

# Perspective

APRIL 2011 • VOL. 27, NO. 2 • A QUARTERLY REPORT ON INVESTMENT AND ECONOMIC TRENDS

## THE OTHER SIDE OF THE COIN

*“Our problems are many but our capacity for solving them is limitless.” – Ronald Reagan*

In the first quarter investors were reminded once again how human and natural disasters can suddenly erupt, causing widespread personal tragedy and enormous property destruction.



Emboldened by the success of the Egyptians, who successfully forced Hosni Mubarak to resign after nearly three decades as president, citizens of Libya began a similar attempt to overthrow Muammar el-Qaddafi. However, unlike the peaceful outcome in Egypt, the Libyan situation has proven to be an ongoing destructive battle. In addition to geopolitical tensions, we witnessed the devastating earthquake, tsunami and subsequent nuclear crisis in Japan. The Japanese quake and tsunami are emerging as the world's most expensive natural disasters on record, wreaking \$300 to \$400 billion in estimated damages.

The consequences of supply disruptions in critical commodities and manufacturing components, and the complex financial implications for investors are difficult to quantify in the short run. Nevertheless, when combined with sharply higher oil prices, continued housing woes, a winding down of stimulus, and a looming budget crisis, it is striking how the intensified geopolitical risk abroad and the tragedy in Japan have not been enough to derail the stock market.

It appears investors are focused on the other side of the coin where promising trends have taken hold amidst a backdrop of daunting challenges. Specifically, hefty corporate profits, strengthening economic indicators, improving employment, attractive stock valuations, and an accommodating Fed have all served as powerful forces to coax investors back into the stock market.

We are in the middle of a moderate investment led economic recovery. Consumers have shown some life, but will continue to be hampered by high unemployment and a weak housing sector. In addition, at some point, persistent increases in food and energy prices will create a headwind.

Government spending will decline due to a winding down of stimulus and an overdue contraction in state spending by

some of the hardest hit states like Illinois and California. The U.S. budget remains out of control. Fiscal policy shocks may come as a result of the budget crises, causing cutbacks and tax hikes.

This is a pivotal time where the question now is to what degree the positive forces will be augmented, and how the challenges will be either dampened or reversed.

## Market

The first quarter of 2011 ended on a high note, with the Dow Jones Industrial Index returning 6.4% and the price of the S&P 500 up 5.4%. However, tensions in the Middle East, the natural disaster in Japan and the sharp spike in oil prices, did create some volatility. In fact, the S&P 500 actually fell 6.4% from its February 18 peak to its March 16 trough before ultimately recovering.

Market Measures*	% Change	% Change	% Change
	1Q Ending 3/31/2011	6 Mo Ending 3/31/2011	1 Yr Ending 3/31/2011
Dow Jones Industrial Avg	7.04%	15.58%	16.36%
S&P 500 (Cap Wtd)	5.80%	17.25%	15.58%
NYSE Composite	5.54%	15.44%	12.85%
NASDAQ Composite	5.05%	18.00%	17.18%
Russell 1000 Large Cap	6.24%	17.81%	16.69%
Russell 2000 Small Cap	7.94%	25.48%	25.79%
Russell 1000 Growth	6.03%	18.58%	18.25%
Russell 1000 Value	6.46%	17.68%	15.15%
S&P CitiGroup Growth	5.07%	16.65%	16.56%
S&P CitiGroup Value	6.80%	18.03%	14.79%
Lipper Large Cap Value Fd	5.91%	17.00%	11.96%
Barclays Capital Int Bond	0.34%	-1.11%	4.63%
U.S. T-Bills (90 days)	0.06%	0.06%	0.06%
Consumer Price Index	1.49%	1.83%	2.21%

\*Total Return

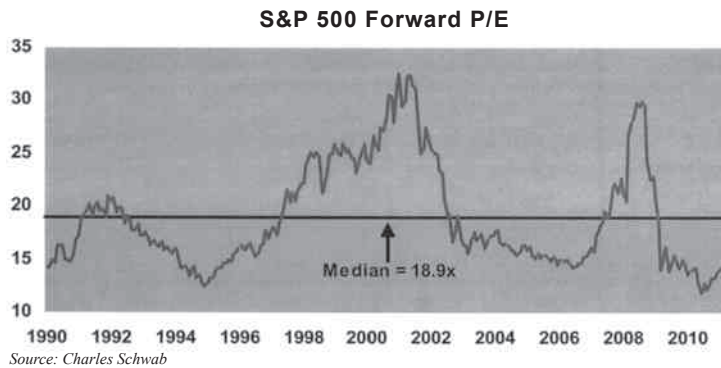
As the stock market is a leading indicator, we find it encouraging that stocks were able to maintain their upward momentum after experiencing the 6.4% pullback (typically defined as a market decline of 5%-10%) without morphing into a correction (typically defined as a decline of 10%-20%).

Throughout the stock market's latest ascent, corporate earnings and subsequent valuations have become primary focal points of investors.

### In This Issue:

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On a forward earnings basis, stocks are reasonably priced. Today's P/E of 14 times is still well below the median of the last 20 years.



Earnings on the S&P500 declined over 92% from their 3Q07 peak to the low reached in 1Q09. Since that time earnings have surged back to the second highest level in history, just shy of pre-credit bubble levels. It took 20 years for the S&P500 earnings to recover from the Great Depression lows and return back to the pre-crisis peak. This time, it has only taken 20 months.

The benefits of a jobless recovery, and evident during the initial rebound in corporate earnings, is the expansion of profit margins and gains of efficiency. However, what's revealing about the latest earnings increases is the fact 69% of S&P500 companies are reporting higher than expected revenues. It's not just cost cutting driving earnings, but top line growth has become a dominant driver.

## Economy

4th quarter GDP came in at 3.2% and was 2.9% for 2010 as a whole. The recovery is showing signs of strength, but these figures, as well as many underlying economic indicators, remain well below historical post-recovery trends.

Once at a low of 25, the Consumer Sentiment Index stood at 77.5 in February – its highest level since January 2008. However, it is the weakest the index has ever been 20 months into a post-recession recovery. In the jobless recovery of 2002, it stood at 90.9 at this juncture, and it stood at 85.3 at this point in the jobless recovery of 1992.

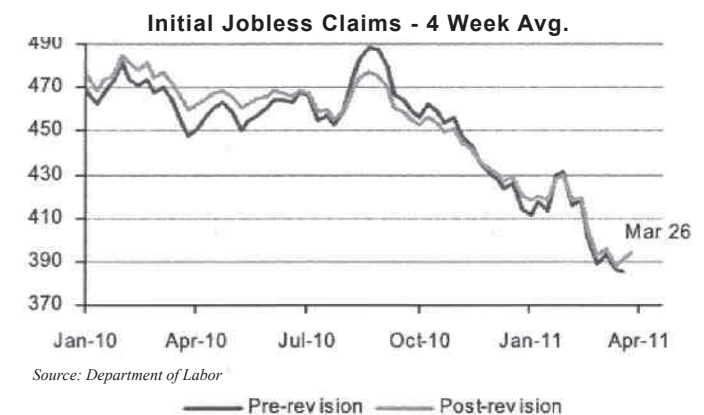
The latest personal consumption reading at 4.4% was the largest gain in five years. While increases in consumer demand continue to coincide with a decline in the savings rate, 80% of consumer spending occurs in the top 40% of the nation in terms of wealth. As prices for virtually all assets have risen over the last two years, \$28 trillion has been created, and the wealth of the top two deciles now exceeds the peak of 2007.

Almost half of the growth in GDP over the past year has come from investments in equipment that businesses are making to build capacity and raise productivity in order to meet stronger demand in the future. The recent ISM manufacturing index came in above 60, ahead of expectations and well above the 50 demarcation line. The non manufacturing ISM number was 59.4 – the highest since 2005. Encouragingly, index

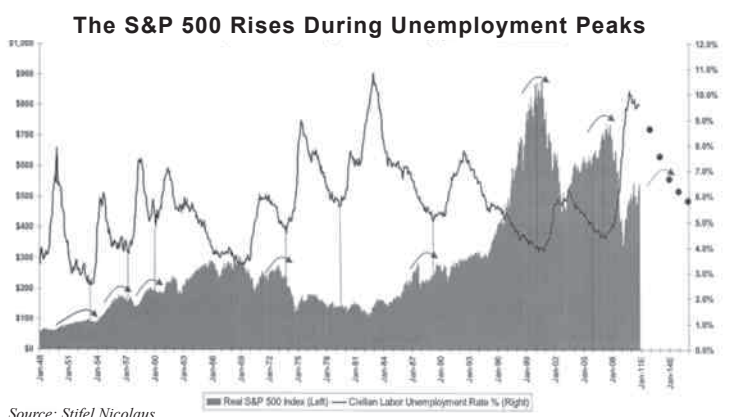
levels this high have been consistent with annual GDP growth of over 6%.

We expect the environment for business spending to remain robust. Cash on corporate balance sheets is still near the peak reached last year, and business inventories still remain near their 10-year lows, suggesting the investment led recovery can continue.

With 8.8% unemployment, the jobs recovery is well below average, but still heading in the right direction. Though new hiring remains sluggish, layoffs are waning and initial jobless claims continued to trend down throughout the first quarter. Weekly initial jobless claims are discernibly below 400k. By the end of March, initial jobless claims fell to the lowest level since July 2008.



Importantly, the unemployment rate is a lagging indicator. The fact that it has turned down is encouraging and a moderately falling employment rate suggests continued strength in the stock market. It has been shown throughout history stock market returns have been far stronger at higher levels of unemployment that accompany economic recoveries, than at the bottoming levels of unemployment that precede recessions.



## Inflation

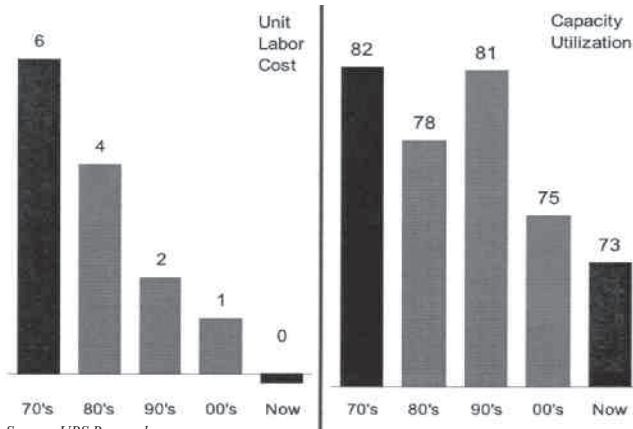
Gasoline prices are back to multi-year highs and have moved from just over \$3 in January to over \$4 in March. The share of after-tax personal income now being devoted to food and fuels has risen to 12.6%. At the start of the last recession, the number was at 13%. However, inflation as measured by the

Fed is still extraordinarily low. Annualized core inflation, excluding food and energy, is 1.1% and the target is between 1.5 and 2.0%.

Ultimately, we believe inflation is on the horizon. The money supply has increased exponentially in a very brief time, and we believe the government will be slow to sop up all the liquidity once the economy heats up. Currently, however, the near term risk of significant inflation will remain low as long as the velocity of money remains extremely depressed.

Employee wages and cost of labor indices that are strongly correlated with CPI have just recently bottomed and are not about to increase dramatically. In fact, unit labor costs and capacity utilization rates remain the lowest of the last 40 years and are far below the levels recorded during the inflationary 1970s and 80s.

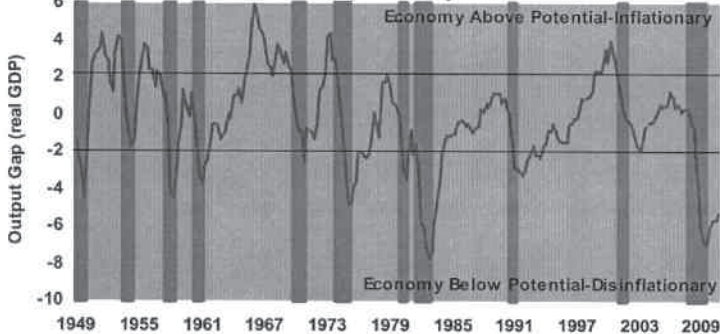
**Labor and Capacity Utilization Not Inflationary**



Source: UBS Research

Similarly, the Output Gap (the difference between actual GDP and potential GDP) remains near historic lows. This is highly correlated with a disinflationary environment as big moves in CPI over the last 60 years have typically occurred when actual GDP exceeds potential GDP by a wide margin. Even though the gap is shrinking, it still suggests significant inflation is currently a low probability.

**Economy Well Below Potential**



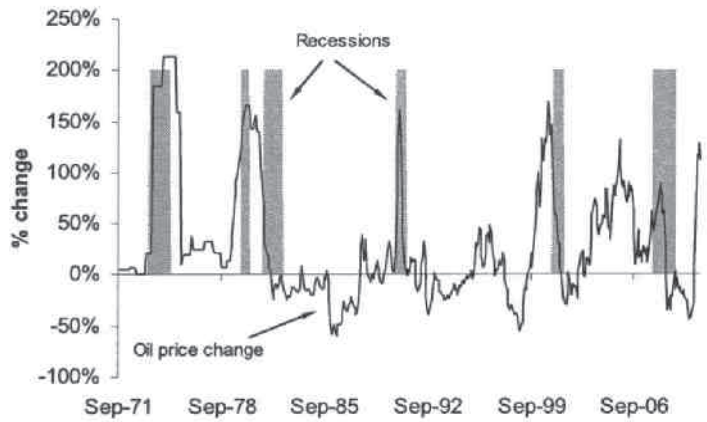
Source: Charles Schwab

Despite reports of Saudi Arabian spare oil capacity doubling the size of total Libyan output, Libyan turmoil has increased the geopolitical risk premium in the price of oil. Crude hit a fresh 3 year high with WTI pressing firmly against the \$110 per barrel threshold. On an inflation adjusted basis, this is a level only surpassed during the tail end of the major price

spikes in 1980 and 2008.

High oil prices act like a tax on consumption. Ten of the last eleven recessions have either been preceded or coincided with oil spikes, the lone exception being the 2003-04 oil spike that coincided with the Iraq invasion. It pays to note that oil price shocks affect the economy with a two-year lag. Economists use the rule of thumb that every \$10 increase reduces GDP growth by about 1/4 of a percentage point in the first year. If the elevated price persists, then the effect is to drain growth by a full percentage point in year-two.

**2-Yr Changes in Oil Prices**

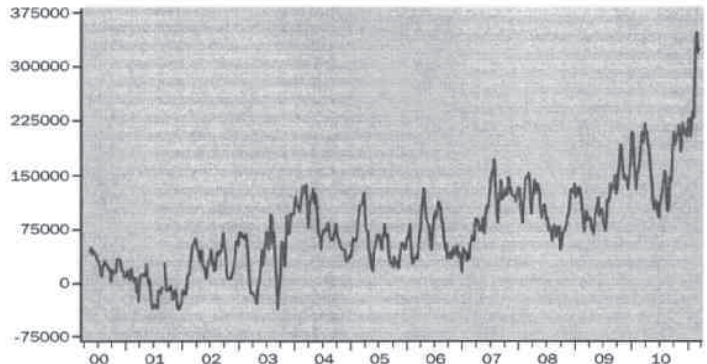


Source: BMO Capital Markets

Looking ahead, should oil prices remain elevated near \$110, we believe it will be difficult for economic growth to reach the 3.3% growth that is currently expected by the market for 2011. On the other hand, should the economy begin to suffer, we suspect oil prices would adjust rapidly. Back in 2008, once it was clear the economy was struggling and speculators withdrew their bets, the price of oil plunged over \$90 from its \$145 peak in just eight months.

Interestingly, as of the beginning of April, the net speculative long position of oil futures and options on the NYMEX was near the highest level on record. It was more than 4 times what would be considered normal, and more than double the level prevailing during the all-time peak in oil prices in the summer of 2008.

**Major Speculative Long Position In Oil Contracts**



Source: Gluskin Sheff

**Housing**

While the Fed has remained committed to an accommodative

policy, the next two FOMC meetings (4/27 & 6/22) may show some shifts in stance as the committee unveils how it will unwind 2007-2011's unprecedented stimulus.

Similar to the anxious anticipation last year of QE1's conclusion, wherein the Fed spent \$1.25 trillion on treasuries and mortgage bonds, the markets now await the end of the Fed's \$600 billion QE2. QE2 never really did bring down mortgage rates and bond yields as expected, but the government is such a large market participant its absence may cause rates to rise.

Tighter monetary policy and higher rates would be a valid cause for concern for the housing market. Home prices have continued to decline over the last year and nearly a third of all mortgages remain in negative equity position. Recent flow of funds data show the U.S. household sector has a negative home equity position of nearly \$4 trillion.

On a national level, February recorded the worst new home sales in history and existing home sales dropped 9.6%. Housing starts were also down 22.5% in February, the biggest monthly drop in 27 years. A significant share of the home sales taking place remain distressed sales of foreclosed homes rather than first-time homebuyers turning confident. The sheer volume of what is in the foreclosure pipeline — at least two million — promises to keep downward pressure on housing prices for several years.

The one bright spot for housing has been affordability. The ratio of median home prices to household incomes is now 1.6. This is below 1989-2003 average of 1.9 and far below the 2.3 peak in 2005. In fact, it is the lowest in 35 years that data has been collected.

## Outlook and Conclusion

The following is a summary of some of the indicators that guide our equity investment policy:

Commodity Prices	Turning
Earnings Growth	Positive
Fiscal Policy	Negative
Earnings Momentum	Turning
Inflation	Positive
Interest Rates	Positive
Monetary Policy	Positive
Yield Curve	Positive
Price to Book	Neutral
Price to Dividends	Neutral
P/E Ratio	Neutral
Volatility	Neutral
Technical Outlook	Turning

## To summarize our current thoughts:

- Inflation outlook still positive in intermediate term
- Sustained economic growth, but still behind past trend
- Unemployment has peaked, but persistently high
- Corporate profits extremely strong and still increasing
- Resilient stocks continue to make modest gains
- Treasuries are overvalued
- Dollar weakness persists with QE2
- Price of oil testing upper boundaries
- Budget deficit expanding

While Japan accounts for only 6.4% of U.S. imports and 4.7% of exports, the long-term effects of the tragedy are not yet defined, and the financial implications may have yet to play out. In the meantime, the stock market has been able to shrug off major external events abroad and overlook the backdrop of challenges at home.

The economy has achieved a self-sustaining recovery, but an expected 3.5% GDP growth rate for 2011 is slow for an economy moving from year two of a recovery into year three. During this transition period from early-cycle to mid-cycle, the U.S. economy is typically ripping along at a 4.5% clip and monetary policy is moving towards restraint, not at unprecedented accommodation.

The Fed has tried to keep interest rates in check and put a floor under housing, but it has come at the expense of commodity inflation. Persistently high prices in energy and commodity stocks will ultimately sow the seeds of an economic slowdown, and the end of QE2 could spell a rising trend in interest rates.

Inflation fears will continue to grow as long as the economic recovery continues. Ultimately, inflation will be an issue for the economy. However, significant inflation will only be realized once the velocity of money picks up. In the short-term, there's enough slack in the economy to keep inflation at bay.

As the stock market continues to digest all these considerations, we believe it will continue to grind higher throughout the year as long as profit growth stays strong. Valuations are far from extreme, and the quality of corporate earnings is very high. Companies have money to spend and industrial demand is strong. The economy is like a supertanker. Once it has a full head of steam, it takes time to reverse course. Despite long-term fiscal consequences, the enormous stimulus has set growth trends in motion.

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