



Insights from Northern Trust

Recessionary double dip or moderating U.S. economy? Michael Wente offers his insight.

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Discounting “Unusual Uncertainty”

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Last week investors focused intently on U.S. corporate earnings and assessed the prospects for future earnings growth through the window of the U.S. economy. Once again, fears of a potential recessionary double dip surfaced. Worries about euro zone debt and austerity measures, China’s economic strength, U.S. financial regulation, BP’s oil spill and to some extent even the European stress test all took a back seat to the focus on U.S. corporate earnings and the U.S. economy. The overhaul of U.S. financial regulation was signed into law mid-week but had little effect on the markets as investors realized it will take months or even years for the script to be brought to life.

Initially, the markets generated some light gains but were essentially stagnant as economic and earnings releases failed to provide any crisper focus on prospects. Economic releases were primarily housing-related with housing starts, building permits and unsold inventories all disappointing slightly relative to expectations. Most of the shortfall was attributed to the elimination of the first-time homebuyer tax credit. Housing affordability is at a 40-year high as prices are low and credit is cheap, but qualifying for credit is tough. Earnings early in the week were also unconvincing. Results were at best mixed, with disappointments coming from General Electric, Texas Instruments and IBM. Upside earnings surprises came from Pepsi, Apple, CSX and Intel. Investors were searching specifically for guidance on future earnings, which were lacking in these announcements.

Absence of conclusive earnings or economic data heightened investors’ interest in Ben Bernanke’s semiannual report to Congress on the state of the economy. After all, who should have more insight into the possibility of a double dip than the Federal Reserve chairman? Early statements in Bernanke’s testimony supported an outlook for moderate economic growth with a gradual decline in unemployment and subdued inflation. Specific Federal Reserve expectations were for real gross domestic product (GDP) growth of 3.0% to 3.5% in 2010 and 3.5% to 4.5% in 2011 and 2012. At the same time, unemployment is expected to decline to between 7.0% and 7.5% by the end of 2012. The latter half of Bernanke’s testimony raised investors’ concerns especially when he indicated the Federal Open Market Committee (FOMC) members felt a greater than normal uncertainty about the outlook for growth and unemployment. Late in his statements Bernanke indicated that the economic outlook remains “unusually uncertain” which triggered the Dow Jones Industrial Average (DJIA) to fall sharply and finish the day down 109 points.



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But what a difference a day made! Thursday brought a number of significant earnings releases that hit the trifecta of earnings announcements for which investors were thirsting. Caterpillar, 3M, UPS and Union Pacific all reported good earnings, good revenue growth and, more importantly, provided optimistic guidance. These strong earnings reports were able to overshadow weak but better than expected economic releases addressing employment, housing and U.S. leading economic indicators. Existing home sales for June came in at 5.4 million units, down 5% from 5.7 million units in May but exceeding expectation of a 10% decline. Leading economic indicators declined a slight 0.2% but beat estimates of a 0.3% decline. The DJIA rallied 202 points primarily in response to excellent earnings reports and, more importantly, optimistic guidance.

The week concluded on an up note with EU bank stress tests producing satisfactory results, additional positive earnings announcements and General Electric raising its dividend 20% as evidence of its optimistic outlook. Reports of second-quarter earnings for 175 of the S&P 500 companies were upbeat, with 55% beating their earnings expectations by a material amount and only 4% missing by a similar magnitude. On the revenue side, the numbers were more in line with expectations, with slightly more hits than misses by a small margin. The Standard & Poor's 500 (S&P 500) ended up 38 points or 3.5% for the week. The MSCI EAFE index finished the week at 1453.44, up 1.5%, while the MSCI Emerging Markets index capped the week 981.42, up 3.4%.

Undoubtedly the double-dip versus moderating U.S. economy debate will continue. It is clear the degree of uncertainty about the U.S. economy has risen over the last month. Early in July Northern Trust's chief economist, Paul Kasriel, lowered his projections for GDP growth in the second half of 2010 to 1.8%, 1.7% in the third quarter and 1.9% in the fourth. He does have 2011 picking up to 3.2% year over year. So we do see the economy moderating but not slipping into another recession. We have recently adjusted our longer-term total return expectations for the S&P 500 to 7.5% from 9%, MSCI EAFE to 7.2% from 9%, and MSCI EM to 10.5% from 13.5% to reflect our reduced global growth expectations.

Investing in less certain times is nothing new. To compensate for the incremental risk (uncertainty), one must apply a higher discount rate to future returns. If investments are discounted at a higher rate and valued more cheaply than historical norms, the resulting price level can offer a good opportunity for attractive returns.

Using the 10-year Treasury note as an illustration, at the current 3% yield, an investor pays 33 times its annual earnings or a price earnings (P/E) ratio of 33. On the equity side of the ledger, the S&P 500's long-run average P/E ratio is about 16. Conservative estimates of S&P 500 earnings for 2010 are \$80, meaning that at today's price level of 1100, the stock market is trading at a P/E of 13.75. So, today's stock price level implies a 14% discount to the long-run average. Northern Trust believes this discount is reasonable given today's market uncertainty.

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