

DJC

THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON



William Rutherford

A perversely optimistic future

POSTED: Friday, April 9, 2010 at 09:10 AM PT

BY: William Rutherford

With unemployment at a stubbornly high rate, home foreclosures still proliferating and commercial loans (especially for real estate) teetering, is there reason for optimism? Sometimes adversity is reason for optimism, and sometimes in a perverse way.

For starters, the economic news is not all bad. Consumer confidence is firming. Manufacturing is firming. Inventories are low and will have to be restocked. We just came off a decent quarter for earnings in the S&P. The retail sector has added jobs for three months in a row. The market, generally considered a precursor of the economy, has risen robustly. The Dow was up 4.1 percent and the S&P was up 4.9 percent for the first quarter of 2010. The equity markets were up for the fourth straight quarter.

With interest rates low for an extended period of time, money has sought a more comfortable home. Money goes where it is treated best, and so it has found its way back into the equity markets and the credit markets. Credit spreads have tightened, and indeed the credit markets have become more liquid. Just a year ago banks were reluctant to lend to each other. Companies were struggling to roll over commercial paper even with very short maturities. Companies were beginning to wonder how they would have enough cash to meet payrolls and payables. Now, credit markets are absorbing bond sales, especially massive U.S. government bond sales. The high-yield market is absorbing corporate debt at a record pace and the great lump of corporate debt that needed to be refinanced is being sold. The high-yield markets are working on repaying debt not due until 2013 and 2014, with 2010 and 2011 and much of 2012 already sold.

Equity markets have rejoiced at these developments. And as risk levels have come down, the appetite for risk has increased, so the equity rally has continued apace. To be sure, the equity markets are at risk for rising interest rates, but the Fed does not appear ready to increase rates until there is more confidence in the economic recovery. (The Fed may raise the rate at which it makes emergency loans to banks.) The woeful dollar even caught a break in a perverse way. Greece appeared to be in possible default on its bonds, which exposed the fault lines in the Euro. Even with the vague promise of IMF aid, Greek national bonds have weakened.

The Euro weakened and the dollar gained relative to the Euro. A stronger dollar led to a leavening of commodity costs, which is good for the economy and inflation. The DJ-UBS commodity index was down 5 percent for the first quarter of 2010. Food processors and retailers found the costs of their raw materials were down, with corn and wheat down 12 percent and 17 percent, respectively. That allowed for greater margins and the ability to hold the line on retail food costs. Oil prices, however, reached a 17-month high.

Metals traded at higher prices. At the Fed, however, fears of deflation appeared to trump fears of inflation.

In general, banks continued their restrictive lending practices even as the economy began to recover. The backlash against the banks, which I have long predicted, continued apace as legislators in Washington, D.C., looked for ways to restrict bank pay and impose new taxes. Now the unions have taken on the banks. Unions, which have seen the impacts of the economic downturn on their members' families, are responding. Labor leaders led the call for the resignation of Ken Lewis the defrocked CEO of Bank of America. Richard L. Trumka, president of the AFL-CIO, said recently of banks: "They gorge themselves in a trough of taxpayer dollars, while we struggle to make ends meet." Treasury Secretary Timothy Geithner said recently that it was "deeply unfair" that some financial institutions that got taxpayer-paid bailouts were emerging from the recession in better shape than millions of ordinary Americans. The top 25 hedge fund managers earned more than \$25 billion in total, more than they earned at the top of the market in 2007.

Recently, the woman who cleans the office of the chief of U.S. Bank in Minneapolis was forced into foreclosure for a loan serviced by JPMorgan Chase. The publicity forced a meeting brokered by U.S. Bank between the janitor, Rosalina Gomez, and JP Morgan Chase. A union happened to be in contract negotiations with U.S. Bank and credited the discovery of Gomez's plight with getting better wages and health care at the bargaining table. At about the same time, Bank of America became more proactive in reducing mortgage balances for homeowners facing foreclosure. The banks were finally realizing that it was in their interest to keep homeowners in their homes, and not on the street while houses sat empty. The idea has yet to catch on in the commercial market.

Washington has now passed a massive health-care bill. Left unsettled is how to pay for the big price tag. But the bill was not passed by Congress in the customary way. While the Senate passed a health-care bill, the House passed a rule, which contained a health-care bill, which was not in the same language as the bill passed by the Senate. President Obama signed the rule, which had not been reconciled in the usual way with the Senate bill, into law. This allowed the Democrats to either say they voted for the bill or deny that they voted for the bill - whichever suited their political future the best. The president appointed a commission to find the \$500 billion needed to fund the bill. In addition to the various taxes that the bill imposes on such things as hospital supplies (bedpans?), tax rates are certain to increase. Many worry that the new costs and taxes will be bad for the economy. AT&T took a \$1 billion charge in the first quarter because of the impact of the bill. Many other companies took large charges as well. Many worry that the costs of the bill will crowd companies out of the credit markets. Large government and large government debt has historically been bad for economic growth. There is no reason to believe that this time will be any different.

The U.S. government, which has already been on a massive borrowing spree, will have to borrow even more. All levels of government will encounter borrowing limits, and when that happens, we can look forward to a period of shrinking government, and with that shrinking will come a better climate for business: a perverse positive.

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a five-star rating from Morningstar. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" For investment information contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com