# Economic Outlook

By Ronald L. Welburn, CFA / President

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### The Outlook for the Economy

On August 27th the Department of Commerce will announce its revision of second quarter real GDP growth. We expect that growth will be revised downward from 2.4% to approximately 1.5% because of the large June trade deficit of $49.9 billion. When data was released for the second quarter GDP prior quarters were revised as follows: 3Q 2009 1.6%, 4Q 5.0% and 1Q 2010 3.7%. Overall growth for the latest twelve months through June was recorded at 2.4% for real GDP. In view of the large fiscal package of $862 billion and significant monetary easing with federal funds at 0-25%, the recovery is much weaker than that registered in prior recoveries, particularly in regard to employment. At present, there is a widespread feeling among the public and many Congressional leaders that further fiscal stimulus would only add to the enormous fiscal deficit of $1.4 trillion, (10% of GDP) without benefiting economic growth. Economists are divided on the subject, with some suggesting that further Keynesian stimulus is necessary to avoid returning to recessionary conditions. With regard to monetary policy, there is little doubt that Ben Bernanke, Chairman of the Federal Reserve, will do whatever he feels is necessary to avoid conditions of deflation even if it means further quantitative easing and expanding the Federal Reserve's balance sheet. In contrast to the U.S. government, authorities in the United Kingdom and the European Union appear more ready to accept austerity and are working on programs to reduce government spending. The state and local governments in the U.S. are legally mandated to balance budgets and as a result policies of fiscal austerity are currently being implemented, albeit reluctantly. Most individuals in the U.S. are in the process of deleveraging with the June savings rate at 6.4%, which compares to nearly zero in the 2005-2007 period. In contrast to governments, corporations have close to $2 trillion on their balance sheets and in general are in good financial condition, having refinanced much of their debt. Obviously, the process of deleveraging does slow economic growth but at some point will reach a level from which financial expansion can again occur.

Since April, many economic statistics suggest that economic growth has slowed but not to the point of returning the economy to a condition of recession. All the housing statistics have been particularly weak including building permits and starts, and the sales of new and existing homes against a backdrop of rising foreclosures and mortgage delinquencies. Of the 8.5 million jobs lost in the recession only about 600,000 have been created so far in 2010 with unemployment at 9.5%. Initial jobless claims recently hit a nine-month high at 500,000. This is unusual at a time when the economy has improved for four quarters. Sequentially, the leading indicators have flattened out over the past three months. Inventories have modestly risen with the inventory sales ratio at 1.26 in June versus 1.25 in May. On the positive side, equipment and software spending by corporations has been strong for the last three quarters, growing at 14.6%, 20.4% and 21.9% respectively. It is capital spending by corporations, which, after a time lag, creates jobs. In July the ISM Non-Manufacturing Index (services) increased to 54.3 from 53.8 in June whereas the Manufacturing Index fell to 55.5 from 56.2 in June. All numbers over 50 reflect expansion and so far manufacturing has led the recovery, but services, which account for 85% of employment, are now picking up after lagging earlier. Statistics involving rail car and container shipments are quite strong. Productivity increased 3.9% year-over-year with personal income up 2.6% twelve months through June. Industrial production was up 1% in July and up 7.7% year-over-year with capacity utilization at 74.8% in a strong uptrend. Overall, despite some disquieting statistics we still believe that the economic recovery is continuing, albeit at a historically slow rate.

At present, the yield curve spread (the 10-year T-Bond yield minus the 3-month T-Bill rate) is 246 basis points and the country has never had a recession when the yield curve spread is positive. Usually, recessions occur when yields are inverted to end periods of inflation. We remain positive on the U.S. economy with a growth rate forecast of 2% (down from 2.5%) in 2010 with 1% CPI inflation and a gain in profits of 20%. For 2011 we believe that the

U.S. economy will grow 2.5% with inflation of 2% and a profits gain of 10%. The outlook for 2011 could be greatly affected by the results of the elections in November.

## The Outlook for the Financial Markets

Between January 2008 and June 2010 $559 billion was invested in bond funds whereas $233 billion exited from equity funds. The same trend has continued throughout July and August. During the above period Treasury bonds returned 13% while stocks lost 21%. While one cannot fault investors who have made money in bonds, as opposed to losing money in stocks, during the above time frame, one can make the observation that at present, investment in bonds has become a momentum trade at a time when interest rates are at the lowest levels in sixty years. Investors unfortunately often buy past performance instead of analyzing what the future may bring. With 10-year Treasury bonds currently yielding 2.61%, which compares to over 15% in 1981, after a period of high inflation when bonds were ridiculed as certificates of confiscation, one could hardly view them as great values unless a period of deflation is about to occur. Similarly, the stock market collapse of 2008 frightened many investors out of stocks just before an 80% rally from March 2009 to April 2011. At present, stocks, as measured by the S&P 500 Stock index, (1071) have fallen about 13% from their April highs and are nowhere near as cheap as they were in March 2009, when the S&P index fell to 666. Nevertheless, they are approximately 30% lower than they were priced in 1999 eleven years ago. At present, the S&P 500 Index sells at 13.7 and 12.6 times our 2010 earnings estimate of $78 and $85 per share for 2010 and 2011. Excluding fundamentals, the investor can buy bonds at 30-year highs or stocks at 11-year lows. Based on a risk-to-reward outlook we believe that stocks offer more price appreciation than bonds at current levels. This analysis is based on an economic recovery accompanied with low inflation at a time when emerging markets are leading the developed countries in terms of economic growth and fiscal prudence. The development of middle classes in Asia and South America is occurring at a time when consumers in the U.S. are in the process of extricating themselves from high levels of debt accumulated over the past 30 years.

Over the past month interest rates have fallen, with stocks modestly lower and commodities modestly higher. The 10-year Treasury bond yields 2.61% compared to 2.95% a month ago. High quality long-term corporate bonds yield 5.4% versus 5.8% last month. Long-term municipal bonds yield 4.46% compared to 4.57% and 30-year mortgages yield 4.69% versus 4.75% a month ago. The CRB Index (450) of commodities has increased 6.6% over the past month because of a 9.6% increase in copper ($3.29 per lb.) and significant increases in coffee and wheat because of weather problems. In contrast, oil ($73 per barrel) has fallen 5% as inventories have hit 27-year highs. Also the Baltic Dry Index (2756) after a precipitous fall from May to July of 60% has recently recovered by 62%. The U.S. Dollar Index ($83) has modestly risen over the past month as some weakness has returned to the euro. Foreign stocks, as measured by the Morgan Stanley EAFE Index (1430) have also slightly out-performed U.S. stocks over the past month. Gold ($1196 per ounce) has been basically stable over the past month.

We would make a modest change to our asset allocation model with 60% equities (-5%), 25% municipal bonds, 3% gold and 12% cash (+5%). We do not believe that there is a risk of near-term inflation from the federal government's fiscal expansion. We believe that the economy will continue to grow at a moderate pace against the background of financial reform and that the Federal Reserve will be successful in avoiding a possible deflation resulting from the deleveraging of individuals and corporations.

Ronald L. Welburn is President of Ameraudi Asset Management. He is a Chartered Financial Analyst (CFA) with over fifty years experience in the investment field. Prior to Ameraudi and from 1988 – 1998, Mr. Welburn worked with Merrill Lynch Asset Management, where he was Senior Vice President of the Private Portfolio Group. Mr. Welburn is a graduate of Harvard College and has a Masters degree in Finance from the Wharton School of the University of Pennsylvania.
Please direct all inquiries to Ronald L. Welburn, President, Ameraudi Asset Management Inc.
19 East 54th Street, New York, NY 10022 Telephone (212) 833-1090 Fax (212) 319-4949 [www.ameraudi.com](http://www.ameraudi.com)