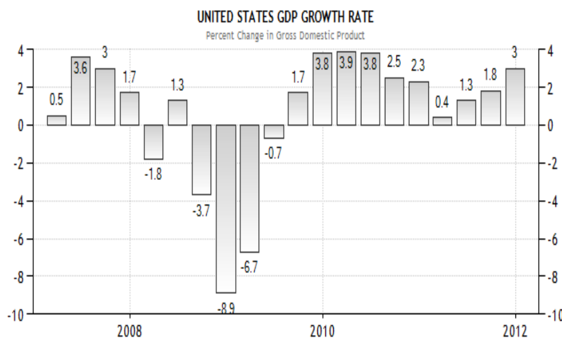
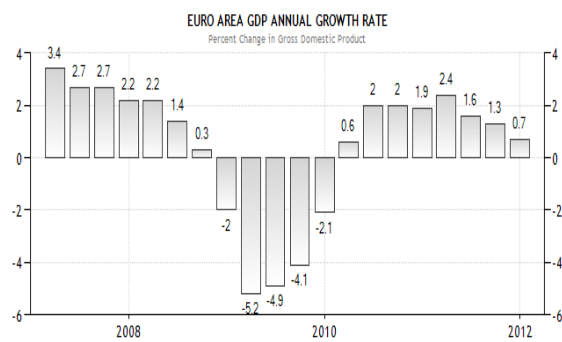
THE ROAD AHEAD

This month I want to paint a picture of where I think the U.S. economy and stock market will go over the next few months. To do that, we need to start by looking at how the U.S. compares to other areas. That's because the U.S. is part of an increasingly interconnected world. According to Bloomberg, about 40% of U.S. corporate profits come from overseas.

ECONOMIC CONTRACTION IN THE WORLD AT LARGE

Look at the economic growth rate charts below. The U.S. is the upper left. You can see that growth has been trending up during the past four quarters. Now look at growth in the Euro Zone (upper right), India (lower left) and Brazil (lower right). All three regions have been trending down and should act as a drag on the U.S. Europe is already below the line this year. I would have preferred China to India but could not find a chart in similar format. All charts are from TradingEconomics.com.





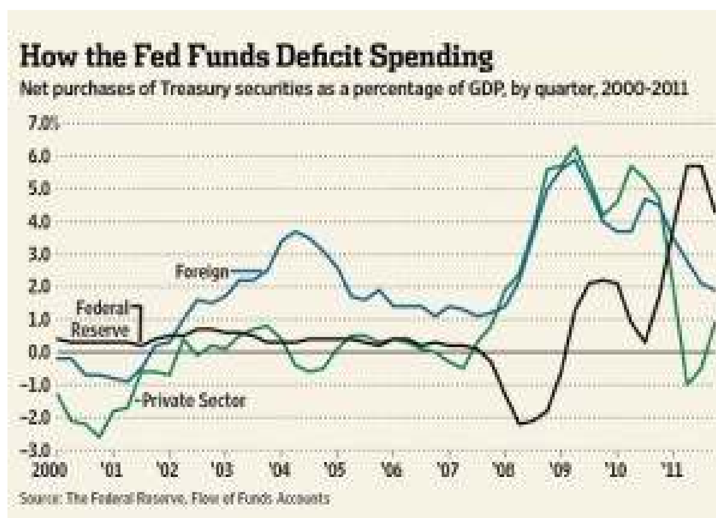
CHINA NOW DWARFED AS BIGGEST BUYER OF U.S. DEBT

Right now the U.S. federal government is borrowing about 40% of every dollar it spends. To do that it must sell a staggering amount of new U.S. Treasury bonds.

People assume that China is the biggest buyer of U.S. government debt. Well, people would be wrong. The biggest buyer of new U.S. Treasury debt is . . . drum roll, please . . . the U.S. government, specifically the Federal Reserve. An Op-Ed piece in the March 29, 2012 *Wall St. Journal* addressed this well.

How much is the Fed buying? To quote the article, entitled *Demand for U.S. Debt is Not Limitless*, "Last year [2011] the Fed purchased a stunning 61% of the total net Treasury issuance, up from negligible amounts prior to the 2008 financial crisis. . . This not only creates the false appearance of limitless demand for U.S. debt but also blunts any senses of urgency to reduce supersized budget deficits" [underlining added for emphasis]. This means that in 2011 the Federal Reserve bought 50% more U.S. debt than did all other countries and investors combined (61% vs. 39%). That is shocking!

How does the Fed buy all this debt? Simply by writing a check, which it can do without money to back it. Don't try this at home. While the money appears out of nowhere it is real debt that the U.S. must repay.



As seen in this chart, foreigners (blue line) have actually been sharply reducing their purchases of U.S. debt for the last three years. Because of their reduced demand, it has been the Federal Reserve (black line) stepping in as a huge buyer that has allowed the interest rates on this debt to stay extremely low, as if there was huge actual demand for it. There is not. By the way, the green line is for private investors like mutual funds and other U.S. investors.

At some point the Fed will have to stop this massive buying. What then? When 60% of the demand for U.S. debt disappears there will be a huge increase in U.S. Treasury rates. That is Economics 101 – supply and demand. There will thus be a large increase in interest payments owed and deficits will grow.

When rates on government bonds go up sharply, so will rates on mortgages, corporate and municipal bonds, increasing the cost of business for companies, municipalities, states and taxpayers. At that point, you will see rapidly slowing growth and we may be back to the high interest / no-growth days of Jimmy Carter and of these European countries today. There is a day of reckoning folks and at the current rate it won't be long.

CORPORATE PROFITS SLOWING

Corporate sales and profits have been growing at a blistering pace since 2008. This and a recovery from low stock valuations in 2009 are much of what has fueled our stock advance since the bottom.

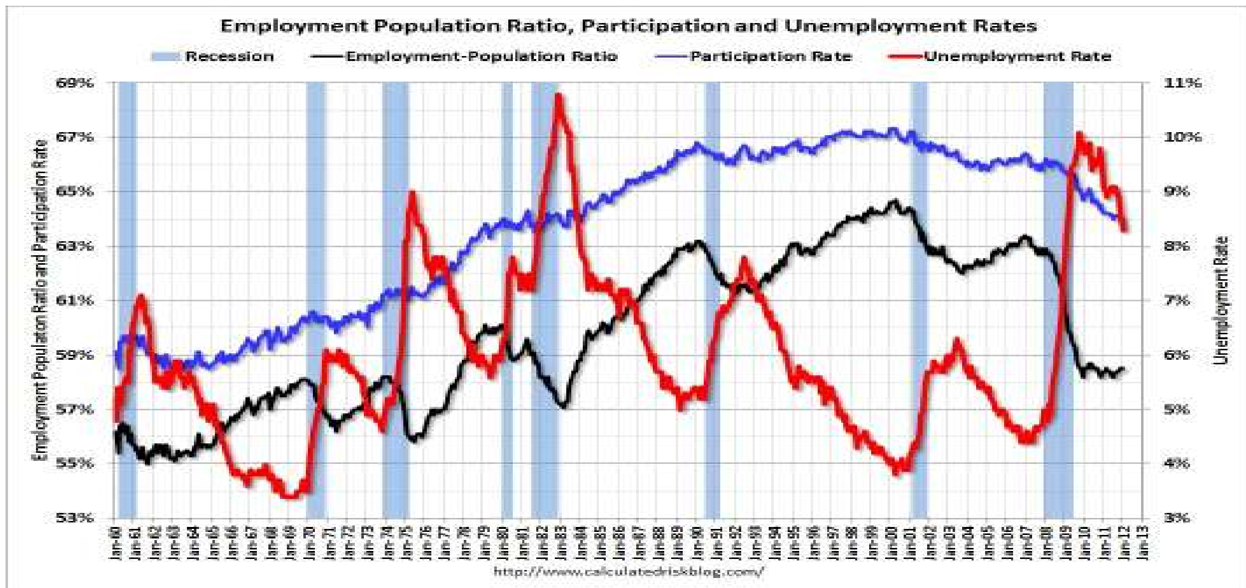
Now, Bloomberg reports that analysts see projected profit growth slowing to a rate of 6% this quarter while the NY Times says that, "Standard & Poor's Capital IQ survey, forecasts that earnings will have grown 0.93 percent in the first quarter, compared with the first quarter of 2011, for the companies that make up the S.& P. 500-stock index." Either number would be a huge slowdown from the 19% growth of 2011. Job cutting is largely out, hiring and capital investment are in and while those are good, they lead to lower cash levels and lower profits in the short run. Lower profits usually mean lower stock prices.

INCOME GROWTH STALLED DESPITE DROP IN UNEMPLOYMENT RATE

In this week's *Barron's* Lacy Hunt, chief economist at Hoisington Management pointed out that federal income tax receipts are down -0.2% from last year. How does that square with a recovering economy and a drop in the unemployment rate? Shouldn't income and thus income tax receipts be higher?

Good question. On the unemployment situation, I agree with Ben Bernanke's supposed view (surprise!) that the most important indicator is the *employment* rate, not the unemployment rate.

Look at the chart below that I have shown before. The red line is the unemployment rate. The blue line is the *employment* rate, here called the participation rate. It is the percentage of working age Americans who are working and it has been declining. If employment is really getting better the blue line should be going up, not down. The black line is the employment to population ratio (children and retirees included). It has been flat for three years now.



As regular readers know, the reason the unemployment rate alone is not a good picture of labor conditions is that the way it is calculated anyone that gives up looking for work and retires or goes back to school, moves back home or goes on welfare is not counted as being unemployed. So the unemployment rate as calculated understates actual unemployment. When the number of long-term unemployed is extremely high like it has been this effect is even more pronounced.

CONSUMER SPENDING

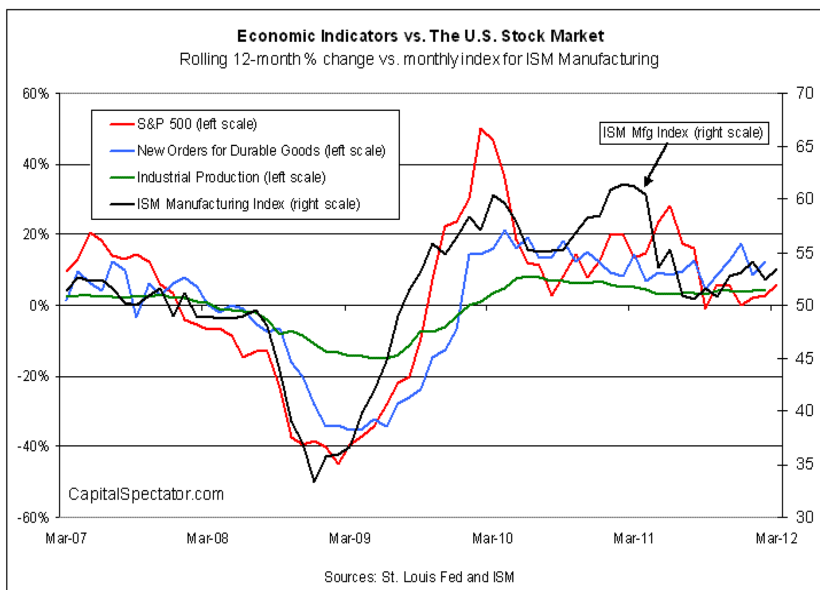
One good report is that consumer spending is higher. Well, if income is not growing as demonstrated by flat income tax revenue how then is consumer spending higher? There are two answers.

The first is that consumers are borrowing again. I am not sure that is a good sign as it was debt that got us into this mess and I am extremely skeptical that Americans have reduced debt enough already.

The second is that a large group has seen their cost of housing go down not from a big mortgage to a smaller rent payment but from a big house payment to zero! According to this week's *Barron's* article "The Fruits of Foreclosure" nearly 1,900,000 homes are in foreclosure and it is taking a national average of 348 days to get the foreclosure processed. In Florida that is 806 days and in New York 1,019 days. While some walk away early in the process many are staying in their homes rent and property tax-free. For a household that used to have a $2,000 monthly house payment, that is $2,000 every month for spending or saving. Americans being Americans, my guess is that most of that is being spent. *Barron's* estimates that it amounts to 10% of total U.S. retail sales.

MANUFACTURING

Here finally is some good news. Zoom in on the chart of U.S. manufacturing indicators below. This shows the recent correlation of the U.S. stock market (red line) with three signs of manufacturing activity. They correlate pretty well, though none of the three consistently turn before the stock market.



The good news is that two of three indicators have been generally trending higher during the last eight months. The other indicator is flat. Still, they are generally lower the last three to four months.

Given the overseas headwinds with which I started the newsletter the very recent downturn in manufacturing growth may last.

Source: The Capital Spectator

ELECTION YEAR POLITICS

With Rick Santorum dropping out of the race for the Republican nomination (sorry, I meant "suspending his campaign") it will almost surely be Romney vs. Obama in the election this November.

Gallup's April 2, 2012 poll shows Obama leading Romney 49% to 45% among registered voters. Even if those stay the same in the polls, I think actual results might be higher given that there is little enthusiasm among many Republicans for Romney, especially among the Religious Right. I would also not count out an Israeli attack on Iran before the election. Fresh military action usually favors the president.

The stock market has probably priced in that result as well as a slim Republican takeover of the Senate. That means gridlock in Washington, not unusual for a president's second term and something the stock market actually tends to prefer, perhaps feeling that less from Washington is more.

WHY THE STOCK MARKET MAY STILL GO HIGHER

OK, given that overall pretty bearish outlook, stocks should go down for a while, right? Well, yes. That is why our stock allocations are slightly low and the picks generally conservative. But . . . given that Ben Bernanke seems to feel a special responsibility for creating growth in the U.S. economy when things look bad, I expect talk will then revive about another round of quantitative easing, aka bond buying.

The first two rounds of easing were very enthusiastically received by the stock and bond markets and I expect QE III will be as well. Currently Ben has been making pains to say quantitative easing is not in the cards but I think a few bad hands will change his mind. People usually spend more when their investments are going up in value.

INVESTMENT STRATEGY

Given the discussion above, my investment strategy view is as follows.

- Stocks – slightly underweight and conservative but with some exposure to tech, other growth
- International stocks – yes on certain emerging markets only
- Taxable bonds – very selective, using only the top funds and adding floating rate bonds
- Tax-free bonds – short-term only, funds in lesser amounts than before
- High yield bonds – at risk because of high correlation to stocks
- International bonds – yes on hedged emerging market debt
- Cash – a little higher than normal
- Gold – 10% weighting as I think gold is now better priced and back to its L-T upward trend line
- Oil – needs to fall a good bit to be attractive
- Energy MLPs – good income but some risk associated with a stock market decline
- US Dollar – too unpredictable right now
- Commodities – not interested during a slowing world economy
- REITs – too pricey in general
- Residential real estate – difficult to buy but a good investment now
- Commercial real estate – OK, pricing differs a lot on various sectors

The performance of alternative funds has been very spotty and I always follow the flood of new vehicles but I am not doing much of anything with them now. I prefer things with a consistent track record of at least five years, three years minimum in certain cases. Longer track records with the same management team are always better in my view.

Dave Hoshour
Cornerstone Investment Services
A Fee-Only Investment Manager
3003 Thorndale Rd.
Indian Trail, NC 28079
704-698-1040
888-320-4495 fax
800-566-2721 toll-free
DaveH@CornerstoneInvestment.com
www.CornerstoneInvestment.com