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## **ECONOMIC AND MARKET REVIEW**

**January 2010**

### **Economic Review**

We have to mention that it seems that in the last few weeks the intensity of information related to the possibility of consumer/devaluation driven deflation have increased. There is no scientific or statistical basis for this comment, but it seems worth noting. There appears also to be much more concern about the prospects for the economy and the mushrooming Federal debt. There is a common concern how successful the withdrawal of monetary and fiscal stimulus will be.

Another recent concern involves foreign economic threats to our security and the pressure that other governments can place on the U.S. An example is this week's story from former Treasury Secretary Paulson that during the 2008 crisis Russia attempted to entice China to place pressure on the U.S. government securities market by selling U.S. bonds. This is indeed a very complex economic condition that the U.S. and the world find itself! The coupling is astounding. Jeremy Siegel stated 3 years ago that "globalization is over." He was correct.

#### **CPI Data:**

As of today, falling prices have been noted in Germany and the U.K. It looks like the same may be in store for the U.S. Fruit retailers are seeing the most rapid deflation in over fifty years. Restaurants have lost pricing power at the greatest rate since 1994. Rents of primary residences have plummeted since 2007. Hotels after significant pricing power losses have seen some strengthening. There is no room for improvement in home improvement stores. December saw clothing stores sales with a price increase of a modest .4% year over year. Not surprisingly, now jewelry has deflated significantly after a recent increase over the last few months. Further falls have continued to be experienced with toys, movie theatres, book stores, and tuition.

Pricing rises have been seen in the auto sector, airlines, hospital services, and telephone services. *(Data has been provided by Gluskin Sheff).*

According to Reinhart and Rogoff, the over-whelming level of debt in the economy is likely to prevent a monetary inflation spiral. High deficits are instead likely to lead to higher taxes and further depreciation of economic activity.

The crystal ball isn't without inflationary points of view. Well-known Robert Arnott of Research Associates and Pimco suggests that with public debt is at 140% of GDP (including local and GSC debt). The U.S. is only second in debt to Japan and Lebanon. The 140% is twice as high as the debt of Greece. Arnott says that if you include corporate and household debt plus the unfunded entitlement programs such as Medicare and Social Security, the debt level would be 840%. Arnott says, "I defy you to show me anywhere there is de-leveraging." He says that taxing out of that level of debt is impossible. Assuming that there is not a sustained surge from GDP growth, the debt would have to be managed by inflation according to Arnott.

### **Bye, Bye Stimulus:**

Marked and economic watchers seem to be worrying about what's going to transpire when the government stimulus starts to be withdrawn. The global economy had 2 trillion added to it by the government since 2008.

### **Home Prices, Watch Out:**

With new household formation, according to Gluskin Sheff, down over 800,000, it will take over five years to cut the total inventory back-log of houses in half.

Case-Shiller notes a fourth quarter revival of falling house prices.

### **Housing Rentals:**

Economist reports that the home prices outside of the U.S. are still far above their fair value. The evaluation method used by the Economist estimates that house prices in the U.S. are back in line with rents.

In spite of the Economist valuation, what happens when the Fed stops buying mortgages and drops the tax credit program to housing prices leaves a big question. There is an excessive supply residential real estate which could generate a renewed 10% to 15% decline in home prices nation wide according to David Rosenberg of Gluskin Sheff.

### **Roof Collapses:**

The December existing home sales fell 16.7%. Every region in the U.S. was down during December. This data includes foreclosure sales. Foreclosure sales in December, reported by Gluskin Sheff, resulted in one-third of the sales.

### **Commercial Real Estate Losses:**

Banks are facing about \$1.4 trillion of U.S. commercial real estate loans maturing in the next four years. Credit Suisse reports that almost 55% of the commercial mortgages that will mature are currently under water. This is bound to contribute to a significant increase in defaults.

### **You and I Frugal:**

Fidelity survey reported that 60% of those who made New Year's resolutions promised to change their expense habits, i.e. tighten the belt, pay down debt, boost savings, or radically change the family budget. This trend, say the deflationists, will contribute to pricing falls.

### **Employment:**

The unemployment rate has continued to worsen when considered are the numbers of workers in the labor force who cannot find work and are taking part-time as a necessity and those that have given up their efforts. The rate, often referred to as the real-rate, is 19.1% or approximately 30.4 million people as opposed to the 15.3 million that is officially noted.

According to Financial Times, the economy needs to generate more than 100,000 per month just to keep the rate flat.

Dishnu Lekraj, an employment analyst, recently reported to Morningstar, that he sees reasons that employment is going to get better from here on out. His reasoning is that the temporary help industry has experienced better initial unemployment claims with some companies lifting hiring freezes.

### **Markets**

It goes without saying that the equity markets and the fixed income markets have rebounded dramatically. Equities turned positive and recovered 73% of their losses during the fall of 2007 thru 2009. Bonds recovered dramatically from their depths in 2008 at the Lehman bankruptcy with some by categories up over 30%. It is somewhat unusual that bonds and equities to improve so dramatically at the same time.

Bonds generally during an economic growth pattern will lose value due to rising rates. Is the equity market accurately forecasting a good recovery? Or, are bond yields suppressed by government intervention?

The possible explanation is that the equity market has over-shot its values from the depth of the fall in early March 2009. A number of investment watchers, such as Shilling, Rosenberg, Mauldin, Grantham, and even Leuthold, think the market is no better than fairly valued, if not, over valued (Grantham came out this week and said fair value is 860 on the S&P500. That amounts to a 20%+ over value equity market).

### **An Over Valued Market:**

The normalized earnings approach of Shiller was reported last week to suggest that the S&P is over-valued by 27%. Further justification for an over-valued market is that 85% of the S&P stocks are now trading at above their 50 day trading average. Bullish sentiment is also at a high of 72%.

Rosenberg points out that if the GDP growth for 2010 fails to meet the 3% consensus by 1% that the S&P should be valued 720 (today it's in the neighborhood of 1150).

As of February 1<sup>st</sup> the reporting season for company earnings is coming in strong. Four out of 5 that have reported to date have reported 4<sup>th</sup> quarter earnings higher than expected. Revenues have jumped as well (compiled by *Thompson Reuters*).

### **Oil, A Slippery Slope:**

In early January, the Financial Times reported that oil demand did not support the \$80 per barrel price tag. That report so far has proven to be right. Oil has fallen below the \$75 per barrel price since.

### **Silver or Gold?**

In 2009 we saw commodities soar, especially gold. We have now gone from jewelry as a luxury to advertisers suggesting that everyone should own gold bullion, and it is the “only asset that doesn’t lose value”. Limited attention has been given to silver. It will take a return of 3x for silver prices to get to where gold was in relative terms at the peak back in January 1980.

### **Japan two decades lost:**

The Economist reports that the Nikkei ended 2009 73% below its peak at the end of 1989 (that’s right 20 years ago). Urban property prices in Japan have fallen and are at 2/3 of their values at the end of the 1980’s decade. The once highly sought after ski apartments in Japan are now worth 1/10<sup>th</sup> of their value at the bubble in 1989. Bonds, however, are at 78% cumulative return (ten year government bonds). It sounds like the end of the equity cult doesn’t it?

## **In Summary**

Where does all this minutiae take us? How do we respond? There are tidbits of good news and forecasts for an economic turnaround soon. There are numerous unknowns that cause us pause. Among them is the question of how pricing will respond to the economic conditions that exist and the policies that are implemented. Another is how to unravel the historic debt now in place and growing daily. How will the economic activity react once the government withdraws the monetary and fiscal stimulus? The White House budget suggests a trillion dollar Federal budget shortfall annually for the next 10 years. It seems that we are now at the point of necessarily dealing with the over indulgence and over borrowing of the last 20 years.

Many of our client friends should be cautious with their risk taking and not gamble heavily on a healthy and quick economic recovery. There have been two notable bubbles in the last ten years that have caused fallout. The very significant stimulus and resulting risk taking by investors may be inflating a 3<sup>rd</sup>!

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