2011: The Economy in Transition

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2011 is set to be an interesting year as both the Bulls and Bears make strong cases.

The Bull Case:

A Recovering Consumer: As we begin 2011, the economy is showing signs of accelerating growth. Unemployment claims have recently plummeted, and we may start to see a corresponding rise in job creation. Along with a normal rise in wages, job creation should lead to stronger demand for goods and services and a sustainable economic expansion. While the consumer debt burden is large and will likely remain a headwind, debt service as a percent of income is quite normal due to the unusually low rates. The consumer is clearly the key to future economic growth and appears to have several tailwinds.

Loan Growth: Despite being loaded with Treasuries, banks are able to have a positive spread on this investment due to the low 'cost' of money. Bank loan portfolios have been stagnant, a major impediment to growth, but this may be changing. The willingness of banks to lend has been increasing. At current survey levels, loan portfolios show signs of expanding, which is another key piece to the economic resurgence.

Money Flows into Equities: Sentiment among portfolio managers is bullish. Most are betting on the economy accelerating and expect a ten to twenty percent increase in the stock market. Nevertheless, bullish sentiment in itself is not a positive for the market, so the market will be more dependent on the entry of additional investors that have been on the sidelines, namely pension funds and individuals. Recently, money has started shifting out of bonds into stocks. Individuals have just started net buying stocks again and pension fund sponsors may reallocate assets. At the peak, pension funds had 74% in stocks, but now have less than 50%. Thus, any shift in asset allocations towards stocks can drive the market higher.

Fiscal Stimulus: The 2011 political scene should become more benign, as the tax cut and unemployment extensions have passed. Business is beginning to see the tax landscape more clearly, and this will remove some of their spending hesitation, yet another encouraging development. Europe continues to be dogged by the debt crises in Portugal, Spain, Ireland, and of course, Greece, but the U.S. banks have little exposure to these problems and Europe should work them out slowly over time. By year-end 2011, this should fade into the background.

The Bear Case:

Nonetheless, 2011 will be a challenge for portfolio managers. There are a variety of risks that can still abort the recovery. Investors must be diligent in re-assessing the macro fundamentals. Let me outline our concerns.

Quantitative Easing ends badly: Bond rates have recently spiked up due to the long-term inflationary impact from the Fed buying short term Treasuries and ballooning the money supply. This illustrates that the Fed cannot completely control longer term rates, and it appears that investors are getting more negative on bonds with historically low interest rate levels in the long end of the curve. The impact from the rising interest rates could be to derail the housing recovery and strain the banking system. In turn, banks change back from trying to increase their loan portfolios to protecting capital and shrinking their balance sheets.

Housing is still the area of major concern: It appears that prices may resume their decrease after stalling out this summer and fall. Supply on the market has declined, but is still above normal, and foreclosures will continue to plague the market with below market price sales. The Southwest and Florida remain the worst off. For example, it is reported that two thirds of Nevada mortgages are under water. The one major positive is that affordability is at an all-time high, so if banks loosen their credit standards and job creation starts to accelerate, the national housing market can continue its slow recovery. Cheap ARM's will enable financing for housing if demand continues to increase, but housing requires close scrutiny over the next several months.

Commodity Headwinds: Commodities have been soaring, adding to bond investors' fears of future inflation, but slack in manufacturing capacity and unemployment should prevent any real inflation problem soon. Ultimately, any sustained acceleration in inflation will require a sustained increase in wages. This will not happen this year as it will take some time to decrease the unemployment rate and firm up wages. Nevertheless, companies will be forced to accept higher input costs with minimal subsequent increases in the prices of their goods. Companies are financially strong so that they can withstand this pressure, although many will see pressure on their margins by mid-2011.

Oil is our biggest concern. Should oil prices exceed $100 a barrel, it will be a real drag on economic growth. The economy will take time to reflect this, but I expect the stock market to immediately become sloppy as the triple digit price is reached. For this reason, expect any downward move in oil prices to be met with stock market strength. Oil exposure is a good hedge as it will do well when other stocks are threatened by high oil prices. Eventually, high oil prices stall the economy and destroy oil demand, resulting in lower oil prices as well as other commodities. This natural supply-demand correction will require some economic pain though.

Peaking Profit Margins: Commodities aside, Bears point out that corporate profit margins are at all-time highs and should decline. Since the Second World War, cash margins have trended towards a mean that has not drifted up or down over time. In an environment of shrinking profit margins, one can see how business confidence is shaken and therefore, job creation threatened. One thing the Bears miss is that we are at the beginning of a recovery, such that sales increases mitigate the margin erosion of corporate profits. However, expect them to trend toward a normal level over time.

Chinese Monetary Tightening: China is in the process of trying to cool growth and prevent inflation from increasing further. The main inflation culprit has been food, which is something that increasing supplies over the coming year should take care of. In the meantime, many worry about world economic growth with a slowing Chinese economy, but Chinese tightening will also cool off commodity prices, prolonging the recovery. Growth in China is another key variable to watch although we don't think their strong growth should be impaired.

Our Take:

Although the Bears may ultimately be right, we remain positive on the equity markets which will benefit from the asset shifts out of bonds, quantitative easing and an acceleration in the economy. That said, stocks with commodity cost pressures like food companies and retailers should be avoided. Technology is a safer area as it will not have cost pressures and capital spending should be solid. Any company that will grow without being too dependent on economic growth is a good bet. Like 2010, a moderate return in the stock market should favor high income stocks.

It is likely that the recovery will continue next year and the market will do fairly well, but several key components warrant watching very closely. It will be important to be flexible, nimble, and above all, be able to anticipate any abrupt change in the economic and financial landscape.