

Market Monthly

An analysis of the economy and the markets

SEPTEMBER 2009

■ **The Economy**

For the first time since January 2008, the July reading of the ISM manufacturing index climbed above the expansionary level of 50, to 52.9. This data combined with other evidence — including a steep yield curve — improved stock performance and narrower credit spreads, have fueled our argument that the recession has ended, and we are in the midst of a recovery. Of course, the strength and sustainability of the recovery remain questionable. We believe higher exports and government and business spending are imperative to the process, because consumer spending is likely to remain weak for a while. Housing, another key to a lasting economic turnaround, is showing signs of life. The S&P Case-Shiller Home Price Index posted its second-consecutive month-to-month gain in June, and new and existing home sales have started to improve. Year-over-year, home prices remain lower, but the rate of decline is slowing. During his recent testimony before Congress, Federal Reserve Chairman Ben Bernanke discussed the possible ways the Fed could remove liquidity from the system. Some of the options include raising the federal funds rate target, selling longer-term securities from the Fed's portfolio, and issuing reverse repurchase agreements. Although Bernanke said he believes now is an appropriate time to discuss exit plans, he stressed the economy is not yet at a juncture to take action. We believe future Fed tightening is unlikely until late-2010, at the earliest. Long-term economic growth likely will be below historical averages due to the headwinds of deleveraging, higher taxes, increased regulation, and the housing overhang. Nevertheless, a “V-shaped” recovery remains the non-consensus view, leaving upside surprises possible.

■ **Equity Markets**

The path of the stock market may be rocky, but we expect it to move on a generally upward trajectory for some time due to the vast improvement in the credit markets and expected improvements in economic activity (i.e., demand reflation). Inflation is not a concern now, and the Fed should remain on hold for some time. These are bullish factors for stocks. Although the market has bounced mightily off the bottom, it is still sharply off its highs, suggesting the Armageddon scenario is no longer priced in, but neither is a significant recovery. Therefore, as we move out of recession, the equity markets should outperform bonds. Sales volumes and pricing in the housing market are beginning to show some resilience. Rising mortgage rates could threaten a housing recovery, but housing demand levels remain depressed overall and should improve over time, as long as mortgage rates remain below 6%. There are several current U.S. government policy initiatives likely to result in unintended economic consequences, including the “cap and trade” energy program, health care overhaul, tax changes and financial-sector reforms. These policies likely will cause the U.S. to import more than it otherwise would and put downward pressure on the dollar. As such, foreign manufacturing centers, such as emerging Asia, China and India, actually may be the primary beneficiaries of these proposed U.S. government policies. On a positive note, if the current health care legislation is meaningfully diluted, health care stocks should perform well. In China, fiscal stimulus — which has supported commodities, infrastructure projects and some consumer spending — is causing the nation's economy to grow at a rapid pace. But this fast growth runs the risk of creating a credit bubble. As the economies of the world stabilize, China once again will resume its role as the marginal buyer of most commodities, thereby straining supply and driving up prices. Consequently, we expect emerging markets, commodities and industrials to perform particularly well over the next three to five years. In addition, factor in the eventual risk of inflation due to global monetary stimulus, and commodity-related assets have exceptional appeal. Consumer deleveraging, the mortgage overhang and sub-optimal U.S. economic policy are likely to generate slower-than-normal real economic growth rates, thereby creating a new level of “normal” growth rates. As foreign economies reflate their demand levels and as foreign governments (India, China, Japan, etc.) move toward free market policies, their “new normal” growth rates should accelerate somewhat. Therefore, their currencies should continue to perform better than the U.S. dollar, as the flight to safety of the dollar unwinds and the U.S. grapples with growing budget deficits and massive quantitative easing.

■ **Fixed Income**

At its latest monetary policy meeting, the Federal Reserve left its federal funds rate target unchanged and stated it “expects that inflation will remain subdued for some time.” We agree with the Fed’s inflation outlook and expect rates to remain on hold for the balance of this year and next, effectively anchoring short-term rates at a very low level. More important, the Fed also began to reduce some of its quantitative easing programs because financial market conditions are improving. Treasury yields declined by approximately 10 basis points in August, and high-quality corporate borrowing costs continued to fall. Investment-grade corporate bond spreads tightened by an additional 16 basis points in the past month, but high-yield spreads actually widened by 19 basis points. This marked the first monthly increase in high-yield spreads since January. Although positive corporate earnings announcements have aided this sector, recent higher volatility, as measured by the Chicago Board Options Exchange VIX index, has been a detractor. Bond mutual fund inflows have been massive, as investors reach for more yield than the near-zero yields money markets are paying. Therefore, we would advocate investors remain overweighted in investment-grade corporate bonds and market-weighted in high-yield bonds. We also believe agency bonds appear attractive, considering they are slightly cheap relative to their long-term averages. Furthermore, we think investors should consider underweighting Treasuries and mortgage bonds and maintaining a neutral weighting in municipals. Our research indicates fair value for the 10-year Treasury may be 3.65%, based on current inflation trends. Therefore, we believe a 10-year Treasury yield of approximately 4% would represent a good buying opportunity, while a yield of approximately 3% may signal an opportunity to sell. We caution against locking in rates below 2% for any fixed-income sector. Recently, TIPS (Treasury inflation-protected securities) have received attention as a hedge against future inflation. Nevertheless, we believe it is still too soon to purchase them. We expect near-term inflation to remain benign, which could lead to a lower income stream and a reduced principal value for TIPS.

■ **Investment Strategy**

We maintained our equity overweight in our balanced and growth models. Within our equity allocations, we overweighted U.S. equities, underweighted international stocks, and maintained a strategic weighting to emerging markets. Additionally, we underweighted fixed income and real estate exposure, and we maintained a strategic weighting to commodities. Subdued inflation and the Fed’s extremely accommodative monetary policy remain encouraging factors for stocks, and as the economy improves, we expect equities to outperform fixed income.

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