Prospects for 2011

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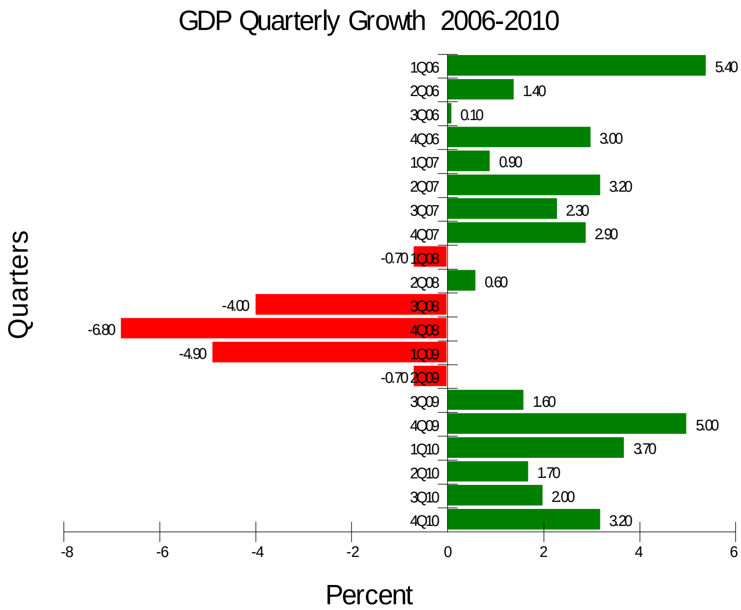
February 3, 2011

As the following bar chart indicates, the U.S. economy has made a complete recovery from the recession which began in the third quarter of 2008. The following summary and analysis of demand and supply determinants strongly suggest that this impetus will continue in 2011.



• The U.S. economy grew at an annual rate of 3.2% the final three months of 2010 after expanding 2.6% in the third quarter of 2010.

• Private sector demand gave a boost to the economy as government spending fell due to a drop in defense outlays and cut backs in debt-laden state and local governments. Inventory growth also declined, suggesting that orders to restock should be positive in the first half of 2011.

• In spite of aggressive efforts by the Federal Reserve to boost economic output and generate job growth, inflation remained benign.

• The level of real GDP growth for Q4 2010 of $13.4 trillion exceeded the prior peak in the fourth quarter of 2007.

• GDP grew 2.9% in 2010, the best showing since 2005, with personal spending increasing .7% and retail sales surpassing pre-recession highs. In spite of debt woes, austerity in Europe, political unrest in the Middle East, and inflationary pressures around the world due to higher energy and commodity costs, consensus expectations for GDP growth are between 3% and 4% in 2011.

• The IBD/TIPP Economic Optimism Index rose 13.3% to its first positive reading since September 2009 as the outlook for jobs and the economy improved. Consumer confidence is loosely associated with consumer spending which accounts for 70% of aggregate demand. Q4 2010 spending gained 4.4% which was the largest gain since Q1 2006, adding 3% to GDP.

• Durable goods rose 21.6%, the largest increase since Q4 2001 as demand for cars and trucks rebounded sharply. Durable goods order trends have been positive since late 2009, which reflects a revival in consumer demand and improving expectations for continued consumption growth.

• Exports rose 8.5% in the fourth quarter while imports fell 13.6%, resulting in a 3.4% increase in trade as U.S. companies continue to benefit from strong overseas growth and a weaker dollar.

• Retail sales have surpassed pre-recession highs and give another indication that the economic recovery is on track.

• Existing housing sales have picked up slowly over the past few months, and in December reached the highest point since August 2007. Growth will remain weak, however, as rising mortgage rates will adversely affect potential buyers from entering the market.

• New home sales rebounded in December to their strongest level since April. This increase was almost entirely due to strong growth in the West where sales increased 72%. The rest of the U.S. was up only 1.4%.

• The index of leading indicators increased 1.0% in December, well above consensus expectations of .6%. The purpose of the leading index is to signal turning points in the business cycle. In that context the Index of Leading Indicators has been positive for every quarter except one since April 2009, whereas the ECRI Weekly Growth Index has been trending positive since July 2010. Both the coincident and lagging indicators also gained strength in December with increases of .2% and .3% respectively.

• Excluding food and energy costs, core prices increased a modest .1% in December. These CPI data are consistent with respect to inflation expectations and the prevailing view of the Federal Reserve, that exceptionally low levels of federal funds rates are likely to be warranted for an extended period.

• Expansion in the manufacturing sector picked up steam as the ISM Manufacturing Index increased from 58.5 in December to 60.8 in January, confirming that the manufacturing sector is on a stable and upward path as we begin 2011. This conclusion is supported by the fact that industrial production surged .8% and capacity utilization increased from 75.4% to 76% in December.

• Nonfarm business productivity increased 2.6% in the fourth quarter. Productivity gains help keep cost-push inflation pressures from rising wages in check. This was the sixth time over the last eight quarters that unit labor costs declined on a quarterly basis. The lack of growth in labor costs, coupled with continued growth in output should act as a catalyst for payroll growth in the near future. This can currently be observed in the lower drift in initial claims which is helping to improve attitudes about job security and give impetus to spending and income gains.

In summary, improvement in aggregate demand (GDP) is generating higher than expected corporate profits. With 45% of S&P 500 companies having reported, earnings are slated to increase 36.1% from a year earlier. Moreover, 71% of these companies have beaten expectations. Earnings are on track to rise for every sector except utilities. This growing demand and profit picture, in conjunction with productivity growth, will undoubtedly spur more hiring, leading to increased disposable income which will in turn fuel demand. Given that the average length of the positive portion of the eight business cycles since 1947 is 5.7 years (see Commentary by Richard Hoyt, "Current and Past Markets", May 2, 2010), and we are roughly two years into this phase, the momentum suggested by the above statistics is likely to continue for some time, certainly through 2011. Accordingly, it is our intention to stay fully invested in sectors that are most likely to take advantage of the current economic environment.