

PERSPECTIVES

...thoughts and commentary on today's financial issues

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John C. Beuerlein
Chairman,
Chief Investment Officer

ECONOMIC UPDATE

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The year 2009 witnessed the economy and the markets moving from fears of a global financial meltdown to recognition that the various forms of fiscal and monetary stimulus being provided by governments were enabling economies to stabilize and begin the process of recovery. In the United States, equity returns were in excess of 25% for most indices, municipal bonds achieved total returns greater than 10%, and the economy delivered 2 quarters of growth (Q3 & Q4) after four consecutive quarters of negative growth.

Questions remain, however, about the character of the recovery we are in. In this piece, I will share our perspective on a few of the most common questions we receive concerning the economy and the markets.

Although the government has reported that the economy grew 2.2% in 3Q-09 and 5.7% in 4Q-09, it still doesn't feel like a recovery to me.

The U.S. recession may be over, but it is becoming increasingly clear that the recovery will be constrained by the reluctance of households to spend. Despite the boost to incomes from the recent fiscal stimulus, underlying retail sales remain weak. Lost wealth, persistently high unemployment and limited credit are forcing households to save rather than spend. Strength in the industrial sector has developed as inventories are rebuilt and foreign demand from emerging economies improves. Accordingly, export growth has been improving. However, the overwhelming importance of the consumer sector means that as long as households remain in the doldrums, the overall recovery will be uneven.

The 0.3% m/m decline in retail sales in December is a reminder that consumers still aren't buying into the economic recovery. Without a more significant acceleration in consumption growth the recovery will remain labored.

Where there are signs of a pick-up in domestic demand, there is still a heavy dependence on fiscal stimulus. The hope, of course, is that government spending will kick-start a sustained recovery. Business sentiment has improved in recent months, suggesting positive momentum is being sustained into the spring of 2010. But with consumer confidence still at levels that have historically been associated with recessions, and unemployment remaining at elevated levels, the recovery could still disappoint as the fiscal stimulus fades (and eventually is reversed).

We expect the strongest growth in 2010 to occur in the first half of the year as we benefit from the inventory cycle and the lingering effects of the current government stimulus package. Growth in the second half of 2010, while positive, is likely to be weaker than in the first half as these tailwinds abate. The caveat to this forecast is if the labor markets improve substantially quicker than anticipated. Until labor markets improve, it is unlikely that consumer demand will be able to support economic growth at a sustained level much higher than 2.75%.

With all of the money that the government is pumping into the economy, isn't it just a matter of time before inflation becomes a problem?

Milton Friedman, the Nobel economist, said that "inflation is always and everywhere a monetary phenomenon". The assumption in this statement is that the money from the government is finding its way into the economy. Indeed, the monetary base – the total amount of dollars in circulation or in the commercial bank deposits held at the Federal Reserve – has grown from \$850 billion to over \$2 trillion since the fall of 2008. Unfortunately, the increase in the monetary base is primarily remaining within the banks via their deposits at the Fed. In other words, the banks are not lending the money. The Fed relies on the banking system as

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the mechanism for effecting monetary policy, but the banks are not increasing their books of loans. Year over year loan growth is contracting at about 7% - the most severe contraction since they began reporting loan growth data in 1973. Not all of the blame rests on the banks, however. Bank surveys indicate that demand for loans is declining, as well.

Unless the banks are willing to lend, the velocity of money in the economy will remain subdued and money growth in the overall economy will not occur. Without growth of the money supply, inflationary pressures cannot develop.

Inflationary pressures, however, will develop if the Fed is unable to withdraw the excess liquidity it has provided in a timely fashion once the recovery becomes self-sustaining. The Fed has indicated that it is very aware of this challenge and will respond appropriately. We'll be monitoring this development.

In addition to the lack of loan growth, there is substantial excess capacity in our economy and the global economy. Ten percent unemployment coupled with capacity utilization at levels that are below the lowest levels reached in five out of the last six recessions indicates that inflationary pressures will remain subdued for the foreseeable future.

After the run in the markets during 2009, is it time to take some chips off the table?

The advance in the equity markets from their March 2009 lows through the end of the year was notable not only for its magnitude, but also because there was a steady decline in market volatility during the advance. The biggest pullback in the S&P 500 during the advance occurred from mid June to early July over 19 market days resulting in a 7% decline in value.

In 2010, we believe equities will continue a labored advance with increasing volatility. The advances in 2009 resulted from the reversal of an Armageddon scenario for financial markets and the corresponding expansion of price to earnings (P/E) ratios. With P/E ratios now more in line with historic norms, advances in equity prices will be fueled by earnings and expectations of improved earnings. We believe that the strongest earnings growth will occur in the first half of the year, in line with the strongest economic growth occurring in the first half of the year.

We forecast domestic equity returns of 5% - 10% in 2010. Emerging market equity returns may be slightly higher, but will likely involve higher volatility.

Most fixed income markets also enjoyed strong returns in 2009 as investors started to increase their risk appetites a bit. The lower quality fixed income securities enjoyed the largest returns in 2009 - of course, the lower quality securities generally experienced the largest declines in 2008. Government securities actually suffered in 2009 as investors retreated from their safety to slightly more risky fixed income alternatives.

With this as a background, we do not believe that it is time to take chips off the table. In the equity market, we are seeing continued improvement in the number of companies who are beating their revenue estimates. A concern has been that the earnings gains of the past year have been the result of cost cutting rather than revenue growth. The continued improvement in the top line growth is an indication of improvement in the quality of earnings. Although the 4Q-09 reporting season is not complete, two thirds of the 216 companies in the S&P 500 that have reported have topped their revenue estimates. This is the best performance in this metric since 4Q-04. Taking chips off the table at this time appears to us as more of a market-timing call than a tactical portfolio adjustment. As we look at expected relative returns, we still believe that equities should be held at target allocation levels.

Some have advocated for reducing equity exposure and increasing fixed income exposure. With interest rates at historically low levels, the next significant move in interest rates is likely to be higher, resulting in loss of principal value (on a mark to market basis) for bond portfolios. Accordingly, we have been reducing the duration of fixed income portfolios to mitigate the negative impact of an increase in interest rates - and of course we continue to hold only high quality bonds in our fixed income portfolios.

Our investment committee reviews the economic fundamentals and market action on a daily basis and will reduce equity allocations on a tactical basis when we deem appropriate. In the meantime, the most important item that an investor should monitor is whether or not their actual portfolio allocation is in line with their long term allocation mix which should reflect their long term risk/reward appetite.

