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Economic Outlook

Fourth Quarter, 2009

The recession appears to have ended late in the second quarter this year. With the help of mind-boggling levels of monetary and fiscal stimulus, including “Cash for Clunkers” and tax credits for first-time home buyers, the economy expanded in the third quarter at an annual rate near 3% according to respected forecasters. Assuming no new stimulus programs are implemented, some of the third quarter strength may have stolen from fourth quarter activity; but nevertheless, we expect the economy to continue its expansion in the fourth quarter.

There currently are two widely divergent views as to where the U.S. economy is headed. One view is that the Federal Reserve has printed money at a rate that inevitably will lead to higher inflation rates. The other view is that the U.S. consumer remains financially over-leveraged, and the process of deleveraging will result in low growth rates for the economy and inflation. There is ample data to support either case.

For investment strategy purposes, the re-inflation scenario is not a current concern. Following four quarters of economic contraction, we would welcome an environment where business levels reach a point where supply is unable to keep pace with demand. Businesses have done an extraordinary job of streamlining their cost structures, possibly even overshooting in reducing headcount. Given the slack in production capacity and labor supply, inflation does not appear to be a “here and now” threat.

The deleveraging issue is difficult to predict because we do not have good data as to who the consumers are that are over-leveraged, what is their overall asset/liability condition and how much leverage is too much? Already we have seen record bankruptcies and home foreclosures, along with record declines in consumer credit. It appears credit already has been purged to a large extent from the financially weakest consumers. With two consecutive months of house price increases, per the Case-Shiller House Price Index, perhaps the U.S. housing market is stabilizing. Home mortgages have been the primary source of consumer leverage.

While we believe the economy will continue its recovery now in process, we do acknowledge the presence of large negatives, i.e., increasing unemployment, large budget deficits, expanding regulation, potential tax increases, etc. Despite these negatives, we believe upward momentum in the domestic and global economies will continue as low interest rates, improving credit markets and stronger corporate profits overcome the negatives.

As previously noted, U.S. business has adapted to the negative economic environment in the prior four quarters ended June 30 this year by aggressively cutting costs. Currently, most U.S. businesses are “lean and mean.” Due to these cuts, corporate excess cash relative to capital expenditures in the second quarter was the highest in nearly 50 years. In the second quarter, pre-tax corporate profits with inventory valuation adjustments and capital consumption allowance rose at an annualized rate of 23.8%.

Valuation for U.S. equities appears attractive. We expect the S&P 500 to earn about \$72 in 2010. At its current level of 1,035, the S&P 500 sells at a price/earnings ratio of 14.4 times 2010 earnings. This P/E multiple is attractive given that we are early in a recovery cycle, and inflation and interest rates are at historically low levels. We believe the current equity markets offer opportunities to buy higher than average quality at lower than average valuation.

We believe equities represent better value than low-yielding fixed income assets. U.S. Treasury bonds appear significantly overvalued as supply concerns and inflation expectations create interest rate risk. Mortgage-backed securities offer yield advantages, but significant volatility would erode returns creating larger than normal risk for the sector. Corporate bonds continue to offer attractive yields, and many debt issuers have stable earnings and are not dependent on an economic recovery to meet their debt obligations.

Master Limited Partnerships (“MLPs”) also offer good value. MLPs are publicly-traded infrastructure investments offering investors a high level of current distribution, growth potential, and modest correlation to the U.S. economy. We are particularly focused on natural gas-related MLPs. We expect new natural gas infrastructure will be a key part of the solution to the U.S.’s future energy needs.

Note: This commentary contains forward-looking statements about various economic trends and strategies. You are cautioned that such forward-looking statements are subject to significant business, economic and competitive uncertainties and actual results could be materially different. There are no guarantees associated with any forecast; the opinions stated here are subject to change at any time and are the opinion of FAMCO’s Strategy Committee. The data is obtained from sources we deem reliable; it is not guaranteed as to its accuracy. Past performance does not guarantee future results. This report is not an offer or the solicitation of an offer to sell or buy any security, service or investment strategy.

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