



Friday, August 28, 2009

Investors Believe

On Wednesday our nation was saddened by the death of Senator Edward Moore "Ted" Kennedy who succumbed to brain cancer in Hyannis Port, Massachusetts. With 47 years of service in the US Senate he was one of the most influential and accomplished lawmakers of our time. Ted Kennedy was the only one of four distinguished brothers to die of natural causes; President John F. Kennedy, and Senator Robert Kennedy were assassinated and Joseph Kennedy Jr., a naval aviator, was killed in action during World War II. The service and sacrifice of this remarkable family to our country is gratefully acknowledged and deeply appreciated.

The persistent rise in stock prices rolled on this week as investors continue to believe the economy is rising from recession, despite ever-present news of bank failures, sluggish consumer participation, and huge looming federal deficits. In spite of it, the Dow Jones Industrial Average advanced yesterday for the eighth straight day, each to new highs for the year, and representing the longest winning streak since April 2007. The MSCI World Index of 23 developed nations added 0.9% yesterday extending its seventh weekly gain. Copper, among the very best indicators of global growth, jumped to the highest intraday price since Oct. 1st on the London Metal Exchange, while oil climbed 0.9%. The early re-appointment of Ben Bernanke to a second term also gave markets a boost.

The nation's Gross Domestic Product shrank 1% in the three months ended June, matching the initial estimate on July 31st. The report suggests that there is more upside potential for third quarter GDP than previously believed. While still softer than a typical recovery, the momentum on several fronts is compelling. Consumer spending, which accounts for about 70% of the economy, fell at a 1% pace, less than anticipated, following a 0.6% increase in the prior quarter. In a separate report, the government announced today that consumer spending rose in July as households took advantage of the government's 'cash-for-clunkers' program to buy new cars. The 0.2% gain in purchases followed a 0.6% increase in June. Incomes were unchanged, causing the savings rate to decrease. The report also showed that inflation is not a problem as the price index was revised down marginally to flat from the initial estimate of a 0.2% rise. The report also showed that Federal, state and local expenditures climbed at a 6.4% annual pace, the most in more than seven years, according to Bloomberg.

While it is largely expected that the consumer will be slow in coming back, this week's consumer confidence report delivered welcome improvement across nearly all components, ending two months of earlier disappointments. The index rose nearly 7 points in August to 54.1 vs. July's 47.4 (46.6 first reported). Strength is centered in 'expectations' components led by the 'assessment of future business conditions' and the 'assessment of employment.' Ed Yardeni suggests that some degree of improvement might be credited to the success of the town hall meetings in slowing the unpopular healthcare reform juggernaut.

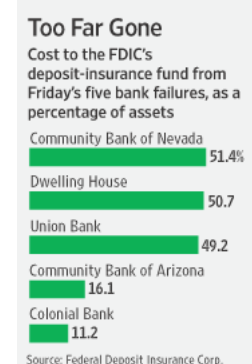
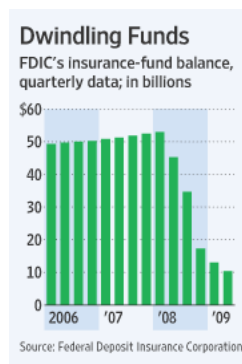
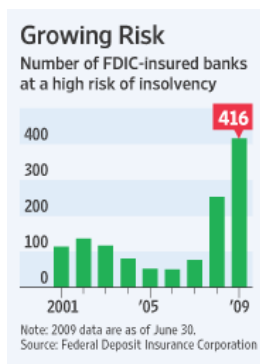
Consumers' buying plans improved for autos even though the 'cash-for-clunkers' program has ended and should not have been a factor. Buying plans for homes rose but did not jump while buying plans for appliances edged back.

The sales data for both new homes and existing homes are suggesting recovery. New home sales reported this week surged 9.6% in July following an upward revised 9.1% surge in June. The 433,000 annual unit pace is the best since September last year. The strong sales pulled down new homes on the market to 271,000 vs. 280,000 in June and compared with 419,000 a year ago. The 271,000 level is the lowest since 1993. Supply at the current sales rate is down to 7.5 months, the lowest level since April 2007 and well down from June's 8.5 months. The median price steadied, down only 0.1% in the month at \$210,100 and offering confirmation of the turning point seen in Case-Shiller data, all according to Bloomberg. MBA reported that their refinance index rose 12.7% for a third straight gain. Mortgage rates moved higher in the week with 30-year loans up 9 basis points to an average 5.24%.

However, recovery in housing is not yet a given. The bond rating company, Fitch Ratings Ltd. recently concluded a study showing that homeowners who fall behind on their mortgage payments have become much less likely to catch up again. The study excludes loans guaranteed by government-backed agencies as well as those that weren't bundled into securities. The 'cure rate' is the portion of delinquent loans that return to current payment status each month.

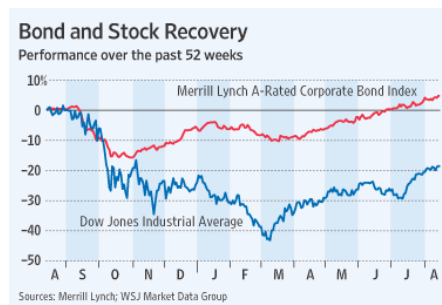
Fitch found that the cure rate for prime loans dropped to 6.6% as of July from an average of 45% for the years 2000 through 2006. For so-called Alt-A loans, a category between prime and subprime that typically involves borrowers who don't fully document their income or assets, the cure rate has fallen to 4.3% from 30.2%. In the subprime category, the rate has declined to 5.3% from 19.4%, all reported by Bloomberg. Because borrowers are less willing or able to catch up on payments, foreclosures are likely to remain a big problem. Barclays Capital projects the number of foreclosed homes for sale will peak at 1.15 million in mid-2010, up from an estimated 688,000 as of July 1st. The Fitch study covers about \$1.7 trillion of mortgages held in securities, representing about 16% of U.S. mortgages outstanding.

Considerable worries persist in the banking industry as well. The Federal Deposit Insurance Corp. said it had 416 banks on its "problem list" at the end of June, equivalent to about 5% of the nation's banks, up from 305 at the end of March and 117 at the end of June 2008. Problem banks had a combined \$299.8 billion of assets at the end of June, compared with \$78.3 billion a year ago. The FDIC's insurance fund, which guards \$6.2 trillion in U.S. deposits, fell to \$10.4 billion at the quarter's end, the lowest since mid-1993.



According to the Wall Street Journal, banks in the US that failed in the past two years were in far worse shape than those that collapsed during the industry's last (savings & loan) crisis. At three of the five banks that failed Friday, increasing the total to 77 so far this year, the financial hit to the agency's deposit-insurance fund is expected by the FDIC to be about 50% of their assets (see the chart "Too Far Gone" on previous page). The biggest hit on a percentage basis so far is the Community Bank of Nevada, a Las Vegas bank with \$1.52 billion in assets and an estimated cost of \$781.5 million. The failure of Colonial Bank, a unit of Colonial BancGroup Inc. that was sold to BB&T Corp., will cost \$2.8 billion, or 11% of the Montgomery, Ala., bank's assets. The Journal has an excellent graphic called "[Tracking the Nation's Bank Failures](#)" which provides an overview of the magnitude and a history of the growing problem.

The dollar continues its five-month decline relative to other currencies down 12% from its mid-March peak of 88.65 to close yesterday at 78.06. The dollar's fall which coincides with rebounds in crude oil and stocks, reflects reduced demand for the relative safety of the US currency. The chart below left (stockcharts.com) shows the dollar returning to pre-crisis levels. The chart on the lower right (WSJ) shows that the bond markets have fully recovered to pre-crisis levels.



Investors are wondering when stocks will do the same. The Dow Jones Industrial Average's rally of 42% since March 9 still leaves the index down 16.5% from Sept. 12, 2008, the last trading day before Lehman tumbled into bankruptcy and Merrill Lynch was sold to Bank of America. As of this writing, the Dow is 32.7% below its all-time high close of 14,164 in October 2007.

A major driver of the rally so far has been the persistence and the strength of corporate earnings. Companies in the S&P 500-stock index are on track to post combined per-share earnings of \$59.59 this year, according to Thomson Reuters. That would be 28% lower than their 2007 earnings of \$82.54 a share. The S&P 500 index now trades at a relatively cheap 13 times 2010 earnings, which are expected to rise by 26%. The S&P 500's current valuation leaves plenty of room for stocks to rise.

The rally so far has favored Technology, Financials, and Energy. Ed Yardeni points out that Technology's market share of 18.4% is now the highest and near a seven-year high and its earnings share of the S&P 500 is 16.3%, its second highest and near an eight-year high. Financials' market share of 15.0% and earnings share of 12.9% are no longer highest in the S&P 500, but are up from record lows in February. Energy's earnings share of 12.9% is now down from a record high of 21.2% in August and fourth highest in the S&P 500 now.

The second quarter earnings season all but behind us now with nearly 98% of the companies of the S&P 500 reporting. After six straight negative surprises through Q4-2008, the S&P 500 Q2 earnings beat their forecasts by 17.1%, the highest since the earnings surprise series began in 1987 and well above the final 5.5% positive surprise recorded in Q1. Excluding the 153.6% surprise from the Financials sector, the overall earnings surprise of S&P companies is 6.9%, which ranks as the third best quarter in the 90-quarter history of the series, according to Yardeni and S&P. Today, Intel announced more good news for the Tech sector, as it boosted its third-quarter sales forecast. The chip maker's shares rose nearly 5% to \$20.35 in early trading as the company cited "stronger-than-expected" demand for its microprocessors, a surprise update to earlier guidance issued in July.

This recovery may indeed be different than former ones as the US consumer may not have to be the driver. The global economy is doing quite well and may just pull the huge US economy along with it. Second-quarter earnings at companies in the MSCI World Index have exceeded analysts' estimates by an average of 12%, according to data compiled by Bloomberg. Again, technology companies have beaten projections by 18%.

It is indeed possible that that the rally could fizzle if the economic fundamentals fail to keep up with expectations. But so far, that does not appear to be the case. Stocks remain cheap on a forward earnings basis and many experts suggest there is plenty of room to run. Add to that the trillions of dollars sitting in money-market accounts which may come pouring into the market if and when investors begin to worry more about missing the rally than losing any more.

Have a good weekend.

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