parties who are likely to bear those costs tend to be easier to identify.
- Financial shocks tend to trigger anger and additional structural uncertainty. In contrast, physical disasters tend to result in people rallying around and supporting the affected area.
- Although a physical disaster may temporarily interrupt a region's ability to supply other regions with certain goods or services, those goods and services can often be obtained elsewhere, or substituted in some other manner. In contrast, financial shocks often cause demand to fade. It is far easier to temporarily modify a supply chain than it is to reinvigorate demand.

UNREST IN THE MIDDLE EAST IS TOLERABLE, TOO

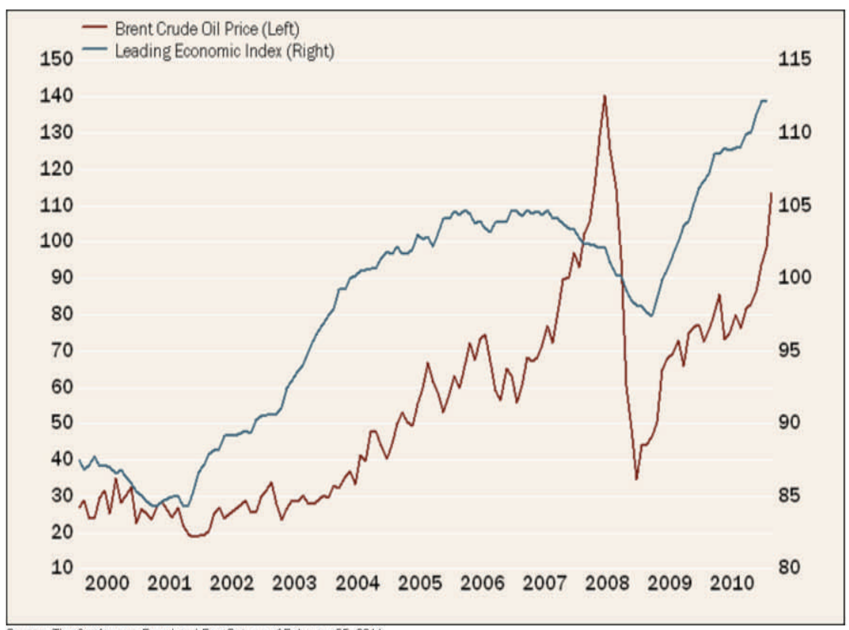
Despite President Obama's apparent desire to ensure that the U.S. is not seen as the primary aggressor toward the Libyan regime, legitimate concern exists that the U.S. will involve itself in yet another costly conflict. Another concern centers on the fact that oil price spikes have tended to precede and possibly even trigger recessions in the oil-dependent U.S. While the chart on the following page illustrates the historic relationship between oil price spikes and recessions in the U.S., there are many reasons that the recent spike in oil prices will not necessarily trigger another recession in the U.S.:

- Libya accounts for only 1.8% of global oil output (2009 figures), but Saudi Arabia has indicated that it is able and willing to fill that void.



Source: FactSet, as of February 25, 2011. Plotted on logarithmic scale.

- The Strategic Petroleum Reserve (based in the U.S.) and the International Energy Agency have both indicated that they stand ready to release emergency oil reserves should that be necessary.
- To the extent unrest spreads in the Middle East and Northern Africa, oil production disruptions would alienate the public. Therefore, social forces work against any sustained disruptions.
- Currently, the U.S. has a glut of oil which explains why domestic crude (West Texas Intermediate) recently cost much less than Brent Crude (which comes from the North Sea).
- In the early 1970s, U.S. energy consumption as a percentage of GDP stood at 16%. Today, that percentage is less than half as much which means that an oil shock would now have to be more than twice as "shocking" to have the same economic impact it had in the 1970s.
- Not only was the oil shock in 2008 far more extreme than the one we're experiencing now (the red line in the chart to the right), the leading economic indicators (the blue line) were much weaker then than they are now. In summary, the oil shock has (so far) been less extreme than it was in 2008 and it is occurring during a period where economic resilience ought to be significantly higher.



Source: The Conference Board and FactSet, as of February 25, 2011.

- Although current (spot) oil prices have spiked, prices in the futures market were recently *below* current prices. Therefore, the folks who are closest to this market expect the price of oil to fall.

- And finally, it is normal for oil prices to rise when economic activity is rising sharply. Therefore, at least a portion of the recent run-up in oil prices ought to be attributed to the global recovery. Capital Economics (another research firm) estimates the "fear/disruption" premium to be 15%.

JOBLESSNESS, WORLD TRADE, & THE U.S. HOUSING MARKET

Initial jobless claims are now at their lowest level since the summer of 2008. Zacks believes this marks an inflection point that will lead to stronger job creation. Capital Economics also sees an improving labor market, but it predicts that unemployment will remain near 9% for some time.

World trade grew 1.9% in November, 1.4% in December, and 1.3% in January and it is now 2% *above* its pre-crisis peak. However, this masks a more important reality. Year-over-year export activity from emerging market economies grew an astounding 15.4% (data as of January, 2011) while the advanced economies (e.g., the U.S., Western Europe, parts of Asia, etc.) sustained a decline of 5.6%. To the extent these statistics are capturing a trend, the emerging market economies clearly appear to sport the superior growth profile.

The U.S. housing market is likely to remain a drag on the domestic economy. Housing prices fell (nationally) almost 9% over the past year with new home sales reaching an all-time low in February. At current sales rates, the number of homes on the market represents almost 9 months worth of inventory. That's a big, bad number that has not improved over the past year. Capital Economics thinks the housing market will remain weak as housing prices fall another 5% this year.

MUNICIPAL BOND CRISIS?

In a *60 Minutes* episode that aired this past December, famed banking analyst Meredith Whitney said "There's not a doubt in my mind that you will see a spate of municipal bond defaults." Asked to define a "spate," Whitney said, "You could see 50 sizeable defaults. Fifty to 100 sizeable defaults. More. This will amount to hundreds of billions of dollars' worth of defaults."

Since Whitney warned of a banking crisis before it came to fruition in 2008, many now regard her as having some degree of prescience. Since having made those remarks, many investors have fled the municipal bond market which has driven municipal bond prices markedly lower.

I am not naive enough to suggest that stressed state and municipal finances will not result in an increase in municipal bond defaults, however, I would like to frame Whitney's remarks in a more complete context. I also regard her $300 billion default estimate as being implausible.

- If Whitney's prediction of "hundreds of billions of dollars" of bond defaults equates to, say, $300 billion, she's implying that 10% of all outstanding municipal bonds will default since the size of the municipal bond market is on the order of $3.0 trillion.
- According to Standard & Poors, the cumulative default rate on all municipal bonds issued through 2007 has been .29%. If Whitney is right and the default rate increases from .29% to 10%, she's essentially predicting that the default rate will increase by a factor of 34!
- Schwab estimates that there are around 10,000 active municipal bond issuers (and maybe 40,000 *in*active issuers) and around 1.5 million actual bond issues outstanding. Dividing a $300 billion market by only the 10,000 or so active issuers results in an average issuer size of no larger than $30 million. If Whitney is correct and 100 issuers do default, the total financial pain might then be on the order of $3 billion. That's a lot of pain, but a $3 billion hit is only 1% of the $300 billion figure she mentioned on 60 Minutes. Whitney's either predicting that especially large issuers will default, or she put her decimal point in a very wrong place.

The municipal bond market is huge, but it's relatively inactive. Like houses, many municipal bonds change hands only infrequently. Yet, they have to be priced daily. Home values are generally determined by reference to similar homes that have recently exchanged hands and the municipal bond market works the same way. However, the bond market uses something called "matrix" pricing instead of the familiar appraisal. The point is that a very small number of municipal bond sales are used to price the entire market. So, if a small number of investors exit from the market hastily, the value of the *entire* municipal bond market gets marked down even if the great majority of issuers can and do continue to pay as agreed. In 2008, a similar (but even larger) stampede occurred on the fear that a wave of municipalities would default, but that wave never materialized.

Unfortunately, this 60 Minutes segment failed to note that Whitney applied to the Securities Exchange Commission to form her own credit rating agency a month before the interview. One might wonder if Whitney made her comments in an effort to create demand for her new services.

WIND STILL AT OUR BACKS FOR NOW

Corporate earnings have risen sharply and are expected to continue rising further, albeit at a slower pace. The temporary reduction in social security contributions for employees (from 6.2% to 4.2% of wages) is providing additional stimulus as is the Federal Reserve's ongoing purchases of some $600 billion worth of long-term Treasury securities. Relatively low interest rates serve to boost demand for dividends as does the extension of the Bush-era tax cuts. Nonetheless, these stimuli come with various expiration dates. As such, Capital Economics expects slowing growth to become apparent in the second half of this year and continue slowing through 2012.

LOOKING FARTHER OUT

Although the emerging market economies continue to exhibit growth, developed economies will probably continue to grapple with major structural issues. For example, even though the European sovereign debt crisis is somewhat contained for now, the developed world must come to grips with the problem of servicing large amounts of debt from a workforce that is aging and shrinking as a percentage of the total population. For instance, American Century (a mutual fund sponsor) expects the proportion of citizens over the age of 65 in Greece and Portugal to nearly double to about one-third of the overall population over the next 20 - 30 years. By 2050, it projects that 40% of the Japanese population will be over 65 and that there will be only 1.4 workers for each retiree. This is a serious issue that many developed (i.e., debt-ridden) nations face to varying degrees.

FINAL WORD

Expect some volatility in your portfolio. When it happens, regard it as an opportunity to acquire assets at better prices. Ned Davis Research calculates that over the past 110 years, domestic stocks have experienced 378 price "dips" of 5% or more (about 3.4 per year), 122 "corrections" of 10% or more (1.1 per year), and 32 "bear" market declines of 20% or more (1 every 3.4 years). Despite the price volatility that's inherent in owning stocks, companies have a remarkable record of increasing their dividends. In 2010, 255 companies in the S&P 500 increased their dividends versus only four reductions and Standard & Poors believes that 2011 will be another good year for dividend hikes. You can only receive those raises if you hang in there.

— Glenn Wessel