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"Let the Cat Out of the Bag"

"Dear Optimist, Pessimist and Realist,
While you were busy arguing about the glass of water, I drank it.
Sincerely, the Opportunist"
- From, Cat in the Bag blogspot

The endless debate and numbingly repetitive news cycle of the post "great recession" years have done little to help investors take action or make money. I believe fundamental improvements in the economy have been obscured by unnecessary psychodrama and sensationalized media reporting. In this year's "perspectives" commentary, I hope to refocus readers on basic realities that may help inform decisions regarding investments of all types: time, money and business.

In the first four months of 2011 the S&P 500 rallied almost 9% with building confidence that the US economy was on the mend and that European debt issues could be controlled. That perception broke in late spring and by July markets were roiling as political brinksmanship over the need to raise the US debt ceiling gripped the domestic scene and concerns rose that peripheral countries in the EU were set to default.

Never mind that the debt ceiling in the US has been raised 74 times since 1960 and ignoring the perversity that the Clinton administration was afraid they were generating such a large budget surplus in the 1990's that US government debt would be paid off by 2012 thus disrupting capital markets around the world - it was a great opportunity for partisan bickering and our leaders seized it with abandon.

During the second half of 2011, financial markets fell and rose by 10-20% six times. If you tracked daily movements for the S&P over this period, it travelled 1,234 points – almost equal to its beginning and ending value for the year of 1,257. Driven by investor fear and herd-like market psychology, this was the most volatile action since late 2008 and resulted in markets disconnecting from strong underlying economic activity.

Thus, while many, including me, had called for a subdued continuation of the positive returns of 2009 and 2010, the S&P was virtually flat for only the third time since 1940 while the DJIA returned a modest 5%. Broader US indices had negative returns and global markets lost $6.3 trillion in value. Conversely, despite historically low interest rates, the flight to safety trade continued to be US bonds with the 10 year treasury hitting a record low yield of 1.87% providing an annual return of 17%.

For those taking a historically balanced view of potential risk-adjusted returns in different asset classes it was a very frustrating year. The ability to maintain objectivity and separate the facts provided by raw economic data from the emotions created by events dramatized by the media is difficult, but remains key to long term investment success.

As we look toward the possibilities of 2012, I am reminded of one of Yogi Berra's timeless quotes: "it's hard to make predictions, especially about the future." With that caveat in mind, here is the evidence and my thoughts regarding the outlook for the year ahead:

US purchasing manager (PMI) activity has continued to rise for close to three years indicating improving end demand. December statistics from the Institute for Supply Management (ISM) regarding manufacturing showed activity expanded for the 29th consecutive month with equally good results for non manufacturing sectors of the economy. While productivity improvements have significantly enhanced corporate margins leading to rapid earnings growth, the pace of improvement is beginning to diminish. Slower gains are being offset by demand for new workers and hiring signaled by an increase in hourly wages, expansion of the average hourly work week and verified by the impressive strength of the recent ADP private payroll report and the government's non-farm payroll statement on January 6th.

Consumer and small business confidence has improved, which will drive spending and investment. Railcar shipments are strong and growing along with demand for pallets and cardboard boxes – always a good, basic indicator of economic activity since everything we purchase goes in a box, on a pallet and on a railcar or truck at some point in its life cycle.

The auto sector is picking up as we enter a new vehicle replacement cycle which should lead to annual sales of 14 million units or more domestically within the next couple of years.

Last year there were 600,000 new homes built in the US compared to an average build rate of 1.4 million over the last 50 years (during the boom of 1998-2006 the average was 1.76 million). Home sales are running at roughly the same level as 1945, yet we have twice the population. Housing starts and permits began to pick up last fall with residential construction jobs increasing for the first time since 2005. As household formations resume and immigration picks up from lower than normal levels, excess inventories will be saturated leading to a housing recovery beginning this year.

In 2011 corporate earnings grew 16%, dividends increased by 14.4% and stock buybacks skyrocketed as cash laden balance sheets were put to use. Global merger and acquisition activity is on the upswing and consumer and business credit is becoming more readily available.

Based on this accumulated evidence, I believe the anemic gdp growth of 2011 will increase to around 3.5% this year. Unemployment, which has declined from a cyclical peak of 10.3% in early 2009 to 8.5% in December will fall at an accelerating rate (as it did following the double dip recession of the early 1980's) reaching somewhere in the neighborhood of 7.5% by year end and less than 6% by 2014.

Over time, regardless of the hyperbole, financial markets follow two basic things: gross domestic product/economic output which was over $15 trillion in 2011 and corporate profits which should reach around $96 per S&P share when 4th quarter results are fully released. Both of these are at new record levels and likely to continue their rise over the next several years. The earnings yield for the S&P 500 is around 8% which makes it extremely undervalued relative to bonds on a historic basis.

There is a great deal of idle money in the system with $6 trillion sitting in individually owned savings accounts and another $700 billion in retail money market accounts. When this cat gets out of the bag it may leap a lot higher than most expect and I don't believe it will be a dead cat bounce. It won't surprise me if we challenge the highs for equity markets set in 2007 and we could be in the midst of an economic and investment market cycle that will prove as powerful as those enjoyed in the 1980's and 1990's.

I'll leave you with a quote from James Branch Cabell in The Silver Stallion (1926): "The optimist proclaims that we live in the best of all possible worlds; and the pessimist fears this is true." I maintain that the travails of the last decade, particularly the crisis of 2008, are not normal. We experienced a reversion of the mean to the downside which will eventually be followed by one to the upside. The truth is that whether the economic glass is full or not we all need to drink from it. Keep a clear eye on fundamental data this year, because that controls the ultimate destination of the market. You might just be willing to quench your thirst by making some new investment decisions suitable to your financial situation.

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