

Capital Market Comment

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Historical Constraints May Be Lessening

One of the disconcerting aspects of 2011 was the disconnect between the fundamentals of the U.S. economy and the equity market. Despite predictions to the contrary, (double-dip recession was forecast in 2011 as it was in 2010) the U.S. economy continued to grow and even at a slightly accelerated rate as the year ensued. The constraints upon world economic growth from the strains in the European community and slowing growth in China have not yet produced sufficient headwinds to derail U.S. economic growth. Most certainly, tax policy, regulation, weak business confidence, and consumer apprehensiveness are adversely affecting the domestic economy. Moreover, banks and financial institutions face higher capital requirements and still employ inflexible lending standards. Yet, the resiliency of the U.S. economy and the reconfiguration of the underlying growth drivers are reinforcing the tendency to expand. Employment gains continued throughout the year with larger increases later in the year, and unemployment, although still high, has receded to the mid-8% range. For December, ADP and The Labor Department continued to show solid improvement in employment with gains of 324,000 (ADP) and 200,000 (The Labor Department) for non-farm payrolls. The leading indicators suggest continued growth (expansion). The index rose 0.5% in November and has risen virtually uninterrupted since 2009.

Although new constraints may surface this year, others are lessening. The housing sector is no longer retarding growth, and has even begun to contribute to growth as evidenced by housing starts and existing home sales. The rise in rents, the improving affordability index, and the number of new families in the United States are driving underlying demand. Even though the inventory of unsold homes has fallen somewhat, the pressure from foreclosures will remain for some time. A directional change in the housing market appears to be underway nonetheless. Additionally, the ISM Index for Manufacturing rose to 53.9 from 52.7 (any number above 50 suggests manufacturing is expanding). This data point marks the 29th consecutive month that manufacturing has expanded and the 31st consecutive month that the economy has expanded. In December, new orders, production, employment, and exports grew while customer inventories were too low. This scenario would suggest further production gains.

A sector that has been a drag on economic activity in 2011 that should be less so in 2012 is state and local government. The improving economy has generated a better than expected recovery in tax receipts. Although the deficit remains, the pressure has lessened.

Third quarter corporate profits continued to rise, significantly exceeded the peak of 2007, with corporate cash flow following the same trend. Furthermore, spending on equipment and software, which increased at a 16% annual rate in the third quarter, was only 62% of corporate cash flow. Enterprises continue to retain high cash balances and deploy a significant portion of corporate funds through stock buy-backs, acquisitions, and dividend increases. In Q3 over \$500 billion of non-financial company stock was liquidated. Compelling valuations are likely to continue these trends. The current level of the 10-year Treasury as compared to the forward P/E on the S&P of 12 suggests that the equity market is trading at a 70% discount to the 10-year Treasury. With rates likely to remain constrained, the valuation disparity is enticing to many companies, and even "investors".

On the international front, China was in the business news most of last year as their country's economic activity slowed and fear of a hard landing surfaced. The most recent data suggest stabilization. The PMI index moved above 50 to 50.3 in December from 49.0, the first directional change in months. Although these numbers are an improvement only at the margin, the headwind may be diminishing.

The Euro remains a center-stage issue and is likely to be so for some time. The evolution of a more manageable structure is underway but doubts remain and only time will provide the basis for a change in investor opinion. However, fiscal integration and the leveraging of the EFSF seem likely to become more clearly attainable this year. The EFSF and the ECB's aggressive lending to the European Banks provide greater fire-power. Despite arguments to the contrary, the ECB is becoming a "lender of last resort." Moreover, given the performance of inflation in Europe, further rate reductions by the ECB should be forthcoming.

The winds of monetary accommodation are blowing throughout the world: the United States, Europe, parts of Latin America, and now even China. With the Federal Reserve laying out the path of the Federal Funds Rate in the future beginning at the January FOMC meeting, diminished uncertainty should gradually emerge.

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