



Friday, August 20, 2010

Corporate-Led Recovery?

Is the economy falling into recession or is it merely stalling? The S&P 500 is off its April high by 12% while the rally in the 10-year US Treasury has driven yields to 2.55%, the lowest in 17 months. Yesterday the government's leading economic indicators showed an increase of .1% in July provides hope that the economy is merely in a stall. But jobs, housing, and even manufacturing which has been a bright spot for the economy were more worrisome as they each declined this week. While the economic numbers were mostly negative this week, there is a bright spot. Intel's acquisition of security software maker McAfee brings the August total of announced takeovers to more than \$175 billion. Acquisitions are on a pace for August to surpass March as the biggest month for deals this year, according to Bloomberg. The month is typically the slowest.

America's companies are sitting on almost \$3 trillion in cash right now. With interest rates at their lowest levels in history, the table is set for a huge revival in acquisitions. We find ourselves asking the proverbial question; which comes first the chicken or the egg? It is obvious that business managers must have a certain level of confidence in the economy, or at least in their markets, before investing their cash in risky ventures. But if a growing number of businesses take advantage of the historic concurrence of bargain stock prices, huge piles of cash and low interest rates and they begin buying up their competitors; then it is just possible that their actions will stimulate higher stock prices broader confidence in the economy, at least at the corporate level.

If corporate chieftains believe the economy is rolling over again they will be less likely to invest and instead hold their cash for tough times ahead. But that is not what we are seeing. Deals are on a pace to pass the totals of this past March which helped sustain a 15% rally in the S&P 500. In addition to the Intel acquisition mentioned, MetLife is buying American International Group for \$15.5 billion. Expect more deals from the technology and telecommunications industries as they have are among the most cash-rich companies globally. According to Bloomberg they are, in order, Intel, Apple, Oracle, Cisco Systems, Microsoft Corp., Google Inc., Sony Corp. and China Mobile Ltd.

Evidence that the broader economy continues to struggle was compounded this week. The New York Fed started the week with bad news in their so called Empire State report on manufacturing. New orders, unfilled orders, and shipments were all lower for August. Further down the coast, the Philadelphia Fed reported that their Mid-Atlantic general business conditions index fell to minus 7.7 indicating month-to-month contraction in business activity. In new and unfilled orders and in shipments, this report announced yesterday, was considerably weaker than the New York report.

On Wednesday though, the government released a more upbeat report on manufacturing. Nationally, industrial production jumped by a full 1% in July which follows a revised 0.1% down tick in June. The consensus for the report had been a considerably lower 0.6%. According to analysis in the Wall Street Journal and Bloomberg the increase was broad-based. Capacity utilization rose to 74.8% in July from 74.1% the prior month and well off the lows of 67.5 reached in June of 2009.

Housing showed some improvement in July, but well short of expectations. Housing starts in July rose 1.7% after an 8.7% decrease in June. The July annualized pace of 0.546 million units came in below the median forecast for 0.565 million units and is down 7.0% on a year-ago basis. Permits fell

back 3.1% following a 1.6% rebound in June. Overall permits stood at an annualized rate of 0.565 million units and are down 3.7% on a year-ago basis.

The catalyst for yesterday's stock market sell-off was unemployment. The government's weekly report of initial claims came in at 500,000 for the August 14th week, the largest total since November. The four-week average of 482,500 is the largest since December, according to Bloomberg. However, on the positive side, continuing claims continue to come fall, down 13,000 for the August 7th week. The four-week average of 4.527 million is the lowest of the recovery.

As the election draws nearer, the chances for any meaningful stimulus from the government grow dim. The brightest hope for recovery rests, as it has from the beginning of this cycle, on the shoulders of the corporate sector. We have stated that business can make decent profits in a slow economy. They can make even better profits through consolidation. If the pace of acquisitions continues as it has so far this month, that trend could be a significant positive for the economy.

Have a good weekend.

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