

Weekly Update: As long as small business refuses to play, it's just pushing on a string

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What's ahead

The Fed this week unveiled "QE2 lite"—a new quantitative-easing tool. But it's not clear how much rolling over maturing mortgage-backed security debt into Treasuries can help. As Dallas Fed Senior Economist Thomas Siems said in *The Wall Street Journal*, "It's not a lack of liquidity that's holding back our economy. Investors and business leaders are waiting to learn more about future taxes and regulations." Indeed, a survey of CEOs by the Young Presidents Organization found confidence waning amid all the policy uncertainty, while a similar monthly gauge by the National Federation of Independent Business remained mired at recession levels (*more on both below*).



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The market sold off sharply the day after the Fed meeting, where officials acknowledged the economy had weakened more than expected. With a very good earnings season behind (*more below*), the S&P 500 has been unable to breakthrough to the upside after approaching resistance of 1,131. (But don't forget, volume is weak in August: Monday was the lowest of the year. Low-volume moves are volatile and less trustworthy). Next support is at 1,060, with major support at 950 to 1,000. The market's focused on possible deflation and a double dip. This morning's CPI, which showed prices rose slightly above expectations in July, suggests chances of outright deflation remain small.

But while the consensus still argues against a double dip, it comes down to hiring—rising employment is the No. 1 catalyst that can take this market higher. But while this week's unexpected decline in Q2 productivity indicates companies really can't squeeze any more from workers, businesses remain reluctant to hire (*more below*). Perhaps they would respond to a second catalyst—a tax cut which the small businessman perceives to be permanent. But is that something in the Obama administration's playbook? Hmm. Last week, I was in Hawaii, lying on a hammock, and my daughter was pushing me gently on a string. It reminded me of the Fed.

Positives

A consumer who wants to spend June's larger-than-forecast trade deficit was driven by a 4.8% jump in real imports, which are up at a 27.6% annualized rate over the last three months. This will probably further reduce already meager Q2 GDP growth on revision, but the surge of imports is a sign of rising domestic demand, with *personal consumption expenditures above their pre-recession peak*. Still, today's retail sales report for July disappointed, with core sales ex-autos and gas down 0.1% and department store sales down 3 of the past 4 months. The back-to-school season will be critical—the National Retail Federation projects a year-over-year increase of 16%. But the major force remains jobs—without more, consumers will struggle to spend more.

Earnings do their part With Q2 reports almost over, approximately 3/4 of S&P 500 companies beat earnings estimates an average 10%, and nearly 2/3 beat revenue forecasts. The strong season was the catalyst for the market's run-up from June's lows, but as noted above, attention is rapidly shifting to the strength of the recovery—a concern reinforced by Cisco's disappointing guidance after markets closed Wednesday. It used the words "uncertain" or "unusual" 19 times. Notably, revenue for the quarter rose 16% for S&P companies with foreign exposure but only 6% for the rest—possibly reflecting why U.S. small businesses continue to complain about poor sales.

Commercial real estate headed for better times? Sentiment among senior real estate executives has been positive for two quarters, while the National Multi Housing Council says apartment market conditions are tightening at their fastest pace in 4 years, sales are increasing at their fastest pace in 11 years, equity financing improved the past quarter at its fastest pace since it began surveying members and debt financing is the most available it's been in almost 9 years. Also, Cushman & Wakefield noted the first downtick in downtown office vacancy rates since the recession began. A turnaround in this sector would provide a welcome and unexpected lift.

Negatives

Small businesses just aren't buying it The NFIB small business optimism index fell a 2nd consecutive month in July, with the net percentage of firms expecting the economy to improve hitting -15%, the lowest since March 2009. The trade group, again citing poor sales, taxes and government regulations, said the "persistence of index readings below 90 is unprecedented in survey history." Reflecting this mood, a Wall Street Journal article written by a small businessman ran through a litany of government mandates and taxes associated with hiring and concluded, "From where I sit, the government's message is unmistakable: Creating a new job carries a punishing price." This is truly the thorn in the side of the bull.

Employers hesitant to hire July's increase in workweek hours, often a precursor to hiring and cited as one of the positives in an otherwise dismal employment report, reflected the ongoing employer preference to add hours rather than workers. The aforementioned CEO survey by the Young Presidents Organization found 62% plan to hold employment steady in the coming year. Even though Q2 nonfarm productivity unexpectedly declined, implying companies have little further ability to wring more output out of their existing input (employee hours have risen 3 straight quarters), signs of future hiring are weakening. Temp jobs fell in July for the 1st time in 10 months; household employment fell a 3rd straight month; and jobless claims hit a 6-month high the first week of August. Ugh. I think I'll go back on vacation.

Sluggish service spending holds back growth GDP revisions going back to 2007 show an unprecedented—and broad-based—stagnation in the consumption of services, from housing and health-care to recreation and professional services. Over the past four quarters alone, Deutsche Bank notes consumption of goods has dramatically outpaced consumption of services by an average of more than 4%. Before the current downturn, service consumption had never contracted during a postwar recession. This is all part of a consumer deleveraging that has been good for the household savings rate, now at 6.4% and on track to hit 7.5% by the end of 2011. But right now, the economy needs consumers to spend, not save, more.

What else

Medicare smoke and mirrors The recently released Medicare and Social Security trustee reports show an improved picture largely because it moves spending away from the trust fund-financed programs and into the general fund—that is, it cuts spending within Medicare by \$575 billion over the next 10 years but increases net spending *outside of Medicare* by \$828 billion. Also, it allocates new revenues (the new 0.9% Medicare payroll tax on earnings over \$250K and the 3.8% tax on passive income starting in 2013) to the trust fund *that were meant to offset the cost of new health insurance subsidies*. Finally, it assumes most Medicare payment updates will grow at a slower pace because of changes in the Patient Protection and Affordable Care Act. But if health-care productivity lags, *as it always has done in the past*, then Medicare long-term costs will be larger than projected.

Investors never bought into this bull Ned Davis Research shows that a net \$31 billion has flowed away from equity mutual funds since April 2009, after the start of the cyclical bull market, while a net of \$425 billion has flowed toward bond mutual funds.

'No, you can't go on Facebook' Private Wealth Magazine notes that experts say that one of the biggest leaks in an affluent family's security is their child's Facebook account.

Views are as of August 13, 2010, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

The National Federation of Independent Business (NFIB) conducts surveys monthly to gauge how small businesses feel about the economy, their situation and their plans.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Consumer Price Index (CPI): A measure of inflation at the retail level.

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