Uncertainty - a correction but not 2008/2009

While the debt ceiling crisis has passed, uncertainty remains as to how policy makers will deal with the long term structural deficit in the U.S. What tax and spending solutions will be enacted? In addition, the development of a credible plan to deal with the sovereign debt issues facing Europe is needed.

The market decline of 10.8% over the last 10 trading days was likely precipitated by concern about growth prospects for the U.S. and global economies. Issues related to the European financial situation have also weighed heavily on the market. We do not believe we are headed back into a late 2008, early 2009 scenario for both the economy and the financial markets; however, we do believe the economy is growing and likely to continue growing at a slow pace. This slower growth rate will likely constrain employment although the latest job numbers indicate the U.S. economy created 154,000 private sector jobs in July with upward revisions of 80,000 in June and 46,000 in May. Our current unemployment situation is a far cry from what we saw during that financial crisis of 2008/2009 where 700,000 jobs were being lost per month, a 5% contraction in GDP from peak to trough and deposit concerns at our largest U.S. banks.

While the risk of slipping back into a recession has been heightened due to government cutbacks, an unemployment rate above 9%, and a weak economy in Europe, we do not believe a repeat of the 2008/2009 scenario is likely. Some positive fundamental data points include:

- 75% of companies have beaten earnings estimates in the second quarter
- Aggregate corporate earnings and revenues are both up about 13% on a year over year basis
- Corporate cash balances are at record levels and a growing number of companies are buying back their stock and raising dividends
- Household debt obligations (rent, credit card bills, car payments, etc., divided by disposable income) are at lows not seen since 1992
- Manufacturing and service sectors are still expanding
- GDP growth is still expanding, albeit at a slow pace

Slow economic growth likely leads to interest rates remaining at very low levels. Today, an investor in U.S. government bonds is receiving 2.4% per year in interest for a 10-year bond. Money market accounts pay virtually nothing. On the other hand, S&P 500 stocks pay nearly 2% dividends on average with many high quality stocks paying 3% or more. Given the financial backdrop for U.S. corporations, relative to the U.S. government, we would rather invest in companies with 3% dividends, rock solid balance sheets, global growth opportunity and selling at valuation levels not seen since the early 1990s. Investment capital will find its way to the best opportunities and U.S. stocks look attractive relative to most other asset classes.

Rising commodity prices have been a major concern as many feared that rising gasoline prices and other commodity input costs would hinder profit expansion and consumer spending. Dispelling some of these concerns, commodity prices have dropped dramatically. Light Sweet Crude Oil is down 24% from 2011 highs and the Thomson Reuters/Jeffries CRB Index is down slightly year-to-date. This should help place discretionary dollars back into consumer pockets in the near term.

We favor owning high-quality, multi-nationals within the large cap equity space. In fact, we have conviction in names that continue to remain financially flexible with record amounts of cash on their balance sheets and the ability to generate profits globally. We continue to maintain an overweight in large-cap equities. Over the last several months, clients whose investment accounts were above our target weights in small-cap equity and emerging market equity would have seen reductions in those allocations. We targeted a reduction in more volatile asset classes as some signs of economic weakness became evident.

As Warren Buffet once said, “Be fearful when others are greedy, and be greedy when others are fearful.” It is difficult to guess the bottom in the equity markets; however, with less than 4% of S&P 500 stocks trading above their 50-day moving average, the lowest percentage since late 2008, this appears to be a good time to build positions in equity and in particular, high quality companies.

If we can answer any additional questions, please do not hesitate to call on any of us at HORAN Capital Advisors.