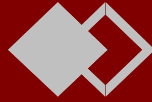


Earl M. Foster Associates

INVESTMENT MANAGEMENT

NEWSLETTER

October 2009

THE FIRST SIGNS OF ECONOMIC RECOVERY

Can Stocks Rise Further?

The economy is embarking on a recovery ignited by a combination of stabilizing home values, strong money supply growth, Federal stimulus funds, and the successful "Cash for Clunkers" program. These provided a "lift" to an otherwise weak environment during the last three months, which helped business conditions show substantial improvement compared to the prior four quarters. So much so, that for the quarter ending September, the economy is expected to have registered its first quarter of growth in a year.

TABLE I
Transition From Contraction To Recovery

Economic Indicator	Peak to Trough Decline*	Projected Growth 2010	Projected Growth 2011
GDP Inflation Adjusted	-3.9%	2.0% - 3.0%	2.5% - 4.0%
Industrial Production	-14.8%	2.5% - 3.5%	3.5% - 4.5%
Retail Sales**	-11.0%	3.0% - 5.0%	4.0% - 6.0%
Existing Home Prices	-28.1%	0.0% - 5.0%	2.0% - 5.0%
Employment	-5.1%	0.0% - 1.0%	1.0% - 2.0%

* Estimated through 9/30/2009
** Current Dollars

While stimulus programs tend to have a temporary impact, they can provide the initial spark for further economic growth, and signs are emerging that this is happening. Thus far, only a small fraction of Federal stimulus funds has been spent and the bulk of it should be released into the economy during the coming quarters. The drop in industrial production is reversing and is expected to grow 2.5%-3.5% in 2010 as companies re-stock their depleted inventories (see Table I). Retail sales, which dropped 11%, should also benefit from a partial restoration of household wealth associated with the recent improvement in home values, increased household savings, and the recovery in the stock market over the last six months.

At the same time, the pace of the recovery will be constrained by a consumer facing a number of challenges. These include little to no growth in employment and the prospect of rising taxes. State and local governments are trying to balance their budgets in a still difficult economic environment, and some are doing this by increasing user fees and/or outright tax increases. On the Federal level, consumers may also face an additional tax burden with the expiration of the Bush Tax cuts in 2011.

As a consequence, economic growth over the next two to three years should be somewhat subdued compared to more vigorous recoveries experienced in the past. More realistic economic growth expectations range between 2.5% - 4.0% compared to the 5% or more pace seen in past.

The execution of monetary policy shifts over the next year or so will have an important impact on the vitality of the recovery. Money supply, the "lubricant" of the economic system, has been growing more than double its normal rate as the Federal Reserve strives to provide liquidity to the economy. When money is allowed to grow too fast and for too long, it leads to price inflation and de-values the US dollar in the international markets. In time, therefore, the Federal Reserve will need to lessen its stimulus by lowering money

supply growth and allowing interest rates to rise. A gradual execution of this policy shift should allow a more orderly economic recovery.

INVESTMENT STRATEGY

Thus far in 2009, the markets have undergone extraordinary changes with divergent trends within the fixed-income markets and a spectacular rebound in stock prices.

Chart I
Interest Rates
Ten-Year vs. One-Year Treasury Yield

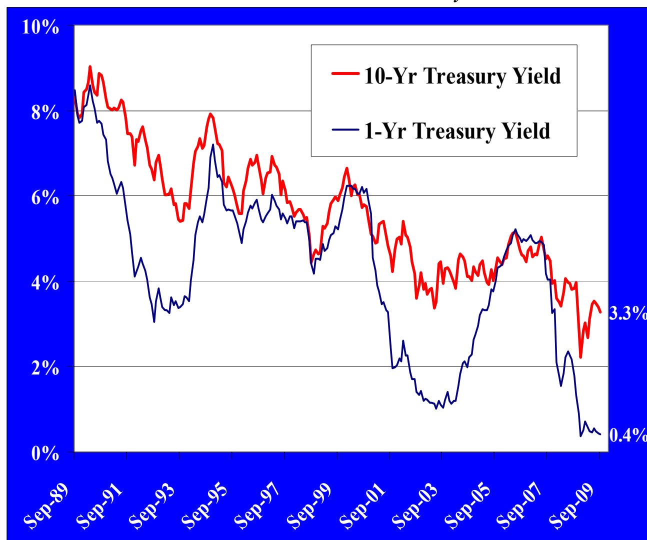
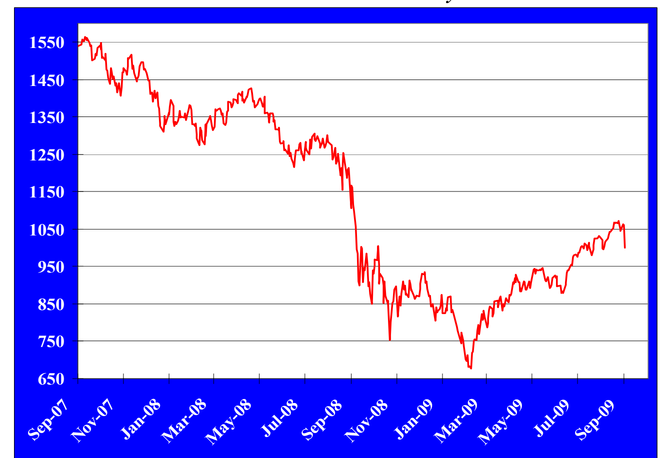


Chart I describes the one- and ten-year US Treasury yields over the last two decades. Two phenomena are particularly noteworthy. First, both short- and long-term Treasury yields are well below historic norms with money fund yields close to zero. Second, longer-term Treasury yields rose sharply since the beginning of the year while short-term yields remained at their lowest levels in more than a half a century. Extraordinarily low short-term rates reflect the intensity of the Federal Reserve's monetary stimulus, and this is not sustainable. Higher rates should be expected as the economic recovery gains traction and the Federal Reserve relaxes its stimulus. Such changes will increase the risk in the fixed income sector and an under-weight relative to normal portfolio exposure is appropriate.

The outlook for stocks remains favorable even though gains from the March lows may already anticipate a good portion of the recovery in corporate earnings. Profit margins dropped by a third during the recession, and a substantial recovery is likely in the years to come. During the recession, businesses instituted aggressive programs to minimize their work-force and trim discretionary expenses. Companies are now entering the recovery with more efficient and streamlined cost structures that will permit profits to expand much faster than economic growth. Standard & Poor's earnings are expected to advance 25% - 30% in 2010 and another 10% - 20% in 2011. This should support a further advance in stock prices and translate into above-average annual percent returns over the next three to five years.

Chart II
Standard & Poor's Index
Two-Year Price History



However, the magnitude of the stock market rebound during the last six months warrants some caution in the near-term. This advance was unprecedented in recent history and may assume more rapid acceleration in the economic recovery than may be possible. In what may be a parallel experience to several sharp stock market rallies during the decade of the 1930's, stocks could reverse some of their recent gains. This is a risk that should not be ignored, nor should the opportunity to add to the stock portion of the portfolio on any significant pull-back.

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