



Friday, August 13, 2010

### Bulls Pause to Reconsider

The 10% rally in the S&P 500 beginning in early July abruptly turned this past Tuesday as the Fed announced a small downgrade in their assessment of the recovery and as a Chinese government report suggested growth was slowing in that economy. The US recovery has been largely attributed to exports which will decline if China and the global economy drift back into recession. The three-day decline in stock prices this week erased 3.8% from the 10% rally. Treasuries on the other hand continued their multi-month advance as the Fed said they would replace maturing mortgage bonds held on their books with two to ten-year Treasury bonds. The Barclay's 7-10 year Treasury index is up 3% since early July.

Investors were initially relieved on Tuesday to hear that the Fed would continue its accommodative stance for economic recovery. But they soon succumbed to fears that expectations for growth had been too high. In their Tuesday statement, the Fed said that "the pace of recovery in output and employment has slowed in recent months" a notable change from its prior statement in June "that the economic recovery is proceeding and that the labor market is improving gradually." Reinforcing the fears was a report from the Chinese government that industrial production expanded at the weakest pace in 11 months in July, brought about by policy curbs.

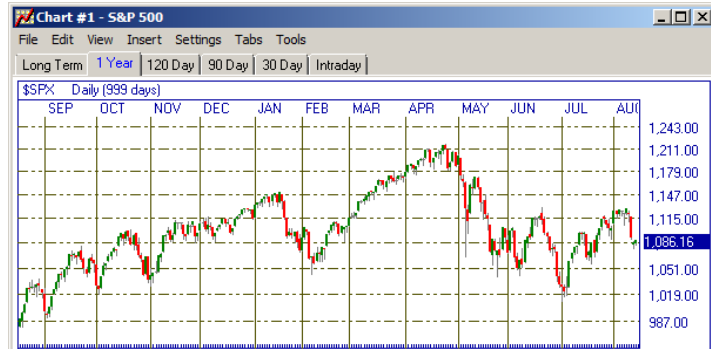
Worker productivity in the US, which grew strongly for five straight quarters declined in the most recent quarter by .9%. Productivity is a measure of worker efficiency in producing goods and services. There is a positive spin: When the economy does pick up, businesses will be more apt to hire new workers to meet new demand for their products.

The meltdown in stocks on Wednesday was largely triggered by the announcement that US exports dropped by 1.3% in June after increasing 2.5% in May. Imports advanced by 3%, widening the US trade gap. The data along with releases from other central banks and governments indicated a slowing world economy.

Today's consumer news stands in mild contrast to the week's largely negative tone. Consumer sales increased .4% in July, the first increase in three months. However, beneath the hood, the increase was mostly due to auto sales and higher gasoline prices. But a gain is a gain. The Reuter's/University of Michigan's Consumer sentiment index also shows some modest improvement. Their measure for consumer confidence increased in July by 1.3 points to 67.8. The measure stood at 76 end of June.

Economists polled by Bloomberg and the Wall Street Journal currently see the US economy growing by 3%, after shrinking 2.6% in 2009. This week several key market players said that the chances of another recession were unusually high. Both Goldman Sacs and PIMCO put odds above 25%. Goldman noted, however, that housing, business spending on equipment, autos, other consumer durable goods, household savings and company hiring offered protection against another decline in economic activity.

It has been generally expected for months that this economic recovery would be uneven, lengthy, and likely characterized by fits and starts. A look at the stock market over the past 12 months paints a vivid picture of how dramatically the changing data and emotions have impacted prices. But note that the rallies beginning in November, February, and July are aligned with the reporting cycles of quarterly corporate earnings. These rallies were for real. They were not based on speculation, but on the quality and magnitude of corporate earnings, which were much better than analysts expected.



Strategists at the biggest US investment banks see the trend for corporate earnings continuing and expect a meaningful second-half stock rally to follow. Bloomberg quotes Tom Lee, chief US equity strategist at JPMorgan Chase & Co. who says rising profits will drive the S&P 500 Index up 16% from last week's close. Bank of America's David Bianco says the S&P 500 will reach 1,300 thanks to record-low interest rates. The fastest annual earnings increase in 22 years will push the benchmark gauge for American equities up 20% in the last six months of 2010 to 1,242, according to the average projection of 12 firms compiled Aug. 3<sup>rd</sup> by Bloomberg.

Bruce McCain, chief investment strategist of Key Private Bank says that both economists and equity analysts can be right. He says that "the cautiousness with respect to the economy is actually enhancing earnings because they're [companies are] slowing down investments that would be a drag."

Cash at S&P 500 companies has risen six straight quarters to \$836.8 billion, according to S&P. Earnings at the same companies will increase 35% in 2010, the biggest annual gain since 1988, according to more than 8,000 analyst estimates compiled by Bloomberg.

Of 443 companies in the S&P 500 reporting results through Aug. 6<sup>th</sup>, 338 exceeded analysts' forecasts. It's the fifth straight quarter in which more than 70% of companies have beaten analysts' projections. The S&P now trades at less than 15 times earnings, 16% below its average since 1937 when adjusted for interest rates according to Tom Lee. Yes, stocks can indeed rise in this environment. With rates as low as they are today and corporations flush with cash, expect exciting news in the area of mergers and acquisitions.

Don't count out the US economy and certainly don't give up on the stock market.

Have a nice weekend.

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