

Economic & Monetary Review

Halsey Associates, Inc.

Summer 2010

Overview

For investors, there is no shortage of dreary news these days:

- Sovereign solvency issues abroad;
- an uneven domestic economy still reliant on government subsidies;
- an environmental catastrophe with potentially huge financial implications;
- and a “strike” on spending by corporations uneasy about the policymaking of the present Administration and Congress.

Against this difficult backdrop, we continue to believe that the US economic expansion that began last year will continue into 2011. As such, and especially given the recent sharp decline in world equity markets, we are bullish.

As the details about Greece’s financial problems have become well-chronicled – excessive and rising budget deficit and high level of debt to GDP, massive entitlement spending, weak economic growth – correctly or not, US investors have connected the dots to our own fiscal woes:

Metric, %	USA - 2010 Projection	Greece - 2009
Federal Spending As Percentage of GDP	25.4%	50.4%
Federal Deficit As Percentage of Spending	41.8%	26.8%
Federal Deficit As Percentage of GDP	10.6%	13.5%
Total Government Debt As Percentage of GDP	94.3%	115.1%

First quarter GDP growth was revised down to 2.7% at an annual rate from 5.6% in the prior period. The credit and equity markets have declined in value steadily since late April as investors began to reduce their expectations of economic activity and corporate profits for the back half of this year. Recent weak data from the auto and housing sectors appear to validate the theory that sales were “pulled forward” by the Government’s incentive programs, which for the most part, ended early in the second quarter.

The unfortunate oil spill in the Gulf of Mexico will have a severe impact on the ecology of the affected area for years, as well as on economic activity. Estimates have risen to as high as \$100 billion for the clean-up and legal liabilities.

The strength in corporate balance sheets stands in stark contrast to those in the public sector. At this point in the economic cycle, hiring, capital spending and merger and acquisition activity would typically be in solid uptrends. This time, however, corporations appear content to allow cash to build (to more than \$1.8 trillion) regardless of its unproductive capacity. Legislation at the Federal level to-date shows little interest in fiscal discipline, with a more decided desire to impose more regulations on businesses. Small businesses in particular, historically a source of significant job creation, have been extremely cautious in their strategic planning.

The news is not, however, universally bad. The economy is expanding. Monetary policy is stimulative, and inflation and interest rates are at very low levels. A sea change in the political arena is a possibility come November. Moreover, the nearly 20% decline in the stock market from the third week of April through early July appears to have discounted the aforementioned well-known problems.

Monetary Indicators

Inflation remains tame. The Consumer Price Index, on a seasonally adjusted basis, was down 0.2% in May and up 2% year over year. The core rate (excluding the volatile food and energy inputs) was up 0.1% in May, posting a monthly increase for only the second time this year, and 0.9% for the past year. Capacity utilization continued to trend higher, to 74.7% in June. This was up 1.4% from the prior month and 9.5% from a year ago, but still below the 85% level that has historically led manufacturers to increase prices. The Federal Reserve Open Market Committee commented on this point at its June 23rd meeting: "Prices of energy and other commodities have declined somewhat in recent months, and underlying inflation has trended lower. With substantial resource slack continuing to restrain cost pressures and longer-term inflation expectations stable, inflation is likely to be subdued for some time."

Consequently, monetary policy remains stimulative. The Committee voted to maintain the target range for the federal funds rate at 0% to ¼% and suggested that these exceptionally low levels could persist for an extended period.

Economic Indicators

The 2.7% increase in real GDP in the first quarter primarily reflected positive contributions from personal consumption expenditures, private inventory investment, exports, and nonresidential fixed investment. Offsetting these were negative contributions from state and local government spending and residential fixed investment.

The slowdown in real GDP in the first quarter from the fourth quarter's 5.6% annualized pace primarily reflected decelerations in private inventory investment and in exports, a downturn in residential fixed investment, a deceleration in nonresidential fixed investment, and a larger decrease in state and local government spending that were partly offset by an acceleration in personal consumption expenditures.

Corporate profits continued to shine, rising 8% in Q1 over Q4 2009, and a strong 34% year over year. While consensus estimates for 2010 and 2011

have come down recently, analysts still expect annual growth rates of 24% and 15%, respectively.

Housing activity is above year ago levels but, absent the positive impact of the government incentives, dropped off in May. Building permits, a leading indicator, declined 5.9% in May, though they remained 4.4% above year ago levels. Housing starts fell 10% in May, but were up 7.8% year over year. Although total housing inventory at the end of May fell to 3.9 million existing homes available for sale, representing an 8.3 month supply, this was up from a 7.8 month supply in January.

Improvement in the labor market has been modest to-date. Total non-farm payroll employment declined by 125,000 in June, but the unemployment rate edged down to 9.5% from 9.7% as the number of long term unemployed looking for work shrank even more. The decline in payroll employment reflected a decrease (-225,000) in the number of temporary employees working on Census 2010. Private-sector payroll employment edged up by 83,000.

Valuation

Stocks seem attractively valued, especially in contrast to bonds. The earnings yield of the S&P 500 stock index, based upon forward 12-month estimates, was 8.4% in early July. This compared very favorably with the 2.9% yield on 10 year US Treasury notes. Despite this widening valuation gap between equities and debt, investors continued a trend that has been in place for more than two years, pulling \$6.6 billion out of equity mutual funds in June and adding \$19.4 billion to bond funds.

Outlook

As a result of the recent equity market sell-off, the shares of many of the companies in our research coverage now appear reasonably valued. On the fixed income side, yields in the 6% range on the highest wrung of non-investment grade bonds maturing within 5 years offer acceptable absolute returns and meaningful spreads over similar dated US Treasury securities.