THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

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Bouncing Within the Decision Box

- July was a good month for stocks: the S&P retraced half its decline from April's 1220 peak to July's 1010 low and closed the month at 1101 – right in the middle of our 'decision box.' Technically, with the primary trend still flat, the stock market is giving few technical clues as to the viability of the cyclical bull market. The call is thus a fundamental one: Can the global recovery be sustained without fiscal stimulus and allow governments to gradually pay down debt? We believe it can, but it is a close call.
- Fortunately, there is little threat of inflation in the developed world, so central banks have the flexibility to support fragile recoveries (and financial markets) with monetary policy and balance sheet expansion. We believe the Federal Reserve and the Bank of England will likely be the most supportive if global growth slows. Also supporting the bullish case for stocks is persistent investor pessimism. We believe the S&P 500 at 1100 (15 times trend reported earnings) is fairly valued. Trend reported earnings are on track to grow to around $100 in five years. Thus, as long as investors see earnings growing in line with the trend in the next five years, the S&P 500 at 1500 to 1600 (its 2000 and 2007 highs) over that timeframe is very achievable in our view. This is our central case, and we see upside to 1280 in 2011. In our view, the bear case is a correction to around 850 – 950, not a return to the lows of 2002 and 2009, if developed economies slip back to zero or even negative growth.
- RiverFront's new strategic benchmarks (effective July 1st) reflect risk asset prices that are significantly higher than a year ago (thereby lowering expected returns) but that still offer materially greater expected returns over low risk assets. Tactically we have been in risk management mode during the volatile last three months. We reduced exposure to low conviction markets and sectors, e.g. consumer cyclicals and Europe, and increased weightings in our high conviction ideas, e.g. emerging markets and most recently, the UK. Our portfolios are now 3 to 5 percentage points underweight our strategic risk asset benchmarks. Our remaining cash, which we have not wanted to commit to the bond market at such low yields, is available in the event of a correction or a breakout.

Deeper recession reveals sluggish consumer demand and some positive structural changes

Last week the government reported second-quarter GDP growth of 2.4%, slightly lower than consensus expectations. More importantly there were significant revisions for the previous three years, which revealed a deeper recession and shallower recovery than originally reported (see Weekly Chart). When the contribution from government spending and inventory building are removed, underlying consumption has only contributed around 1% to overall GDP growth over the last year. While this confirms our view of 'painfully slow growth,' we found some encouraging signs of structural changes within the report that we believe are critical for sustaining growth.

First, non-inventory business investment, led by equipment and software, accelerated strongly to 19.1% from 3.3% in the first quarter, its highest since 1983, after being mostly negative since 2006. As a result, fixed investment contributed over two percentage points to growth in the second quarter, up from less than half a percentage point in the first. While personal consumption added about 1.1 percentage points to growth (a little less than the prior quarter) we think it is decelerating as stimulus fades. Hence, we are encouraged that business spending is taking up some of the slack. Furthermore, we think this is the 'right' kind of investment that the US needs to sustain economic expansion. Prior to the recession, business spending was led by residential and non-residential real estate 'investment' that turned out to be non-productive and wealth destroying. We believe the acceleration in equipment and software spending will raise productivity, profit margins and earnings and should eventually translate into long-term growth and hiring.

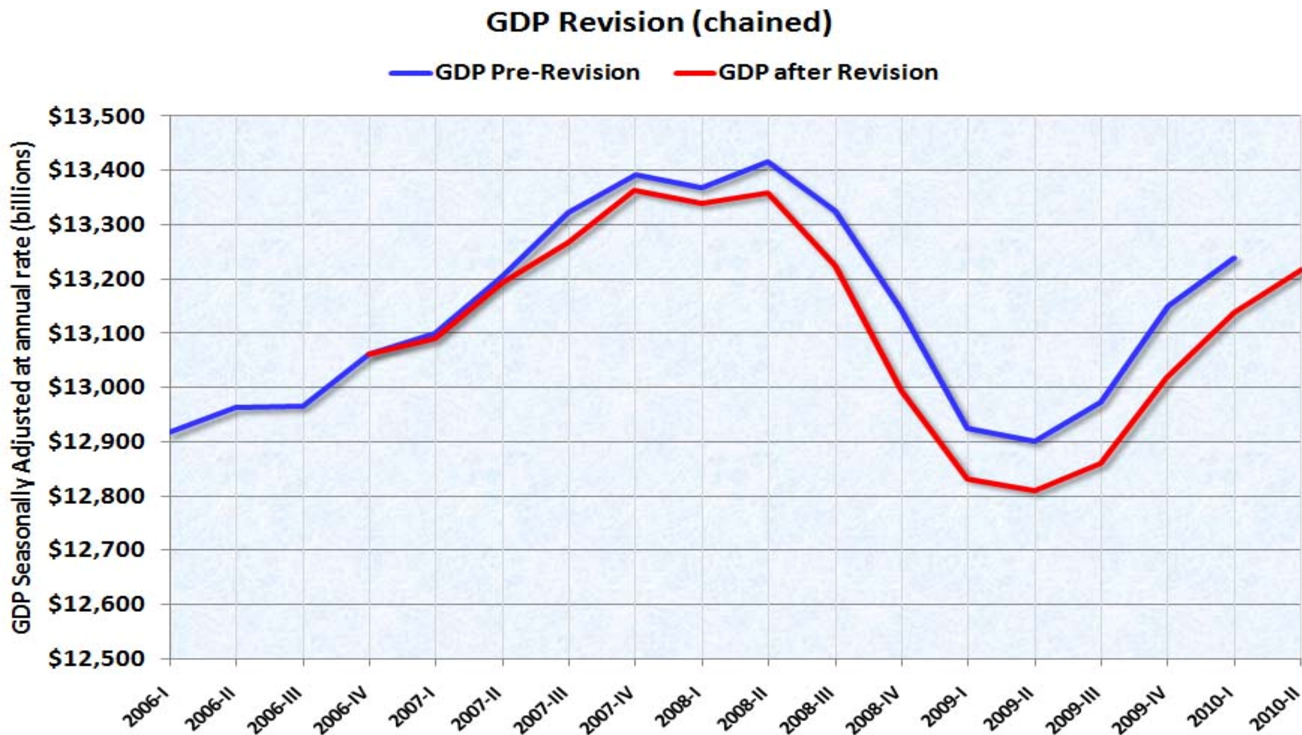
Second, although benchmark revisions have lowered growth, they raised personal incomes and savings by over 1% in 2008 *and* 2009, which means that consumers are significantly better off than previously thought. Moreover, incomes have continued to rise in the second quarter with disposable personal income (DPI) growth accelerating to 4.4% from 3.8% in the first. The personal saving rate also rose to 6.2% from 5.5%, which was up substantially from a pre-revision 4% rate. Over the near term, higher savings (even with greater income) is likely to weigh on consumption and growth,

but over the longer term we believe this will be more than offset by deleveraged households with strengthened balance sheets on much firmer financial footing.

In our view, healthy households are necessary to solidify the recovery and, while it still may take several more quarters (and perhaps years) to fully pay/write down debt, the process is well underway. Rising consumer and business confidence should follow. Subnormal growth in the meantime, while frustrating, has the silver lining that the Federal Reserve will probably remain accommodative longer under such circumstances. This was highlighted by the price index for personal consumption expenditures, which measures price changes for consumers in the GDP data; in the second quarter it was up by only 0.1% and was down from a 2.2% increase in the first.

While investment and income were positive surprises for us, there were some negatives in the GDP reports. Most prominent in our view was trade, which subtracted 2.8 percentage points from growth. While exports increased by over 10%, imports more than offset this gain by rising almost 29%. Trade figures are subject to revisions in subsequent reports but as it stands, trade has not been the growth driver for the economy that we had hoped it would. We continue to expect that exports will contribute to growth over the coming quarters and years, especially as emerging market consumption ramps up, but we are no longer so optimistic that import growth will diminish.

The Weekly Chart: Downturn greater and recovery weaker



Source: Calculated RISK

The chart above, courtesy of Calculated Risk, illustrates the Bureau of Economic Analysis' 2006 – 2010 revisions to GDP and shows that the Great Recession was deeper than originally estimated. From the first quarter of 2006 to the first quarter of 2010, average annual growth was 0.2 percentage points less than the 0.4% growth previously published. Although seemingly small, over that time period the difference means second-quarter GDP is below where it was (pre-revision) during the first quarter and still about 1% below the pre-recession peak.

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