



Friday, October 16, 2009

Persistent Signs of Recovery

The US Economy continues to show signs of recovery, particularly in manufacturing. Third quarter earnings will show just how quick the pace of recovery is. Early reports this week were good with Goldman, JP Morgan, Citi, IBM, beating expectations and Intel raising fourth quarter guidance. The stock market continued its steady rise this week as reports filed in with the Dow closing about 10,000 yesterday for the first time in a year. And as has been the case since March, the dollar continues to decline as the stock market rises.

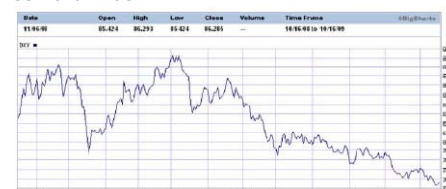
Industrial production increased by .7% last month, more than anticipated, making manufacturing the front runner of the economic recovery so far. The auto makers provided the biggest push gaining 8.1%, but strength was well distributed throughout the country as overall production excluding motor vehicles was still up 0.4% for September. The New York manufacturing region's general business conditions index jumped to 34.57 for October report compared to 18.88 in September.

The pickup in manufacturing is not yet translating into new jobs, but the loss of jobs is falling off as indicated by initial jobless claims falling 10,000 in the October 10th week to 514,000. Continuing claims also fell, down 75,000 to a sub-6 million level at 5.992 million in data for the Sept. 26 week. The unemployment rate for insured workers, in contrast to the overall unemployment rate, continues to slip, down another tenth to 4.5 percent. Levels in this report are the lowest since the first quarter according to Bloomberg.

The US dollar is on the worst two-quarter decline in almost two decades. The latest data from the IMF shows non-gold international reserves at a record \$7.36 trillion in July, but central bankers are diversifying away from the declining greenback in favor of the euro and yen.

The dollar's seven month decline is a near-mirror image of the S&P 500's rise. Take a look at the two charts below. As the dollar gets cheaper US export prices fall, making them more competitive in the global marketplace. The cheaper dollar also makes US assets, like stocks more attractive. In fact, investors outside the US can now buy companies in the S&P 500 at the cheapest valuations on record.

US Dollar Index



S&P 500



According to data compiled by Bloomberg, the S&P 500 is priced at 19.9 times earnings, the biggest discount to the MSCI World Index of 23 developed countries since May 2003. For Europe-based money managers, currency translations push the average cost for a dollar of US profits down to 13.6 Euros, the lowest level ever relative to global equities and a discount that investors in America have never enjoyed.

The world economies are awash in reserves (money), but so far inflation has not reared its ugly head. So why is gold, a traditional hedge against inflation, up 15% in the past 3 months? One reason is that gold investors believe the Fed having to wait until the economy picks up momentum, may be too late in raising rates to contain inflation. The second is like the first, but on a global basis. There is too much liquidity in the global market place for inflation to remain dormant.

The Consumer Price Index for September was mixed with the overall rate slowing as the core rate firmed. The headline CPI rate eased to a 0.2% gain after jumping 0.4% in August. But the core CPI rate of inflation firmed slightly, rising 0.2% after a 0.1% increase in August. The core rate removes the more volatile food and energy components. Overall, inflation remains weak in light of weakening housing costs, consumer demand, and no labor price pressures. Only energy prices have the chance to rise in the short run.

The earnings reports of the next few weeks will provide the first micro look into the economic recovery. We know that manufacturing is showing strong signs of recovery and housing is putting in a solid bottom. It is widely believed that technology will lead the earnings parade as it is first to benefit during the early stages of economic expansion. It is said that businesses were too aggressive in their workforce reductions expecting a prolonged decline. They will likely do as they have in the past which is to invest first in technology to improve productivity then gradually begin to hire if the recovery proves sustainable. Indeed, that is what we are hearing from the nation's leading tech companies.

Next week I'll tackle the enduring question of whether it is better to try to outperform the markets or to capture as efficiently as possible the returns of the capital markets. For now, have a good weekend.