

## Weekly Update: 'We will not have a double-dip recession at all'

September 17, 2010

### What's next

**That's not my quote; that comes from the Oracle of Omaha.** At an economic development summit in Montana on Monday, Warren Buffett said business at all his firm's diverse businesses is on the rise. His comments fit with much of the recent economic data that has been pouring in, including some this week (*see below*). This has helped lift the markets in September, a month that often holds nasty surprises for investors. But then again, the market makes fools of most of us. So far, this has been one of the strongest Septembers on record. But what's next?



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**Earnings season is just around the corner**, and some early indicators this week were good—Oracle and Research in Motion surprised to the upside, though FedEx's cautious outlook disappointed. The consensus expectations for S&P 500 earnings in 2011 continue to be stuck at \$96 (which the market does not believe), which would put the S&P well above 1,300 on reasonable P/Es. At this writing, the S&P is hovering near 1,131, a key resistance level. If it breaks through, Cantor Fitzgerald doesn't see resistance again until 1,250 (that is the year-end target for the bulls). Catalysts for a sustainable move might come with a stronger-than-expected earnings outlook (which would give 2011 estimates more respect), or another round of quantitative easing by the Fed. The catalysts for QE2 would include GDP growth below 2% for a sustained period, unemployment back to 10% (both of which would likely fuel double-dip concerns and push down stocks), or clear signs of deflation—Chairman Bernanke would be very keen to avoid deflation, with today's report on consumer prices reviving the discussion somewhat (*see below*).

**But a bigger catalyst could be the midterm elections.** Despite some noise this week about a split in the Republican ranks caused by Tea Party candidates who won various primaries (does that necessarily mean that disgusted independents will vote for the Democrats!!), the polls continue to suggest a Republican takeover of the House is likely and the Senate remains in play, too. Since 1920, the S&P has risen 15% on average in the six months following midterm elections, and over the last 17 midterm elections, stocks have always moved higher in the 200 days following the election. We're strapped in for earnings and the midterm elections. It promises to be a very interesting ride.

### Positives

**A consumer who kind of wants to spend** August retail sales rose slightly more than expected, and while July's increase was revised slightly down, real consumer spending appears to be accelerating, rising at a 2.3% annual pace so far in Q3 vs. a 1.9% pace in the first half. August's sales were driven more by basics—clothing, gasoline and groceries—than by big ticket items such as autos, furniture and electronics, which were soft. Still, the pickup in sales suggests consumer spending *will add to growth in Q3 GDP*, a problem for those still holding to a double dip.

**This is a problem for the double dippers** Industrial production rose again in August, with capacity utilization nearing 75% (although this level is not awesome). Tech industrial production is rising at a 16.6% annual rate, and is almost back to its previous peak. Meanwhile, business inventories surged a broad-based 1% in July, much stronger than forecast and the 7th straight monthly increase. Yet the inventory-to-sales ratio remained low by historical standards, suggesting inventories are well managed. Inventories are on track to *add fairly significantly to real GDP growth in Q3*.

**For those worried about deflation** Import prices rose much more than expected in August, driven by increases in petroleum and food prices; producer prices rose slightly more than expected, though the core rate is still up a comparatively low 1.3% annually; and consumer prices rose 0.3% as expected, though the core rate was flat and is running at 0.9% annual rate. 13D Research says it's worth noting that, stripped of owner's equivalent rent that accounts for nearly 40% of CPI, there's been a marked revival of inflationary pressures since early 2009, with global meat prices at 20-yr highs, lamb prices at a 37-year high and coffee its highest since May 1997. Sugar prices in January also hit their highest since December 1980 (too bad I'm a sweet-coffee drinking carnivore).

## Negatives

**What do you suppose would put the small businessman in a better mood?** Even though 91% of owners reported all their credit needs met or they did not want to borrow, the NFIB small business optimism index remains stuck at recession levels despite an uptick in August, with capex plans matching November 2009's record low. Its chief economist noted that Washington's "proposals to improve the economy typically focus on easing credit conditions or giving businesses incentives to spend. These policies are unlikely to help most small businesses whose main problems remain poor sales" and uncertainty over taxes, government regulations and the economy. Meanwhile the NFIB said "there is no life in the jobs market" even as the ADP monthly survey shows that small businesses with fewer than 50 employees accounted for 45% of private sector payrolls during August.

**Housing has a lot to work off** U.S. homeowners slashed their asking prices for a third straight month in August, with 26% cutting prices, the highest percentage since October 2009. Also, RealtyTrac reports bank repossessions of almost 100,000 in August, the highest since the site began tracking in 2005. And Moody's says there is so much excess housing inventory that it will take another three years for U.S.A. home prices to find a true bottom—it suggests are as many as 12 million more homes in shadow inventory (in default or foreclosure that may be offered for sale) in addition to those that are vacant.

**Why there are double dippers** The IBD/TIPP economic optimism index showed that 42% of respondents don't think the recession has ended yet. The 0.9% yield on 10-year TIPS is back to where it was at the depths of the recession. Even with the past year's run-up, industrial production is still well below pre-recession levels, and there are signs of deterioration—the Philadelphia Fed's regional index of activity contracted in August. Finally, since 1970, all but one of the seven times year-over-year growth has slipped below 2%—it was 1.6% in Q2—a recession has been signaled.

## What else

**Why so many are so angry** The Census reports that the inflation-adjusted income of the median household fell 5% between 2000-2009, even worse than the 1970s. And the fraction of Americans living in poverty rose sharply last year to 14.3%, the highest level since 1994, while the number of uninsured Americans rose to 51 million, up 4.4 million, the largest annual jump since the government began collecting the data in 1987. Finally, the number of 25-to-34-year-olds living with their parents rose 8.4% from 2008-2010, while the number of multifamily households jumped 11.6%.

**This does not compute** Sixty percent of Americans admit having problems using math in everyday situations, NBC reports. And only 43% of high school grads in 2010 were ready for college math.

**Now that the media hordes have moved on** The New York Times says scientists feel that environmental damage to the beaches and marshes surrounding the Gulf oil spill is less than even the much smaller Exxon Valdez spill of 1989.

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Views are as of September 17, 2010, and are subject to change based on market conditions and other factors. These views should not be construed as a recommendation for any specific security.

**S&P 500 Index:** An unmanaged capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

**Price-Earnings Ratio** is a valuation ratio of a company's current share price compared to its per-share earnings.

**Gross Domestic Product (GDP)** is a broad measure of the economy that measures the retail value of goods and services produced in a country.

**Consumer Price Index (CPI):** A measure of inflation at the retail level.

**Producer Price Index (PPI):** A measure of inflation at the wholesale level.

The National Federation of Independent Business (NFIB) conducts surveys monthly to gauge how small businesses feel about the economy, their situation and their plans.

The IBD/TIPP Economic Optimism Index is a gauge of consumer and business confidence conducted for Investor's Business Daily by TechnoMetrica Market Intelligence.

The Philadelphia Manufacturing Index is conducted monthly by the Federal Reserve Bank of Philadelphia to gauge the level of activity and expectations for the future among manufacturers in Greater Philadelphia region.

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