Halsey Associates, Incorporated

Economic & Monetary Review

Winter 2010

Overview

The early stage of the US economic recovery has been tentative, primarily due to the well-publicized weakness in housing and jobs. Evidence is building, however, that the final quarter of 2009 was the year's strongest, setting the stage for more robust economic growth in the year ahead.

Corporate profits were a pleasant surprise in 2009, as companies moved with unusual speed to cut costs. Profit margins should widen further in 2010 as inventory replenishment, increased capital spending and higher end-user demand boost company revenues.

Against this improved backdrop, short term interest rates, which have been kept at abnormally low levels by the Federal Reserve in an effort to stimulate economic activity, will likely begin to rise in 2010.

Legislation to raise taxes on wealthy individuals and businesses, promised by candidate Obama but largely postponed in 2009 for fear of thwarting the economic recovery, could be passed in the year ahead.

Economic Indicators

The US Economy grew at a 2.2% real (inflation adjusted) rate in the third quarter. The increase primarily reflected positive contributions from personal consumption expenditures, exports, private inventory investment, federal government spending, and residential fixed investment that were partly offset by a negative contribution from nonresidential fixed investment. Imports, which are a subtraction in the calculation of GDP, increased.

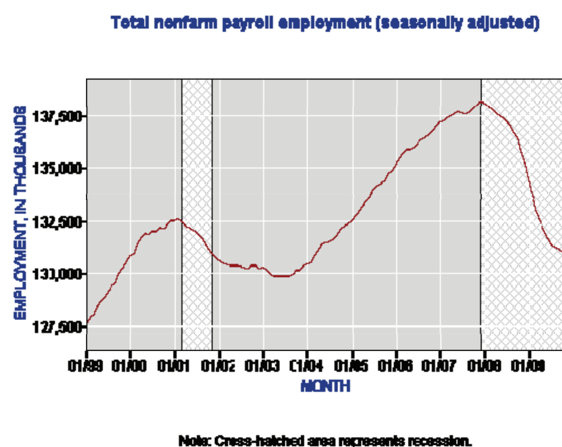
The Conference Board Leading Economic Index™ rose 0.9% in November, the eighth consecutive monthly increase. According to Ken Goldstein, Economist at The Conference Board: "The indicators point to a bright new year. Looking ahead, we can expect a slowly improving economy through 2010."

The housing market continues to improve, albeit off low levels of activity. Building permits, a leading indicator, reached 584,000 in November, the highest level in 2009, and up 6% from October. For the last twelve months, however, permits were off 7.3%. Housing starts rose 8.9% in November from the month earlier, to 574,000 units, but were off 12.4% year over year.

Existing home sales were strong in November at 6.54 million units, up 7.4% from October and a strong 44.1% over the year ago period. Buyers rushed to close before the month end expiration date of the first time buyer's credit (it was subsequently extended into the Spring of 2010). Unsold inventory continued to decline. At 3.52 million units, representing 6.5 months of supply, it was down 1.3% from October and 15.5% from the year ago period.

According to the Commerce Department, business inventories rose 0.2% in October, surprising to the upside and breaking a streak of 13 consecutive months of decline. The increase hinted that the yearlong trend of liquidating stock shelves may finally be slowing.

The Labor markets showed early signs of stabilization. Total non-farm employment was essentially unchanged in November (-11,000) after declining 111,100 in October and 239,000 in September. The unemployment rate edged down to 10% in November from 10.2% in October. The severity of this recession is perhaps nowhere as apparent as in the total jobs lost, 7.9 million, since the start of the downturn in December 2007. The accompanying chart, provided by the Bureau of Labor Statistics, shows the beginnings of a bottom in the labor market. The lagging nature of employment is also well illustrated relative to the 2001-2002 recession.

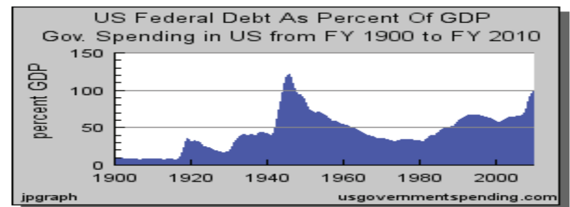


MONETARY INDICATORS

Due mostly to increases in energy prices, the Producer and Consumer price indices rose in November, up 1.8% and 0.4%, respectively. The annual increases of 2.4% and 1.8% were the first since November 2008 (PPI) and February 2009 (CPI). It would be premature to consider these readings as harbingers of a trend of rising prices. Taken in concert with the increase in capacity utilization to 71.3% in November from 69.6% in August, however, it appears that prices may have passed their lows for this cycle.

At its recent Open Market Committee meeting, the Federal Reserve reaffirmed its commitment to keep short term interest rates near 0% for the time being, pointing to low inflation and high unemployment rates. The Fed did set the stage for a change in its monetary policy, however, by noting the pick up in economic activity. It appears that the Fed is waiting for evidence that the recovery is self-sustaining (less dependent on Federal Government spending) before shifting to a tighter monetary policy.

As a result of the stimuli provided by the Federal Reserve and US Treasury over the past eighteen months, public debt growth has accelerated. As the chart shows, debt as a percentage of GDP is forecast to reach 100% next year, the highest level since the mid-1940's when it ballooned to finance the War effort. The productive capacity that was unleashed with the advent of peace in 1945 is unlikely to be matched in the decade ahead given our "graying" population, declining education standards, reduced manufacturing base, and larger entitlement program obligations.



INVESTOR SENTIMENT

A number of publications have proclaimed the past ten years as the "lost decade" for the US stock market. As a result of high valuations at the end of the last decade, the bursting of the dot.com bubble in 2000 and the real estate collapse in 2008, the 10 year cumulative return of the Standard & Poor's 500 index has indeed been negative each month since November 2008. Lower risk government and high quality corporate bonds produced solid returns, with the Barclays Government/Credit bond index up 6.3% per year on a compounded basis over the past decade.

Investors appear to be extrapolating these results into their expectations for future returns. Thus far this year, over $140 billion has been directed toward bond funds, while $74 billion has been redeemed from US stock funds. This follows a nearly $85 billion withdrawal from this sector in 2008. Another area where investors appear to be chasing historical performance is in the emerging markets. In December, the MSCI BRIC (Brazil, Russia, India and China) Index had produced a ten year compounded annual rate of return of 11.1%. Through mid-December, investors had plowed a record $75 billion into emerging market funds, eclipsing the previous high set in 2007.

OUTLOOK

Valuations in the stock and bond markets suggest a far less ebullient year in 2010. The absence of attractive alternatives and nearly $3 trillion in money market funds, however, could propel markets to more extreme valuations as investors reach for higher returns.

Even under the assumption that corporate earnings in 2010 are stronger than the present consensus estimates, few of the stocks in our research universe offer attractive risk/reward trade-offs at current prices. Yields on good quality corporate and municipal bonds with maturities of five years or less are uninspiring on an absolute basis. As such, patience is the order of the day as 2010 unfolds.

234 Church Street
New Haven, CT 06510

INVESTMENT MANAGEMENT SINCE 1967.

Phone: 203.772.0740
Fax: 203.772.1433
E-mail: inquiries@halseyassociates.com