

FirstMerit Monthly Commentary Ain't Misbehavin'

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Our title *Ain't Misbehavin'* is a well-known song written by Fats Waller in 1929. It's sung from the perspective of a lover who is behaving himself impeccably as he waits for the object of his affection to reappear. I think that pretty well describes the relationship between the stock market and the economy over the past several months.

After the long, cold winter of a severe recession, the economy is now teasing us with tantalizing glimpses of the alluring "green shoots" of a new growth phase. Meanwhile, stock markets around the world appear love-struck by the idea that a new economic springtime awaits. The questions asked by investors are: Will the economy prove itself worthy of our attention and hopes and commit to a sustainable relationship? Or, are we fooling ourselves and headed for the heartache of a short term affair?

I'll try to answer those questions today and will start by reviewing the current economic situation.

Last week, the government reported on first half GDP. They also revised data that had been reported in the past – actually some of it in the distant past as the revisions stretched all of the way back to 1947! Not too many of us were paying enough attention to economic statistics 62 years ago to remember what the originally announced numbers were back then, but isn't it odd to think that the accuracy of results of that era could be improved upon at this late date?

At any rate, most of us were on the scene in a more recent time frame in which GDP was just revised by an average of 1.2 percentage points (ppts) per quarter. I am referring (drum roll please) to the 17 quarters covering Q1 2005 through Q1 2009. My recollection is the original quarterly pronouncements about growth or the lack of it were met with the same enthusiasm as last week's announcement that this year's Q2 GDP declined by a mere 1.0%. After quarters of -5.4% (just revised up from -6.3%) in Q4 '08 and -6.4% (revised in the opposite direction, down from -5.5%) in Q1 '09, that -1.0% looks pretty darn good and it was slightly better than consensus projections of -1.5% to -2.0%. We can state one thing with certainty about this GDP report ...the numbers will be revised!

You were probably hoping I would analyze the GDP report and draw some value-added conclusions rather than just amusing myself with cheap shots at government statisticians, so here goes:

We are confident the worst of the Great Recession is over. That's because the biggest contributors to the economic decline (housing and inventories) fell so far, so fast that – even if they fall further – their rate of decline has to slow as will their impact on GDP calculations. We are already seeing that with regard to housing, whether measured by new home sales, existing home sales, new home construction or housing prices – they've all been plunging for three years, so the "collapse" story is over. Even if housing doesn't improve very much or very fast, the absence of the extreme negative comparisons will be a positive for year-over-year GDP growth.

Inventories were actually the big surprise in the Q2 data. Inventory liquidation was revised by -\$26 billion for Q1 to -\$114 billion and Q2 cuts were even worse at -\$141 billion. While the inventory slashing was a nasty negative for GDP, subtracting 2.4 ppts

and 0.8 pts, respectively for the first two quarters of 2009, this development is a strong plus for future production as any bounce in demand will force stepped-up production of goods.

In a “normal” recession, businesses cut costs as their uncertainty increases. In a severe recession like this exacerbated by a credit freeze and fears of Depression, managements slash costs to levels that will allow them to survive the worst case scenario. Consumers also hunkered down as shown by declining consumer spending numbers and a rising savings rate (up from zero last year to +4.6% at the June reading.)

Our long-held expectation that Depression would be averted by worldwide massive monetary and fiscal stimulus packages is finally becoming the consensus belief. Complaints that stimulus plans haven’t returned the economy to a rapid recovery path are ludicrous. Six months ago politicians, businesspeople, consumers and investors alike were just praying for stabilization and now the need for immediate gratification leads to griping about the pace of recovery? Our advice is: the economy has stabilized, so don’t start misbehavin’ now! Stay true to the notion that the economic cycle will again lead you to the correct business and investment decisions.

With no Depression, we see more and more signs that conditions will improve due to pent-up demand. For instance, a program like Cash for Clunkers brings auto buyers into the showrooms and car sales see a short term pop from an annualized 9 million sales rate to an 11+ million rate. Auto production was scheduled to increase anyway, but the headlines around Cash for Clunkers enhances general confidence that those auto inventories will be replenished through increased vehicle production.

As similar scenarios play out in various ways across the economy, overall sales improve and earnings surprise on the upside because costs are so low. That causes businesses to realize they cut too deep and to begin spending on production, employment and capital expenditures. As Industrial Production improves, unemployment stabilizes and – eventually – reverse and become employment gains.

That’s how the economic cycle works.

Our question is not: will the economy rebound – it’s how strong will the snap-back turn out to be? The Great Recession was so sudden, so deep and so close to a total meltdown that it is very difficult for many people to accept the notion that only six months later the debate is centered on the strength and duration of the economic expansion. Nonetheless, that is where we are. At FirstMerit, we are confident an expansion is beginning as indicated by our Expansion Signals Checklist which now shows 6 of 10 Expansion Signals switched on. This is important, because the best stock market returns often occur around economic turning points.

We are often asked about the risk of inflation and our response is that inflation is not a worry for 2009 and probably not for 2010. The Core CPI is under 2% and headline CPI is negative despite a bounce in commodity prices. The key for this timeframe is that high unemployment dampens the “risk” of rapidly rising wages and excess production capacity worldwide further reduces the immediate risk of inflation picking up, so Inflation should remain very low well into 2010. The longer term risk is indeed that government stimulus spending and central bank monetary ease lead to currency debasement and inflation down the road. We will monitor these trends closely, but they are not a major factor in our current client strategies.

Next, let's review how these Ain't Misbehavin' markets are doing. Some may argue that trading volumes should be higher if this rally was "for real", but such Wall of Worry comments have not slowed the advance. On Monday, more round-number milestones fell as the S&P 500 index broke through 1000, and the Nasdaq Composite Index passed 2000. With the DJIA already above 9,000, all three major U.S. indexes now stand at their highest levels since autumn, as do the benchmark indexes of Britain, Germany and France. Emerging Markets are again leading the way with 40%+ gains year to date.

The S&P 500 has surged 51% from its March 6 low to the August 4th close. It remains 36% below the all-time high it hit in October of 2007. The NASDAQ is up an even-stronger 59% since March but is still 30% below its 2007 high. As a reminder of the aftermath of a bubble bursting, the tech-stock-powered NASDAQ is still 61% below its all-time high reached in March of 2000.

So what's more impressive: the rally or how far the indexes still have to go to get anywhere near their all-time peaks? I'm impressed by each factor and that fits right into the message from our Market Meter. Both the level and the trend of the Meter are important for account strategies and both are positive, as the Meter has risen from -3 in March to +1 in July. It appears likely the August reading will be up to +2 when we review it at our monthly strategy meeting this week as the Technical input will almost certainly move to a net of +1 for August as Trend Analysis improves from -1 to 0. Short Term Technicals ticked up to +1 in May and still look favorable.

To answer the questions I posed at the beginning of this piece: 1) we are far from convinced this will be a sustainable economic advance or a sustainable Bull Market that will surpass the 2007 highs. We cannot shake the notion that the bursting of the Credit Bubble forces significant additional de-leveraging for consumers and the financial system as a whole. Lower availability of credit and less desire to use it should dampen GDP growth for years to come. 2) However, our work (Expansion Signals and Market Meter) suggests the cyclical economic and market outlooks are favorable. Rather than viewing this as a short term affair that will end abruptly and very soon, we are open to the possibility of a "positive surprise" that keeps the Market Meter in the plus zone well into 2010.

In terms of investment strategy, this dichotomy between longer and shorter term perspectives means we must stick to our Tactical Asset Allocation plan which causes us to move toward fully invested as the Market Meter improves and to take defensive steps if it reverses. If you have questions about how this impacts your account, please contact a member of your FirstMerit relationship team.

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