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China leads the way to a global recovery

U.S. will need time for its energy, financial and industrial sectors to see economic growth

SUMMING IT UP

William Rutherford

Stocks have rallied nearly 50 percent since its low on March 9. In spite of this, the S&P 500 stock index is still missing nearly $5 trillion in market value since its high in October 2007. The S&P still needs a nearly 30-percent gain just to return to its level before Lehman Brothers collapsed just a year ago, and it needs a whopping 57-percent gain from here to match its October 2007 highs. Is the market due for a pause, a resumption or a correction? What is the likelihood that the market will recover, and what would be the driving forces for a rally?

Keep in mind that the markets look ahead about six to nine months, so we have to ask what about the economy suggests we could see a rally of 57 percent. In the past month, we have seen some strong data suggesting a recovery. According to the national ISM index, economic activity is expanding at the fastest pace in 16 months. Pending home sales recorded the sixth straight month of gains, the strongest pattern since this index began in 2001. Retail sales have not been as bad as expected. The rate of unemployment growth also has not been as bad as expected, even while the percentage of unemployed workers increases. The economy seems to be in a bottoming process; indeed, central bankers are suggesting that is the case, while planning their exits from stimulus packages.

All market sectors are down from a year ago. The energy sector has been the biggest obstacle to the market returning to highs before the fall of Lehman Brothers. This sector makes up almost 12 percent of market capitalization. However, with oil at around $68 per barrel this year compared to $115 a year ago, the sector is still missing $500 billion from October 2008, or about 25 percent of the total market decline post-Lehman Brothers.

Financials have had the third-largest decline, $314 billion, behind industrials at $386 billion. But financials had already dropped significantly pre-Lehman. Looking to the October 2007 high it is financials that make up the largest losses, about $1.4 trillion of the market's $4.8 trillion total.

So it looks like it will take a rebound in energy, financials and industrials to recover the lost territory. Retail has an important role to play, but it is hard to see much help here from poorer consumers. With demand for energy down, and ample supplies, it is difficult to see the energy sector providing much impetus.

Financial stocks are recovering even as we are seeing a high number of bank failures. Banks are rebuilding their balance sheets and reserves through a combination of capital raises and profits. At the same time, banks are reserving heavily for any further downturn. Credit outstanding is reduced, which is a drag on the economy. With the impending problems from commercial mortgages, who can blame the banks for being cautious? However, the burden of tight credit falls unevenly, and small businesses and consumers suffer the hardest hits. Therefore, we probably cannot look to the banks to lead us out of the problems they created, and that will impede all other sectors.

China is now contributing more to global growth than all the developed economies put together. China is leading Asia, and Asia is leading the world.

As an aside, according to the records of the U.S. justice department, after the savings and loan crisis of 1990 to 1995, no fewer than 1,852 S&L officials were prosecuted and 1,073 went to jail. Another 2,558 bankers were jailed for crisis-related offenses. I cannot think of a high-profile banker prosecution related to the recent debacle.

So, if energy, financials, industrials and consumer stocks are not providing growth, where will it come from? Fortunately, there is evidence of a global recovery. German retail sales have risen. Italian business confidence has rebounded. China's PMI expanded at its fastest pace in 16 months. China, with its stimulus package, is now contributing more to global growth than all the developed economies put together. China is leading Asia, and Asia is leading the world.

After a long period under Communist rule, and the disaster of the "Great Leap Forward," China is making up for lost time. China is investing heavily not only in infrastructure, but also in intellectual capital. Both investments will make China more productive and a strong influence in the world economy as well as raise its standard of living. Nearly 6 million students graduated from Chinese universities in 2007, up from 270,000 in 1977. China graduates 700,000 engineers annually. China is building 97 new airports in the next 12 years. Thirty nuclear power plants are currently being built in China. Thousands of miles of new roads and highways are connecting China's fastest growing cities with lagging rural areas; that will generate more economic growth. There are 160 cities in China with a population of at least 1 million (the U.S. has nine), so the transportation upgrade can be powerful.

Although there is concern that its stimulus is waning, the reality is that China is now the leader in this economic cycle. Perhaps we will look back at 2009 and conclude that this year marked the beginning of a new economic era.

Our current investment outlook is short-term cautious, long-term bullish. Be diversified internationally.

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