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OBSERVATIONS ON THE MARKET No. 229*By Greg Denewiler, CFA*

Does anyone really know what is going on? One week's news indicates the economy is slowing down, then a few weeks later the news stories suggest it is not as bad as a few weeks earlier indicated. It creates havoc on a portfolio's short-term performance, which of course then wears down investor confidence. This is evident in the VIX index, which is also known as the fear indicator. The index is currently showing a subdued market that is being buoyed by corporate earnings, but longer-term, suggests the seas will get much rougher six months out. It all seems anything but easy.

It was just a few months ago that Europe was destined to fall of the map. The Euro was being relegated to the trash dump and was predicted with great certainty to be headed to parity with the dollar. It cost \$1.18 to buy one Euro a few months ago, now it is close to \$1.30. Everyone thought the European economy could only go down, considering several of their economies were (are) on the verge of bankruptcy. Evidently the Europeans didn't get that memo because the UK just reported 2nd quarter GDP grew by 4.5%, and the latest German index for six-month expectations rose by 4.4 points to 106.2. The stress tests that were performed on the European banks to determine their health showed that overall, the banking system is sound. We should have known it was about to get better since the Europeans are preparing for their August 'holiday', so of course they feel better.

Memories appear to be short, which is another reason to not take everything at face value. Two years ago subprime borrowers (and lenders) were considered the root of all evil. Nearly every institution that had any connection to subprime loans wanted out. They proved to be much more risky than anyone thought. Well, maybe not. GM, the auto company that we all have a vested interest in now just used \$3.5 billion of your tax dollars to buy Americredit, a subprime lender. What a difference a few years makes.

Corporate earnings continue to surprise on the upside. With almost 50% of companies reporting their second quarter results, about 75% are beating expectations. What is probably more important is that many of the bell weather companies like UPS, Fedex, Caterpillar, and MMM, are suggesting their 2nd half outlooks are improving. GE also just raised their dividend by 20% and announced that they are restarting their share buybacks. Now they just need to start hiring.

The housing market continues to be an integral part of this recovery. New home sales for May declined as expected with the expiring tax credit. This left many investors thinking that without government support, the housing market is still dead on arrival. However, just when it seemed to look so obvious, June new home sales increased by 23%. Maybe 4.5% interest rates have something to do with it. It is becoming cheaper to own a house than to rent it. It seems interesting that the media is paying little attention to the jumbo loan market, which has shown a dramatic improvement in the last few months. It is further evidence the credit markets continue to improve. Jumbo 30-year loans are now down to 5%. This part of the housing market gets little sympathy, but we need a healthy housing market across all sectors to improve consumer confidence.

Eventually, the economy has to produce more jobs, or the economy will experience lackluster growth at best. Everyone knows this, and there is no shortage of opinions on all sides of the debate. Since corporate profits continue to impress, it is easy to build a case that they must eventually start to hire. However, it doesn't take much to throw the whole recovery thesis into chaos. It does seem prudent to take a longer term view to the current flow of economic news headlines, because it is becoming obvious that no one knows how this recovery is going to unfold. What is clear; reacting to each individual news story is hazardous to your financial health.