

DJC

THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON



William Rutherford

Global economy in second quarter not so good

Published: August 9th, 2010

What a difference a month makes.

The market experienced a healthy start this year. The first quarter showed the S&P with a credible, 4.9 percent gain. A global recovery seemed in the offing.

Then problems began to occur. The sovereign debt crisis in Europe threatened to sink the euro and pull the eurozone apart. Iran seemed more likely to be developing nuclear weapons. The U.S. experienced a "flash crash" such as the market had never seen before, shattering investor confidence. The BP oil spill triggered a gulf crisis, and President Obama suffered his very own Katrina moment and unnerved the whole country. Then the job market went into a stall. Consumer confidence waned.

Suddenly the global outlook was not so optimistic. Eighty percent of economists polled said the economy was slowing. Talk of a double dip recession became common. Nobel laureate Paul Krugman warned of a third depression. After the market peaked on April 23, the S&P 500 stock index slumped 16 percent to nearly meet the definition of a bear market. Gloom spread.

Volatility surfaced once again. The flash crash demonstrated the pain that volatility can evoke. For instance, investors who used stop-loss orders to protect their holdings found themselves with enormous losses as their "insurance" failed. The flash crash did demonstrate that volatility can take prices to irrationally low levels.

Many investors fled the markets after the flash crash. Morgan Stanley reported that clients withdrew billions of dollars. We did not lose any clients as a result of market instability. Some saw it as a chance to move back into equities.

Surveys of individual investors pointed to an unusually swift eruption of bearishness among those investors. Fears of another downturn pressured stock prices. The July 14 survey of adviser sentiment by Investors Intelligence, a widely followed gauge of opinions in investment newsletters, found that more advisers were bearish than bullish. A similar study released on July 8 by the American Association of Individual Investors found that individual investors who classified themselves as bearish jumped to 57 percent from just 42 percent in the prior week. Sentiment was as bad as it had been during the crisis. Some thought it was time to buy.

Accepted wisdom on Wall Street is that only after investors have given up on stocks can stock prices start to climb. The perfect time to buy is when pessimism is high and the last

seller has sold. James Stack, editor of the InvesTech Market Analyst newsletter based in Whitefish, Mont., pointed out that the ratio in the July 8 study of bears to bulls was 2.7 to 1. Historically, when the bear-to-bull ratio is this high, the Dow Jones averages were 11.4 percent higher six months later. Typically, technology and consumer discretionary sectors have experienced the best results.

The second quarter ended in the red, with the S&P down 11.4 percent. Investors rushed to Treasuries, pushing prices up 3.5 percent and yields down. Cash, the most stable of all asset classes, earned .003 percent. These losses did not come close to erasing the gains of the last 12 months.

While bonds returned 9.5 percent for the preceding 12 months ending June 30, the S&P 500 had gained 14.4 percent; small caps were up 21.5 percent and emerging markets were up 23.1 percent. The best sector in the previous 12 months was REITs, up 55.2 percent, followed by consumer discretionary at 30 percent, and industrials at 26.5 percent.

With all the focus on gloom and doom, reporters noted that the U.S. economy grew at only a 2.7 percent rate, down from original estimates of 3.2 percent. Few people in the media reported that the economy hit \$14.59 trillion in output, an all-time record high. Incomes, spending and savings all increased. New jobs were slowly being created.

At halftime in the earnings season, 75 percent of companies beat earnings estimates, and only 15 percent missed. Blue chip stocks rose 7.1 percent in July, posting the best month for those stocks in a year. Both the S&P and the Nasdaq posted 6.9 percent gains for the month.

Of the GDP growth, most came from capital spending. Consumer spending was quite a small contribution. I have argued that tax credits for capital expenditures would have been a better stimulus package than short-term jobs.

Private sector borrowing declined for the first time since the Great Depression and is still declining. A combination of lack of confidence and bank stinginess were responsible. Meanwhile, bankers' compensation reached levels from before the Great Recession as ordinary Americans continue to pay through their taxes and new bank fees. Ordinary Americans struggled to meet their own obligations. Because of lack of credit and confidence, growth appears to be slowing to 2.5 percent. It's a slowdown, but not a stop and not a reversal.

China's growth slowed from 12 percent to 9 percent. Economies in China and emerging countries continued to grow faster than in the U.S., and they will lead growth in years to come. The European Union found it was in its best interest to solve the euro crisis, and the ebbing crisis gave hope to world markets. European companies, as a group, have beaten earnings expectations. Germany has now recovered all jobs lost in the Great Recession.

Yet dismal scientists continued to forecast doom.

Warren Buffett once said that investors should be "fearful when others are greedy and greedy only when others are fearful." 'Nuff said.

William Rutherford is the founder and president of Portland-based Rutherford Investment Management, listed in Barron's as one of the nation's leading separate account managers. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact him at 888-755-6546 or wrutherford@rutherfordinvestment.com