



Friday, December 4, 2009

“W” ?

This week's economic reports brought further evidence of economic recovery. The Commerce Department reported today that retailers saw a 1.3% increase in November sales. And it was privately reported that hiring by US discount, grocery, restaurant, and specialty chains in November rose to the highest level in 2009, signaling that retailers may be anticipating a gradual recovery in consumer spending. Consumers are still buying autos without government incentives. And manufacturers are especially optimistic as they look forward to 2010 sales growing by 5.74%, as reported by the Institute for Supply Management.

Along with economic growth typically comes concern of inflation. The probability of inflation this time is significantly higher than during typical recoveries because of the government's plan to borrow massively to finance record stimulus spending. Yesterday, the Treasury was forced to sweeten its \$13 billion offer of 30- year bonds yesterday by increasing the yield to attract bidders who are increasingly concerned about inflation.

On the other hand the Federal Reserve, worried about high unemployment and slow growth, continues an accommodative stance of keeping short-term rates historically low. The combination sets up the widest gap in yields between the 2-year and 30-year Treasuries since 1980. Additionally today, the spread between 10-year yields and 2-year yields (.78%) in Treasuries is at 3.5%, just .04% below the highest ever. Banks can borrow at two year rates .78% and 'lend' (buy buying) 10-year Treasuries at 3.5%, capturing a credit-risk-free yield of 2.72%. Given the choice of risk-free returns like these or lending to commercial credits in a market where non-performing mortgage loans are at 8.3%, which would you choose?

Executives from Bank of America, J.P. Morgan Chase, Citigroup, Morgan Stanley and Goldman Sachs will head to the White House next Monday for a lecture from the President urging them to them to increase lending to small businesses, get serious about restructuring mortgages for struggling homeowners and to call off the lobbying dogs trying to kill his financial re-regulation legislation, according to the Wall Street Journal. This will represent the second such meeting.

Earlier in the week, Federal Reserve Chairman Ben Bernanke, speaking to the Economic Club of Washington reminded economic bulls that the US economy faces “formidable headwinds,” including a weak labor market and tight credit that are likely to produce only a “moderate” pace of expansion. He said that inflation remains “subdued” and might even move lower. In answer to a question after his speech, he repeated the Fed's statement that interest rates are likely to remain low for an “extended period.” We interpret these statements from our chief economist, the one with all the inside information, to mean that he believes our economy is not going to recover as quickly or as strongly as it has from previous recessions. In other words, he does not expect a 'V-shaped' recovery, but rather an “extended period” of sub-par growth, perhaps even a 'W-shaped' recovery which includes a second recession.

The dollar is up 2.5% this week, partly on signs of economic strength and partly on a flight to quality. The Dubai scare pushed the dollar up 1% and traders are not sure there aren't other issues like it yet to surface. Bill Gross, manager of the world's biggest bond fund, points out that a prolonged period of record-low interest rates may foster "systemic risk" of new asset bubbles like Dubai. In the two months following Lehman Brothers' collapse the dollar rallied 16%. Today, traders who have bets against the dollar are now paying the highest prices in more than a year to protect against a sudden rebound in the dollar following the worst annual performance since 2003.

The stock market has been largely stalled since mid-November despite forecasts of 25% growth in US corporate earnings, the fastest in 15 years. S&P 500 options to protect against declines in stocks over the next year cost 40% more than one-month contracts, the biggest premium since 1999, according to Barclays Plc and Bloomberg. Traders expect the VIX, the index that measures options volatility, to double next year. Further, speculation is increasing that the market's 62% ascent which added \$5 billion back to stock values may be stalled or at risk of a correction.

Analysts expect S&P 500 earnings to reach \$78.76 a share next year, according to the average estimate of equity analysts surveyed by Bloomberg. The index trades at 14 times that level, based on yesterday's close of 1102. The median estimate among Wall Street strategists puts the S&P at 1,250 next year. Economist David Rosenberg puts fair value of the S&P 500 at 900. That suggests a drop of 18%. Perhaps the truth lies somewhere between the two.

It may be too that the stock market is partly buoyed by the possibility that the Congress may drop plans to take over the health insurance industry. Speaker Nancy Pelosi signaled that House Democrats may be receptive to changes that instead lower the age of Medicare eligibility to 55 from 65. Senate Democrats are considering offering consumers health-insurance options similar to those available to federal employees and members of Congress.

The economy is showing signs of recovery, though 'headwinds' are persistent and significant. Whether momentum will build sufficiently in the coming months to overcome the significant drag of high unemployment, tight credit, and runaway government spending, remains to be seen. The potential of a double dip 'W' recession or a prolonged stagnant recovery certainly rises the longer banks do not lend and unemployment remains high. A break in one or both would be a welcome sign indeed.

Have a good weekend.

Information provided in this Brief has been prepared from sources believed to be reliable, but it is not guaranteed by Beacon Investment Management and is not a complete summary or statement of all available data necessary for making an investment decision. Past performance does not guarantee future results. Information provided is intended only to inform and does not constitute a recommendation to buy or sell.

The opinions expressed reflect the judgment of the author as of this date and are subject to change without notice. All email sent to or from Beacon Investment Management's corporate e-mail system is subject to archival, monitoring and/or review by Beacon personnel and regulatory authorities.