



Thursday, July 16, 2009

## Live Now, Invest for Tomorrow

It's all too easy to project our current circumstances into the future and assume that things will remain the same forever. We find this phenomenon particularly true the longer a current trend, good or bad, persists. Remember how the "Internet changed everything?" In the late nineties stock valuations were at all-time highs, 'twenty-somethings' became overnight billionaires with dot.com ideas that required an ever increasing suspension of reality (and gravity). Even seasoned CEO's who remain heads today of companies like Cisco, Intel, Apple, and Broadcom said then, that they could barely believe what was happening themselves; the orders were there – the growth was real. Then, all of a sudden the orders went away. The Y2K bug had not bitten. Information companies were indeed subject to the same business cycle as the rest of the economy. And the silliness of most new dot coms was exposed. It all came crashing down. Wall Street analysts who had months earlier championed the record high stock multiples as the new reality were summarily fired. The few who were too deeply involved with large investment banking customers stayed on, but quickly changed their tune. The reality changed overnight.

Our current malaise began when another reality came crashing down – the global financial system proved less than diverse, efficient, and self-regulated. And looking a bit further back, twenty months to be precise, our deep recession started with the collapse of another trend that many thought would go on forever – that of ever-rising housing values.

But just as good trends come to an end, so do the bad. Signs are growing stronger that this 20-month recession is coming to an end. Yesterday the National Association of Realtors reported that sales of existing homes in the US rose in June for a third consecutive month. Purchases climbed 3.6% to an annual rate of 4.89 million, stronger than forecast and the highest level since October. In his remarks before Congress Federal Reserve Chairman Ben Bernanke said that the worst housing downturn in eight decades appears to be moderating.

Mr. Bernanke spent much of this testimony discussing how the Fed would withdraw its stimulative measures, suggesting he thinks recovery is coming. He said "to some extent, our policy measures will unwind automatically as the economy recovers and financial strains ease, because most of our extraordinary liquidity facilities are priced at a premium over normal interest rate spreads."

He cautioned that the recovery is not expected to be brisk when he said "however, economic conditions are not likely to warrant a tightening of monetary policy for an extended period. The timing and pace of any future tightening, together with the mix of tools employed, will be calibrated to best foster the Federal Reserve's dual objectives of maximum employment and price stability."

On the subject of employment, this week's news continues to suggest the worst is over. Initial jobless claims rose 30,000 in the July 18 week, to a lower than expected 554,000. But the Labor Department warns that the improvement is due largely to seasonal factors. In years past the automakers typically idled plants in the summer months, but that idling occurred months earlier this year through bankruptcy. Mr. Bernanke said that he expects unemployment to remain high into 2010 and 2011.

Consumer spending, which largely drives our economy picked up in the July 18 week, according to ICSC-Goldman's same-store sales tally which rose 0.5% in the week but still shows a minus 0.3% on a yearly

pace. On Monday the Conference Board reported that its index of leading indicators was up a convincing .7%, but consumer confidence remained a drag on the index. Without a strong consumer, recovery will be anemic at best.

Companies continue to report their second quarter results with considerable market impact. The Dow Jones jumped 188 points yesterday on earnings surprises from Ford, eBay, AT&T and others, taking the index back to 9000 for the first time since January. Investors are beginning to believe the worst is over for corporate earnings. With 25% of S&P 500 companies reporting so far, earnings are 24.0% above analysts' forecasts which follows a 5.5% positive surprise in the first quarter. Removing the 213.6% positive earnings surprise from the Financials sector, yields are still at a respectable 5.7% surprise. Today markets are digesting bad reports from Microsoft and American Express. Each found current conditions more challenging for their marketing efforts than earlier estimated.

Let's consider another worrisome trend before we change our focus to the long term; that of government spending. Earlier this week, Special Inspector General of TARP, Neil Barofsky, told the Congress that "since the onset of the financial crisis in 2007, the Federal Government, through many agencies, has implemented dozens of programs that are broadly designed to support the economy and financial system. The total potential Federal Government support could reach up to \$23.7 trillion." That is almost twice the Gross Domestic Product of the US. Interestingly, it is almost exactly the value of all private property in the US. With that money, the government could buy up every deed in America.

It is not a trend that can continue. While Mr. Barofsky correctly states that the figures all come from the government, it is becoming clear (we hope) that the government will not need to spend all of the money in the 50 programs cited in his report. In a rebuttal of the report by the US Treasury, spokesman Andrew Williams said the US has spent less than \$2 trillion so far and that Barofsky's estimate is flawed because it doesn't take into account assets that back those programs or fees charged to recoup some costs shouldered by taxpayers. "The estimate includes programs at their hypothetical maximum size, and it was never likely that the programs would be maxed out at the same time."

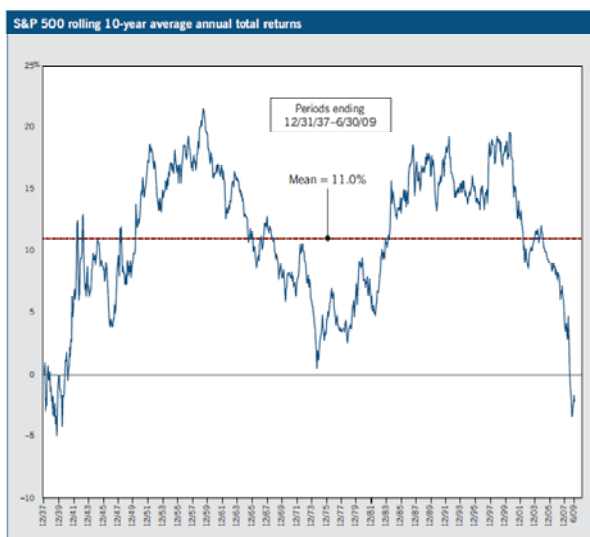
And in response, in a separate report Barofsky offered criticism of Treasury's implementation of TARP, saying the department has "repeatedly failed to adopt recommendations" needed to provide transparency and fulfill the administration's goal to implement TARP "with the highest degree of accountability." As a result, taxpayers don't know how TARP recipients are using the money or the value of the investments, he said in the report.

Another sweeping trend that may be cut short is healthcare reform. Senate Majority Leader Harry Reid announced yesterday that lawmakers will postpone until September a vote on the huge-spending legislation, dealing a blow to the President's timetable. Strategist Ed Yardeni had an interesting take on the whole thing.

"It isn't personal; it's business. I'm hearing more professional stock investors say they hope that President Barack Obama's popularity takes a dive. Of course, they wish him all the best. He is the President of our country and we all want him to do well. Usually, investors perceive that a popular president is more bullish for stocks than an unpopular one. However, investors are increasingly concerned that his spending programs will push taxes up to levels that depress economic activity and corporate earnings. So they are rooting for Gridlock, which is a more likely political outcome in Congress, if the President is less popular. Of course, the immediate issue is health care reform and the resulting tax hikes that will be necessary to finance it. If the Democrats' controversial plan does get gridlocked, a relief rally is likely for stock prices. Indeed, the surge in stocks in recent days may be partly attributable to the perception that the Obama Administration may fumble the ball."

## Invest Long Term

Now let's put away the microscope and peer through the long lens of our telescope, studying history to gain some insight into what to expect in our future. The chart below, courtesy of American Funds, reveals S&P 500 index returns over ten-year averages going back to 1937. For the past 10 years ended June 30, 2009, the index declined an annualized 2.2%. Not since late 1930s have returns been so low; compare the dip on the left with that of today on the right. US equities rebounded significantly after difficult times. Great Depression was followed by 10-year annual returns for averaging 17.0%. Similarly, returns of 8.8% followed difficult 10 years ending in 1974. And more recently the periods ended January 1985, through December 1994 saw gains averaging 15.7%.



During slow markets it is also important to remember the persistence of dividends. Historically, dividends account for a significant portion of investors' long-term total returns even though they can dip during recessions. Joyce Gordon of American Funds provides a hypothetical example of a hypothetical \$1,000 investment in the S&P 500 at the beginning of 1973. With dividends reinvested in new shares the \$1,000 investment grew to \$24,091 at the end of 2008. If the investor chose to take his dividends in cash, they would have totaled \$3,709 and his stock would have grown to \$7,651. Notice though the power of compounding over time. The reinvested dividends resulted in growth more than twice the non-compounded total.

Investing by definition is a long-term proposition. A few do well trading and timing the market, but no one does it well indefinitely. The unexpected is always out there waiting. How well we know that reality now.

The US stock market is slowly decoupling from the US economy as companies seek better opportunities abroad. Emerging markets will likely fare better than the older industrial world because, they ironically have stronger economic practices than the more advanced nations. They are free from the huge debts and are not burdened by out-of-control entitlement programs. They seek the 'American Dream' and they are getting it right just as we run headlong toward a failed socialist European model. Investors seek growth wherever they can find it and competition for their capital is more globally diversified than it has ever been.

The current ill climate will eventually yield to positive news and real growth. The future looks bright for global markets now, and we believe our nation will fully benefit from it very soon. It's time for a new direction.