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Weekly Update: Stuck in neutral

March 5, 2010

What's Ahead

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I've been surprised by how many of the resources that I read have moved their bullish view down to neutral and are voicing various concerns to include China, Greece, etc. It's remarkable to me because, at this moment, we're 1% off the highs of this bull run. We've had a pretty nice rally from the 8% correction we just saw. Why is everyone feeling so negative? The most commonly voiced concerns are about the weak consumer and jobs outlook. These are serious concerns (*though we are seeing some positive signs, see below*).

But what about the strengthening business sector? We note the last 2 quarters have shown the strongest rebound in corporate profits in post-World War II history. The last time profits rose as much as they did in the 4th quarter (32% year-over-year), we were in strong mid-'70s and early-'80s recoveries. Capital expenditure plans are rising, too, with the latest Manufacturers Alliance/MAPI survey its highest in three years. IT accounts for 60% of capex, so it can grow even if factory use rates stay low. Moreover, the corporate savings rate is 35%—companies have never had so much cash. That's good for M&A—half the deals so far this year have been in cash—and capex, which grew 18% in the 4th quarter. Meanwhile, consumer spending grew only 1.8% in the 4th quarter.

And so what occurs to me, what more and more people are beginning to believe, is that business, not the consumer, will be the catalyst for this recovery. You may say, but the consumer is 70%; he's more important. To which I say, actually the bottom half of consumers lacks discretionary spending power—they spend everything they make or get. They can barely make ends meet. It is the top-end consumer who represents 46% of spending in this economy, who is seeing his portfolio improving and in whom we're seeing evidence of pent-up demand. Then, there's the strengthening business sector. But you may say, isn't corporate spending more volatile than the consumer? Sure. But what if it's volatile to the upside? Won't the economy, and the stock market, like that?

Positives

- ***Jobs report encouraging, signaling a true turnaround is upon us*** This morning's read on February's labor market showed the jobless rate holding steady at 9.7% and payroll losses of 36,000—far better than consensus, which had expected the winter storms to inflict a lot more damage. A smaller sampling of households, considered better at capturing turns, rose by 308,000, the 2nd straight monthly jump. Temp jobs, also an early indicator, continued their surge since summer. Finally, Monster's employment index jumped the most since records started 7 years ago, Rasmussen's employment index jumped a record 15% to a 16-month high and Challenger said layoffs plunged 41% to their lowest since July '06. February's jobs report was good considering the snowstorms that blanketed the nation, and with history as a guide, this should bode very well for March's numbers.

- ***ISMs move in expansion lockstep*** Manufacturing slipped a bit from January but is still averaging 57.5 this quarter, the highest for the 3rd quarter of recent recoveries except for '83. February's 56.5 also was consistent with 4.9% GDP growth, well above recent downward revisions for 1Q by some Wall Street economists. Notably, the employment component gained for the 3rd straight month to a 5-year high. The nonmanufacturing reading was much better than forecast, reaching its highest since October '07, aided by improvement in new orders and employment, the latter having risen 3 straight months.

- ***Pent-up demand, I think!*** February retail sales surprised, with monthly same-store sales increasing the most in 2 years. And consumer spending had its 2nd consecutive better-than-expected reading in January. It was the 4th straight monthly increase and, on a trend basis, the most since November '07, with all spending categories rising. At this stage of recovery, consumer spending growth, while below the average of the past 6 expansions, is better than the '91 and '01 growth rates.

Negatives

- ***Housing heading for a double dip?*** New home sales hit a record low and the leading pending home sales index continued its plunge since November. The National Association of Realtors says weather is playing a major role, but it's hard to believe that's the only deterrent. The reality is the percentage of mortgages underwater or almost underwater is nearly a third and continues to climb, making existing owners unlikely to go house-hunting anytime soon (unless they just walk away from their current homes, which isn't helpful for housing). Even with the housing affordability index rising in January for a 6th straight month to near its all-time high, mortgage applications are at a 13-year low. If housing can't perk up on its own the next few months, this could potentially come back and bite us as government aid ends.

- ***Construction's not going to help*** Construction spending fell a 3rd straight month, with broad-based weakness and downward revisions the prior two months. Public construction, which in past downturns helped offset declines in the private sector, continues to contract at a rapid pace despite last year's stimulus package. Housing construction, for reasons noted above, isn't likely to pick up anytime soon, either.

- ***This won't help lending*** One-half of the $1.4 trillion in commercial loans coming due the next 4 years already are underwater and could trigger $300 billion in annual bank losses. In addition, G-7 finance ministers worry that financial reform legislation under consideration in Europe and the U.S. could work to discourage banks from making credit more available. Small businesses cite the lack of credit as one of their major concerns.

What else?

- ***States' fiscal situation may be better than feared*** Consensus may be underestimating state fiscal improvement; states are slated to get $70 billion in stimulus funds over the next 12 months and $25 billion more in 2011. Moreover, state economies and tax revenues appear to go positive in 2010 even as states are raising taxes the most since 1992 and making historic reductions in spending. Strategas Research Partners notes state and local government spending increased year over year every year since '47; but at the state level, their spending fell 3.3% in fiscal '09 and is projected to fall 5.5% this year. What does all this mean? States' budget situation could be better than feared.

- ***Finally, some good news about banks*** Banks' coverage ratio (reserves to noncurrent loans) appears to have troughed in the 4th quarter, as noncurrent commercial & industrial loans fell for the 1st time in 3 years and noncurrent construction and development loans fell for the 1st time in 4 years. Ned Davis Research notes when this ratio bottomed in 2Q '91, S&P banks outperformed the market 60% the next 7 years. Last year's 4th quarter also saw fewer unprofitable banks than four quarters earlier for the 1st time since 2Q '05, and consumer loans increase for the 1st time in 8 quarters.

- ***Priorities in order*** Washington Analysis says 80% of Republicans, 2/3 of independents and half of Democrats support small deficits, even if it means slower growth.

The Manufacturers Alliance conducts a quarterly survey of manufacturers to gauge expectations of future activity.

The Rasmussen Employment Index is a monthly measure of worker confidence in the United States.

The Monster Employment Index is a monthly measure of online job demand in the United States.

The Institute of Supply Management (ISM) manufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

The Institute of Supply Management (ISM) nonmanufacturing index is a composite, forward-looking derived from a monthly survey of U.S. businesses.

Gross Domestic Product (GDP): A measure of the retail value of goods and services produced in the United States.

The National Association of Realtors' pending home sales index is released monthly and designed to be a leading indicator of housing activity.

The National Association of Realtors' housing affordability index measures whether or not a typical family could qualify for a mortgage loan on a typical home based on median incomes, median home prices and average mortgage rates.

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