

Monday, July 13, 2009

Second Quarter 2009

Every quarter seems to popularize new financial jargon. The ‘second derivative’, ‘green shoots’ and the ‘new normal’ are terms that have gained currency.

Stock markets have rallied dramatically since early March even as the economic news has been dreadful. Financial markets usually react to the change in the rate of change – ‘the second derivative’. The stock market lows in early March came before a sign of an upturn in economic activity but, arguably, at a time when economic conditions were deteriorating less alarmingly. By March it could be said that the economy was no longer free falling. A parachute had opened, but it was still falling. From the lows in early March to mid-June risky assets, those that had been most pummelled in the fall and winter, rallied spectacularly. It was hope that led the way. Second derivative improvements are not the same as expansion and a rebound is not the same as a turnaround.

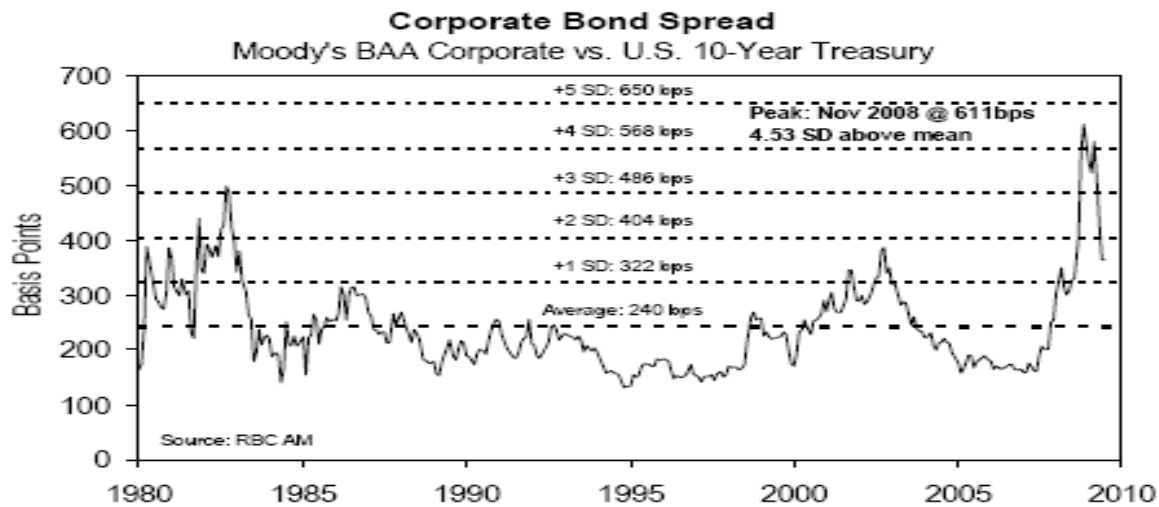
Moving from second derivatives, commentators latched onto the ‘green shoots’. Federal Reserve Chairman Ben Bernanke told the CBS Program ‘60 Minutes’ on March 15th that the ‘green shoots’ of economic revival were already evident. There is of course much debate about what the green shoots are and whether they are wilting this summer, but the following charts make the case that at least the financial crisis has moderated, if not that the great recession is ending;

- a) The 3-month LIBOR (London Interbank Offered Rate) versus short term government administered interest rates shows a trend to more normal inter- bank lending rates. Banks’ confidence in each other is returning:



Source: RBC AM “The Global Investment Outlook- Capital Markets Update” by Daniel E. Chornous, July 8th, 2009

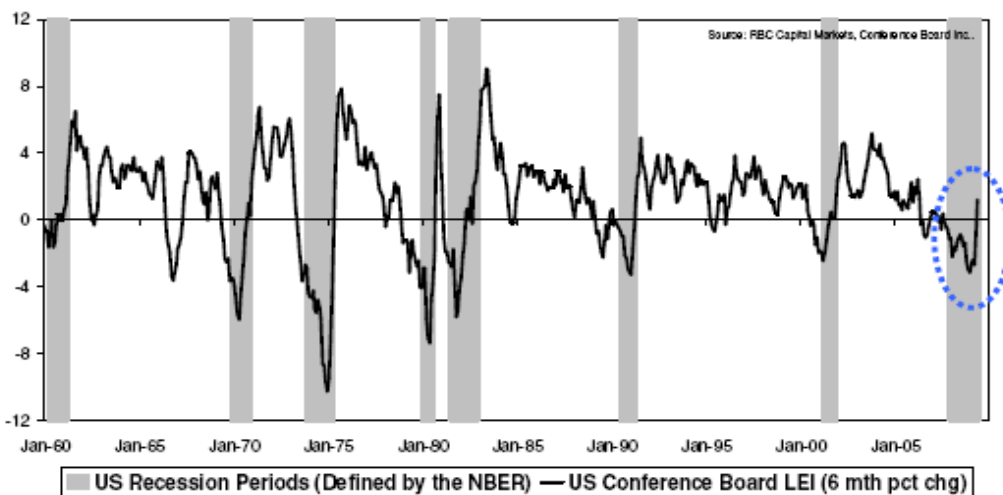
- b) Corporate bond spreads have narrowed. The yield on Moody's BAA Corporate Bond Index versus U.S. 10 year Treasury yields, while still above normal, are no longer extreme. Investment grade corporations can now raise money in the debt markets at a more reasonable price. The financial crisis is easing, even as the economic crisis continues.



Source: RBC AM "The Global Investment Outlook- Capital Markets Update" by Daniel E. Chornous, July 8th, 2009

- c) Corporate bond spreads and stock prices trade very closely with leading economic indicators. The six month rate of change of The Conference Board's Leading Indicators recently increased to 1.2%, the first positive reading since July 2007. According to RBC's Myles Zyblock a "positive reading has appeared, on average, three months ahead of the end of recessions since 1959".

Exhibit 4: Conference Board's LEI Usually Turns Positive in Advance of the End of Economic Recession

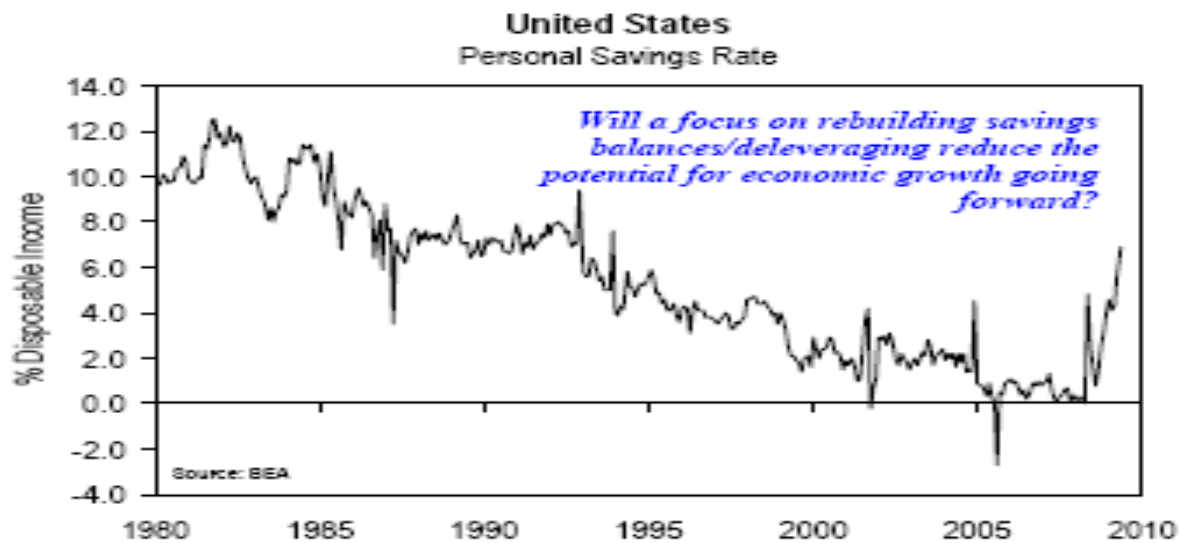


Source: RBC Capital Markets "RBC Investment Strategy Weekly" by Myles Zyblock, July 8th, 2009, Pg 4

These signs of improvements in financing costs and in the leading economic indicators are grounds for optimism, but mine is tempered by seasonal and cyclical factors. What I call my superstitions about stock market timing. Seasonality suggests looking for bargains in the fall, when the days get short, and cyclicality in this case refers to the Presidential cycle, the idea that Presidents spend the first two years trying to get bad news out of the way (such as putting GM into bankruptcy) before spending two years focusing on re-election.

My third buzz word refers to longer-term dynamics and is more profound than the other two. The 'new normal' was coined by Bill Gross, the highly articulate bond manager (the 'bond king') for PIMCO, the world's largest bond managers. Gross describes a future characterized by much lower 'new normal' rates of economic growth: 1% to 2% rather than the 3% GDP growth we used to have. This difference may seem small, however the implications become much larger over time. For example, the difference between 2% and 3% economic growth would mean that the economy would only double once in my children's lifetimes instead of twice. A lower growth rate for the economy implies, among other things, lower price/earnings ratios for stocks.

Deleveraging, reregulation, increased taxation and reduced consumption are some of the changes Gross predicts as a consequence of the bursting of the bubbles of the last decade. Demographics (the bulge of boomers are moving towards retirement) and the shift to thrift leads Gross to advise investors to remember Will Rogers "who opined in the early 30s that he wasn't as much concerned about the return on his money as the return of his money. (William H. Gross, Staying Rich in the New Normal, PIMCO, June 2009).



Source: RBC AM "The Global Investment Outlook- Capital Markets Update" by Daniel E. Chornous, July 8th, 2009

The excesses of the last few years, including the imbalance between over production in China and over consumption in the U.S., are going to take time to work out.

Sincerely,
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