The BOECKH INVESTMENT LETTER

VOLUME 2.5
APRIL 22, 2010

The Economy vs The Stock Market

The global financial market rally is now in its 13th month. As we have pointed out repeatedly, it has occurred against an unsettling, uncertain and unbalanced macroeconomic backdrop. There is an array of structural problems that could derail the recovery once momentum from fiscal and monetary stimulus ends. However, slower than expected growth isn't necessarily a big negative for investment returns. Sustainability, liquidity flows, interest rates and long-term profit expectations are crucial variables. In this letter we offer a brief review of what we believe will be the weak link in the U.S. recovery and explain how investors should position themselves for it.

Forecasts for the durability of this bull market are wildly divergent, and with good reason. Most signs of recovery are clouded by the influence of government stimulus and reflation efforts. Moreover, year on year comparisons are misleading. Almost anything would look better than the abyss we were in a year ago. However, a common mistake many of the more bearish analysts are guilty of, is the assumption that investment returns are predicated on their near-term assumptions of the GDP growth rate.

In terms of the negatives, runaway public-sector deficits and debt growth are the greatest threats, which we will discuss in detail in a coming letter. However, there is likely at least a year or two before this weighs heavily on markets. The reason is that a massive fiscal drag is likely to hit the U.S. and other economies in 2011, in good part from tax increases. While extremely negative from a supply side perspective, it should help cool the angst coming from debt projections at least temporarily. However, the political process is always a wild card when unemployment is high, and it remains to be seen whether the structural deficit will actually shrink on a sustainable basis.

In the U.S., the more immediate threat to the recovery is consumer deleveraging. Housing prices and unemployment have stabilized, but a quick rebound is not in the cards. Years of credit-fuelled consumption, which was taken to its ultimate stage of excess during the housing bubble, will be a slow and painful process to unwind. There are no shortcuts, and given that domestic consumption is responsible for 70% of economic activity in the U.S., sluggish growth seems inevitable.

Personal consumption expenditures are growing, although only at a 2% rate from last year. Retail sales are up substantially, but must be adjusted for government incentives which have been successful in causing a bulge in current spending, likely at the expense of future consumption. Worryingly, consumer confidence remains low, which is a reflection of weak income growth, high structural unemployment and excessive household debt levels. This is a grim picture particularly if income growth remains anaemic. It is important to keep in mind that the wealthiest 20% of Americans are responsible for 65% of consumption, and that their buying power is more closely correlated with stock market performance than with income. Recent stock market gains have given this source of consumption a boost, while the lowermiddle class has had to be more frugal. However, asset-driven spending is a two-way street. A sharp break in the stock market and further weakness in housing prices could cause household spending to dry up again. Below, we present some charts that highlight the unbalanced and artificial nature of the recovery.

The case for a weak recovery.....

Chart 1: U.S. Residential construction is still extremely weak

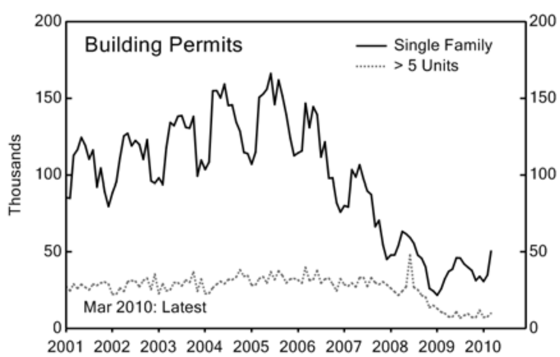


Chart 2: Sales volume bounced...temporarily

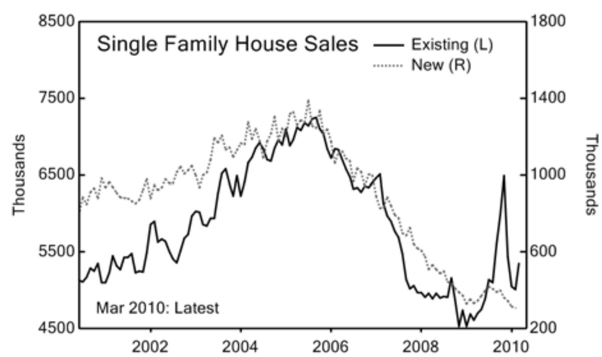


Chart 3: Structural unemployment highest since the 1930s.

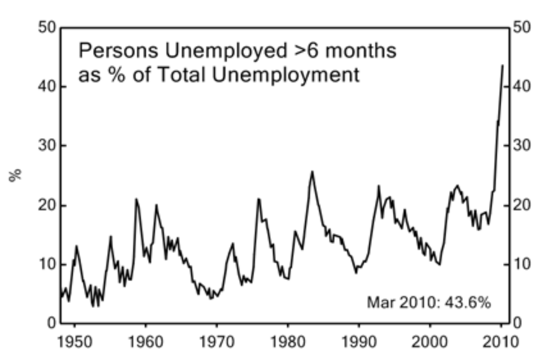


Chart 4: Six unemployed for every job opening.

Chart 5: U.S. consumers are spending again, but...

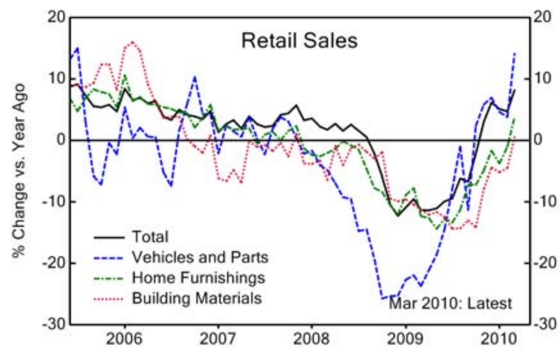


Chart 6: Consumption expenditure is growing but still weak.

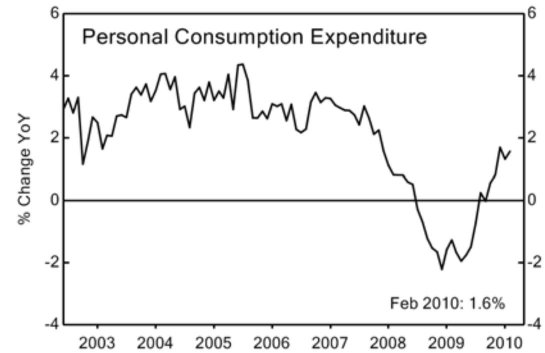


Chart 7: Consumer confidence remains low.

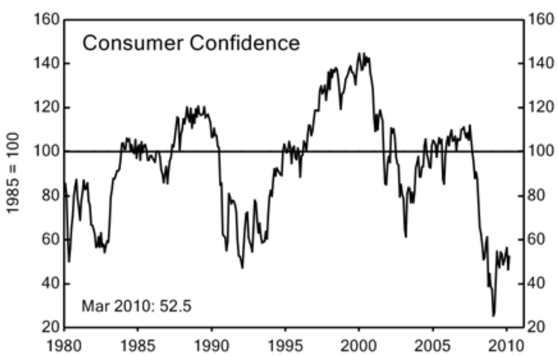


Chart 8: Where is the money coming from? Not income.

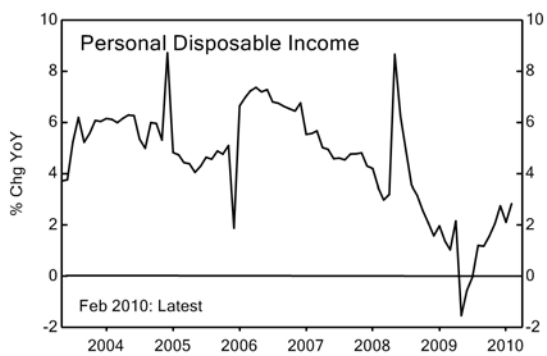


Chart 9: Not borrowing.

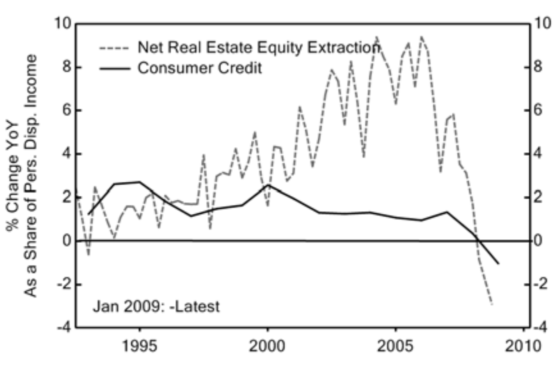


Chart 10: Answer: investment returns are driving spending for the upper middle class.

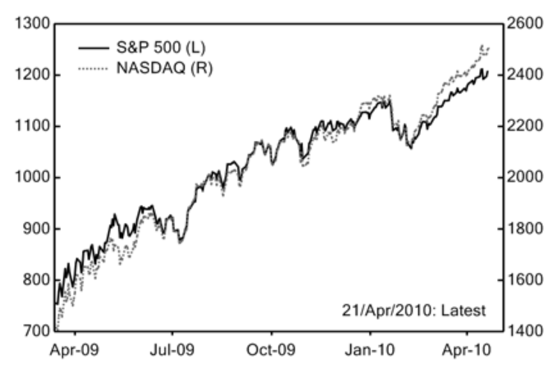


Chart 11: Household deleveraging has a long way to go.

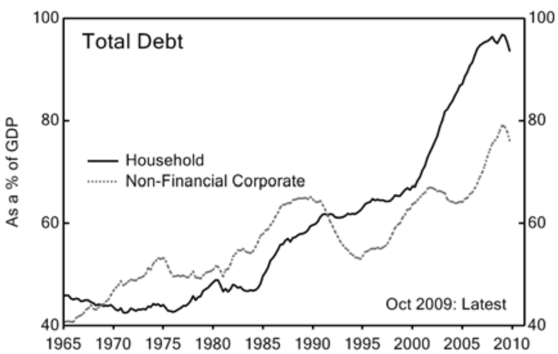


Chart 12: U.S. still too reliant on domestic consumption.

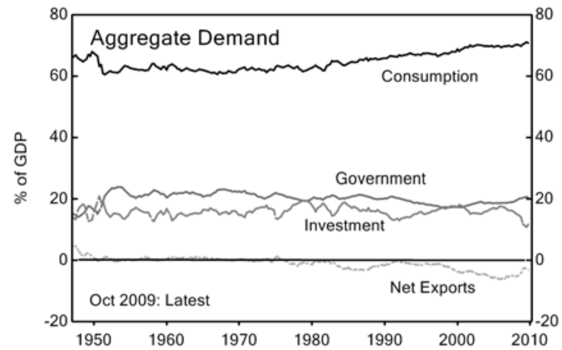
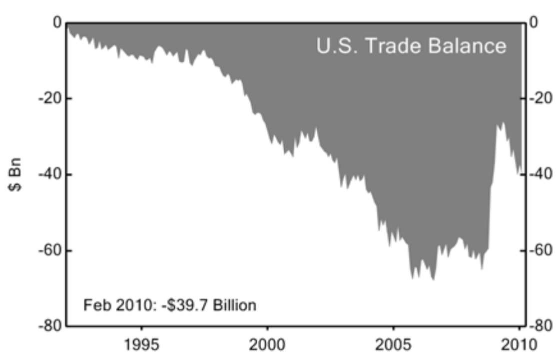


Chart 13: Exports? There is always hope…but starting to deteriorate.



Conclusions

Despite all of these worries, U.S. stocks continue to rally, climbing the proverbial wall of worry. This has mystified the bears because they have underestimated the power of near-zero interest rates and massive new injections of central bank liquidity in the U.S. and elsewhere. And, very importantly, they have not paid enough attention to the dramatic improvement in the corporate sector (See our letter: Return of the Bond Vigilantes: The Great Dilemma, Volume 2.2, February 25, 2010). U.S. non-financial corporations have rarely been in better shape. The combination of low corporate net debt levels and sharply rising productivity will likely continue to produce positive results. Normally corporate productivity surges in the early stages of a recovery, but it usually only lasts for a few quarters. An important uncertainty for investors is how long can corporate earnings remain strong in the absence of a robust recovery in the global economy?

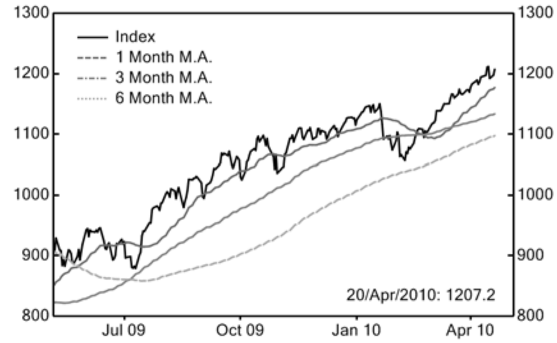
Our take on the overall situation is that economic growth will slow abruptly after the year-end to perhaps 2% per year. But investors should be careful not to put the cart before the horse. The horse—low and stable short and long-term interest rates and plentiful liquidity—will continue to do its work to support asset prices. The key is to have enough growth so that profits can continue to rise but not so much growth that government borrowing will crowd out private borrowing, inflation rises and the Fed and other central banks have to raise rates significantly. A stable U.S. dollar and the Treasury bond market continue to be key U.S. benchmarks that will tell us when the current environment might turn more hostile. So far, so good: we're still bullish, but not complacent.

Tony & Rob Boeckh
Date: April 22, 2010
www.BoeckhInvestmentLetter.com
info@bccl.ca

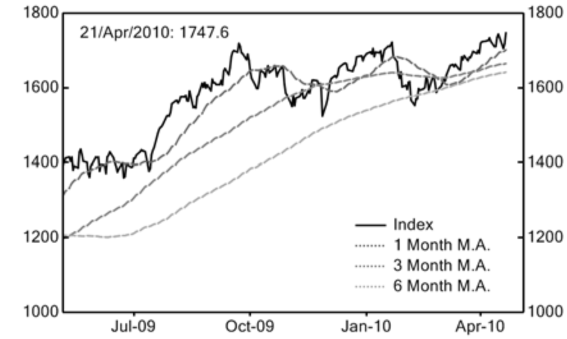
*All chart data from IHS/Global Insights, and may not be reproduced without written consent.

Charts: Stock Markets

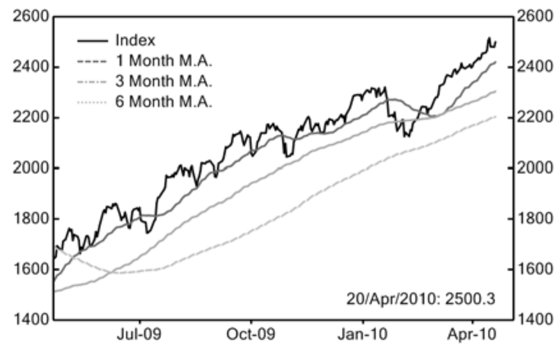
U.S. S&P 500 Composite



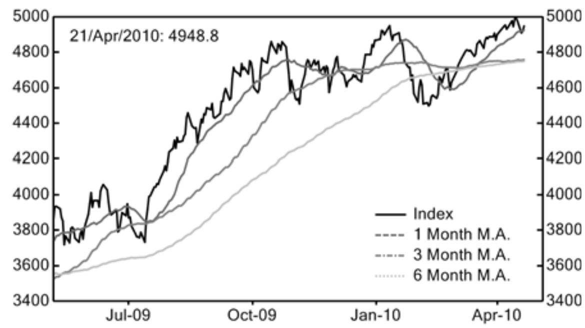
South Korea: KOSPI



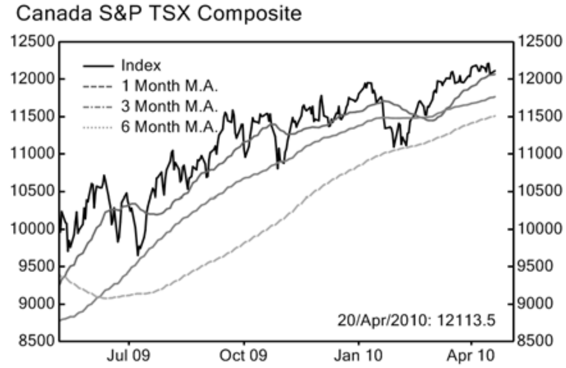
U.S: NASDAQ



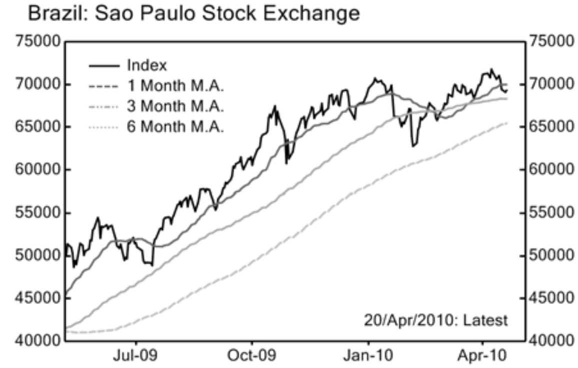
Australia: S&P/ASX 300



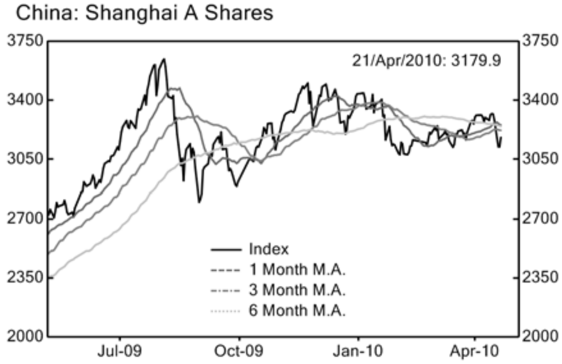
Canada S&P TSX Composite



Brazil: Sao Paulo Stock Exchange



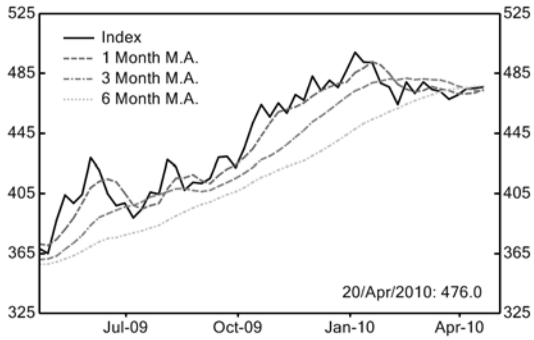
China: Shanghai A Shares



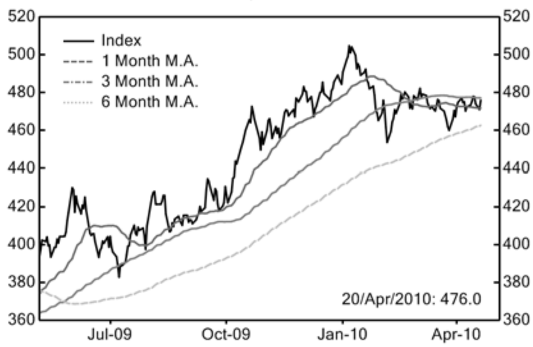
Emerging vs. U.S. Markets

Commodities

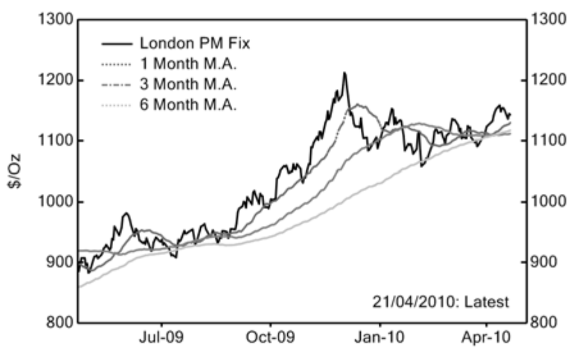
CRB Continuous Commodity Index



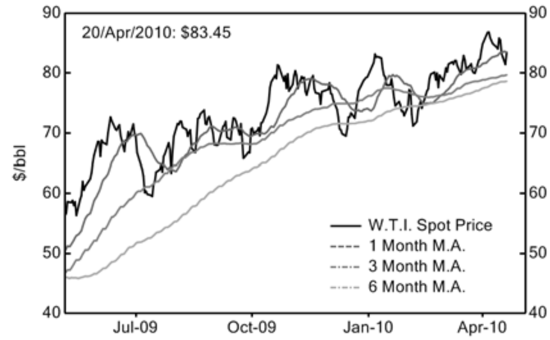
CRB Futures Commodity Index



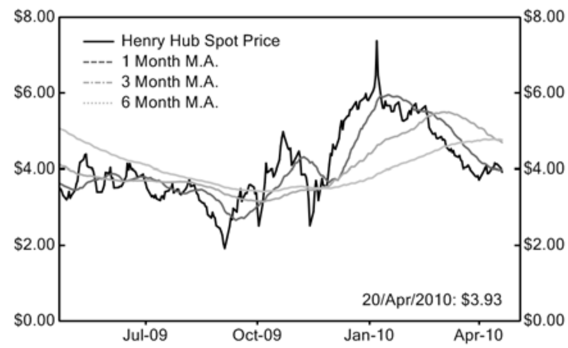
Gold



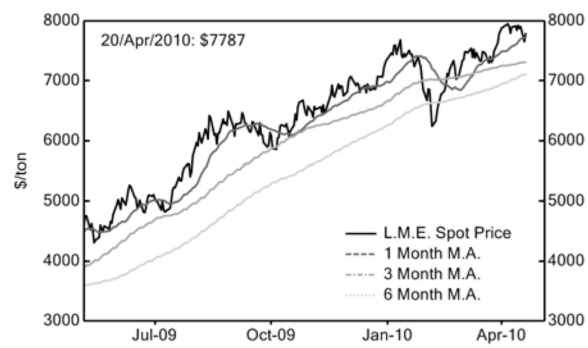
Oil



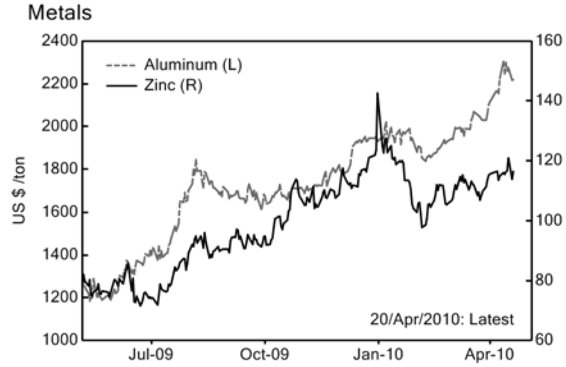
Natural Gas



Copper

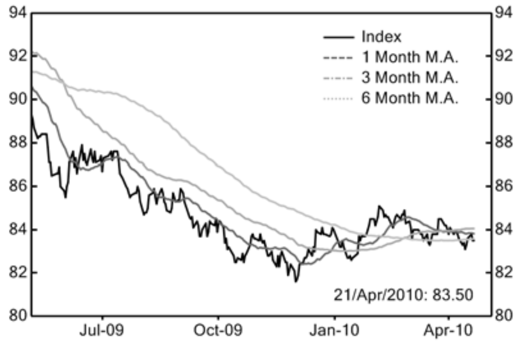


Metals

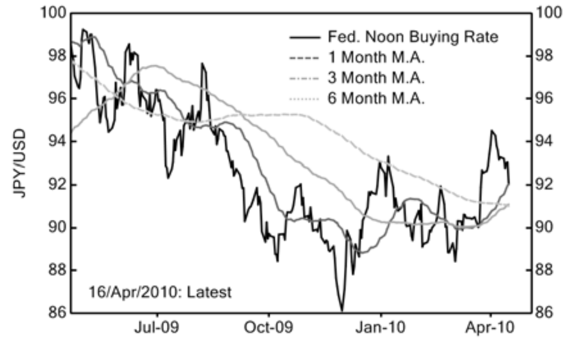


Exchange Rates

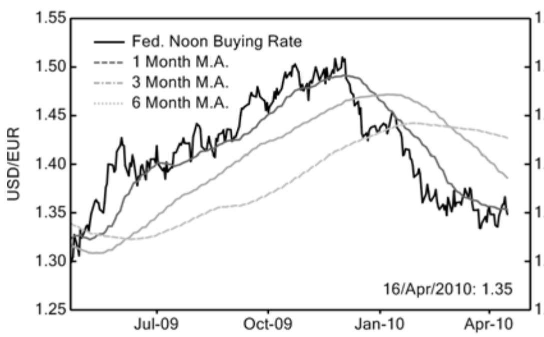
JP Morgan Trade Weighted Dollar Index



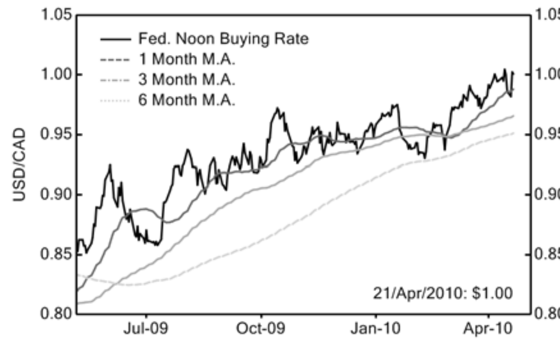
Japanese Yen per U.S. Dollar



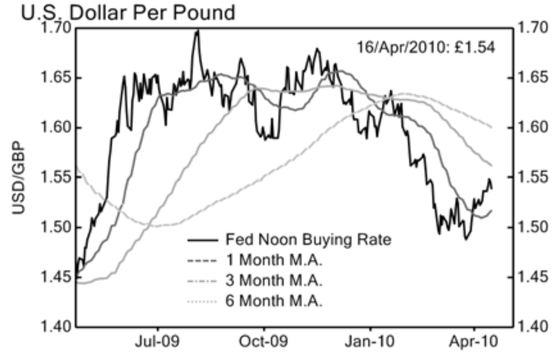
U.S. Dollar Per Euro



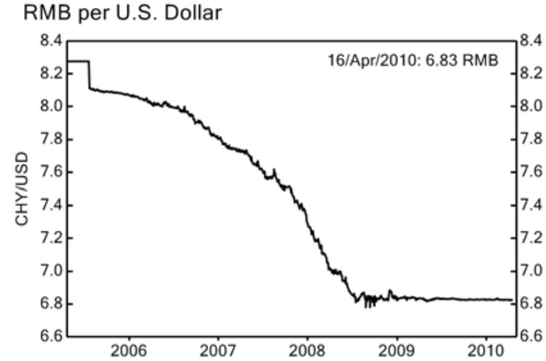
U.S. Dollar Per Canadian



U.S. Dollar Per Pound

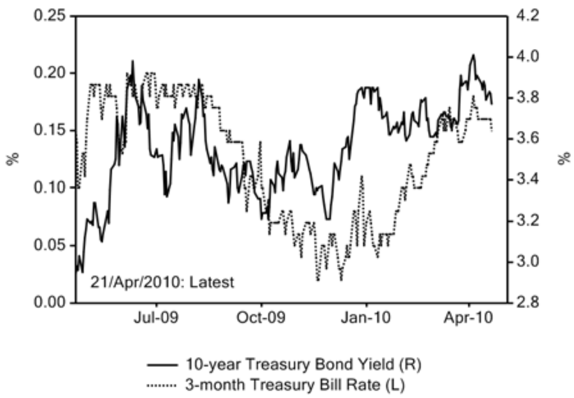


RMB per U.S. Dollar



Interest Rates

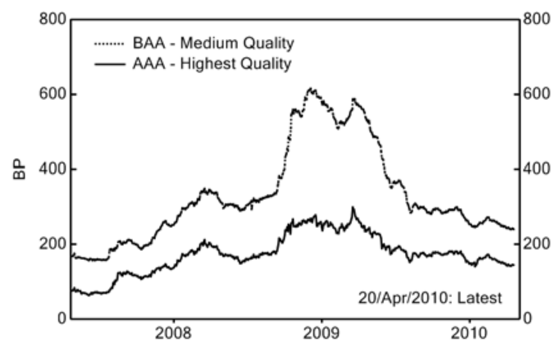
Yield: U.S. Government Paper



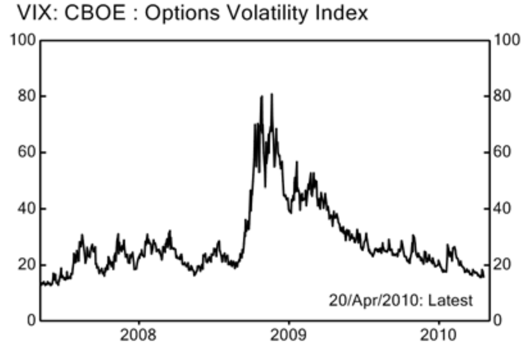
Yield Curve

Conventional Mortgage Rate

Corporate Spread over 10 Year Treasuries (Moody's)



VIX: CBOE : Options Volatility Index



Source: Federal Reserve