

BULL AND BEAR BULLETIN

Taking the Temperature of the Economy

With 2011 bringing to an end the Federal Reserve's Quantitative Easing 2 (QE2), the pending collapse of Greece and the other Eurozone nations, the showdown over the U.S. Government debt ceiling and how all these factors destroyed consumer confidence and left the economy on the potential brink of another recession, it is not too surprising that the S&P 500 Index return was 0.00%, excluding dividends.

Despite the volatile year, the equity markets ended 2011 with some positive momentum as interest rates reached record lows due to the Federal Reserve's latest Quantitative Easing measures, code named 'Operation Twist', and signs that Greece would avoid bankruptcy through at least March. With some of the doom-and-gloom removed from the markets, we experienced an extreme bounce back in consumer confidence, which produced a positive retail spending season and helped reaccelerate the economy in the fourth quarter.

The improved confidence and spending levels have helped drive increased consumer loan demand and the financing of many large ticket items (Chart 1). With additional consumer consumption and loan growth, the operating environment improved for many corporations. The improved operational environment also left corporations with reduced inventory levels, which should be a benefit to their product pricing and ultimately to their overall profitability (Chart 2).

Ultimately, as the operating environment remains favorable and inventory levels diminish for an extended period of time, there should be a gradual acceleration in the amount of production each company utilizes on a daily basis called "capacity utilization." Once the utilization rate achieves a point where customer demand begins to outstrip available production capacity and available inventory, there is typically an increase in the number of new jobs created. Historically, this pivotal capacity utilization rate has been around 80.0% versus the most recent reading of 78.1% (Chart 3). If consumer demand remains resilient beyond the holiday shopping season, capacity rates should either remain at their existing levels or increase, which would be a significant boost to the U.S. labor market.

While there are encouraging signs that the economy continues to improve, the optimism is tempered by the fact that the standard of living for the average citizen remains stagnant, as inflation costs continue to outpace wage gains and the job mix continues to gravitate toward lower paying jobs.

Adjusted for inflation, the average hourly earnings in the U.S. have decreased 12 straight months on a year-over-year basis, with an average decrease of just over 1.0% versus the prior year. In addition, the growth in disposable income or "take home pay" per person remains stubbornly slow (Chart 4). As long as our nation's standard of living remains in jeopardy, either through inflation or slow income growth, any gains in consumer demand are likely to be either short lived or financed through existing savings.

Even with a continuation of a mixed economic picture, our overall assessment is that corporate profitability will remain resilient in the near term, which should continue to produce additional economic momentum and higher corporate profitability. Any long term acceleration will need to be supported by higher wages and an improved standard of living.

As it relates to the overall markets, higher corporate profitability should support higher stock prices, despite a lack of significant gains in household incomes, as long as inflation does not significantly pressure corporate input costs. Likewise, in the absence of strong inflation, bond yields should remain relatively low versus historical standards. However, any significant increase in inflation would put upward pressure on 20-year and 30-year interest rates and would drive corresponding bond prices lower.

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Chart 1

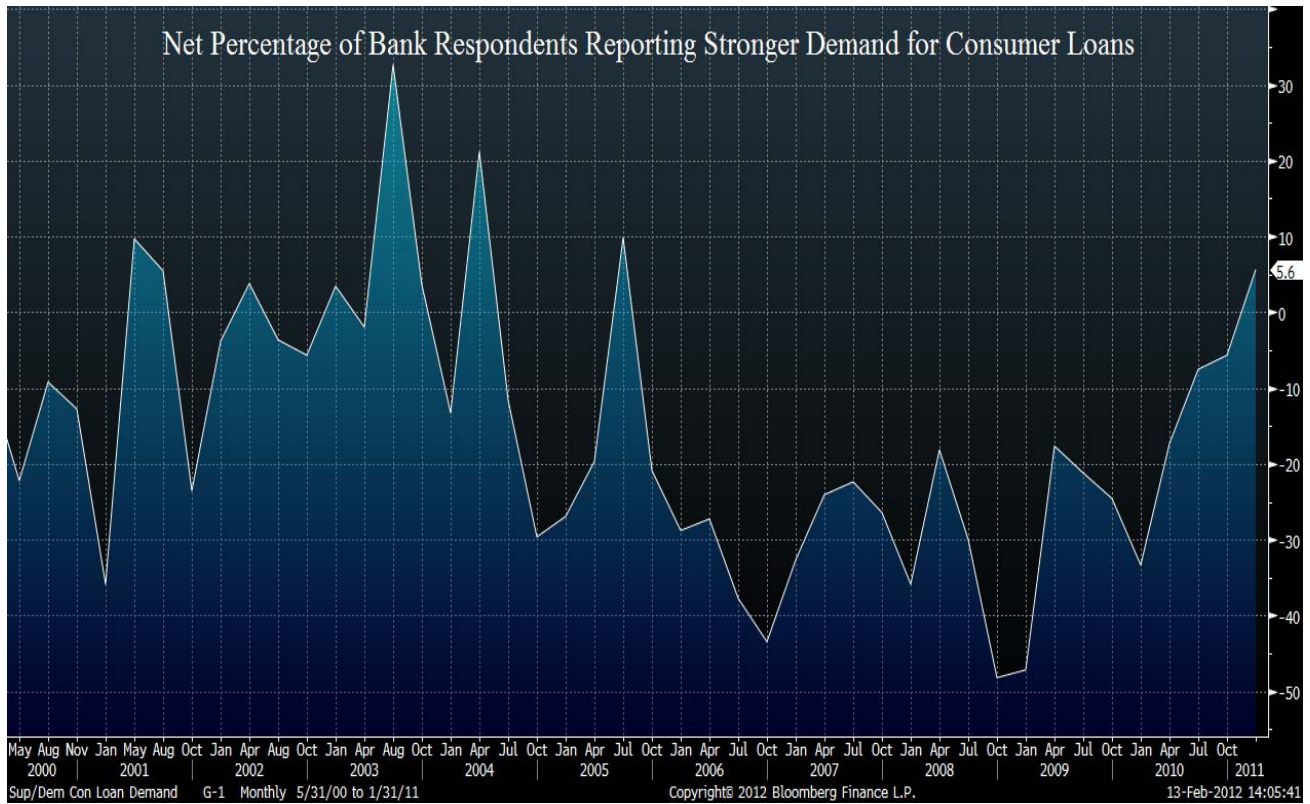
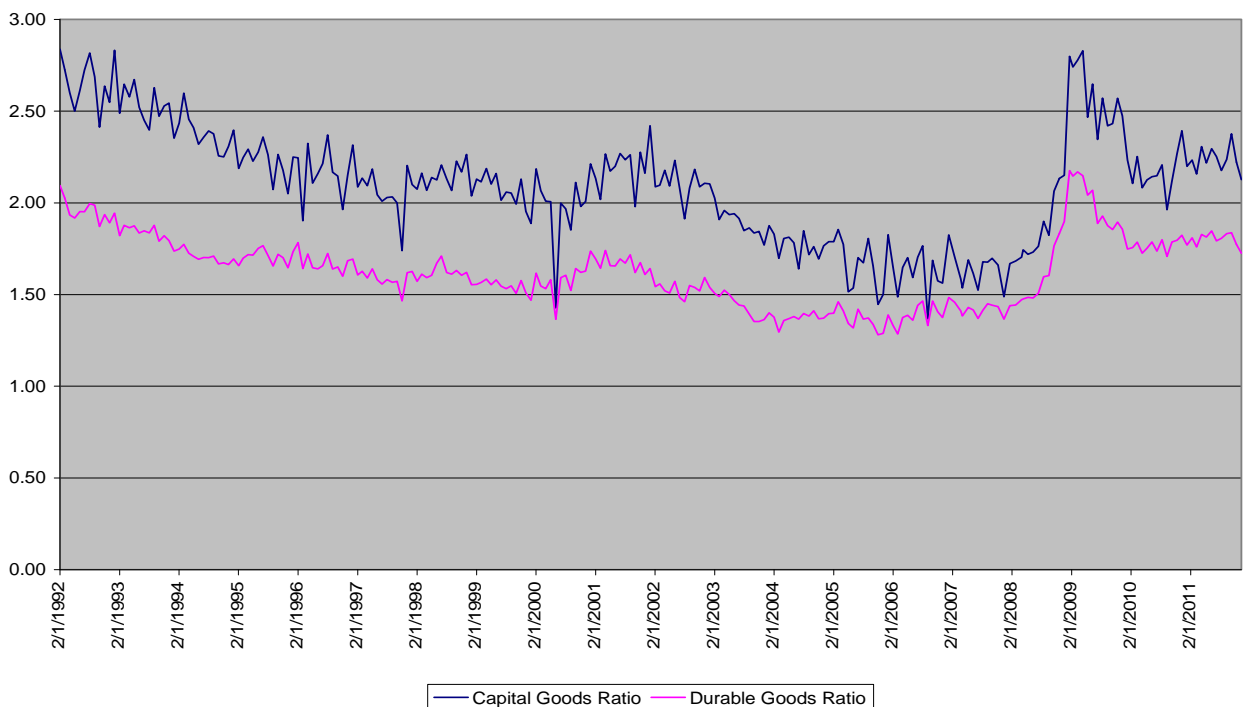


Chart 2

Good Orders: Inventory-to-New Orders Ratio



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Chart 3

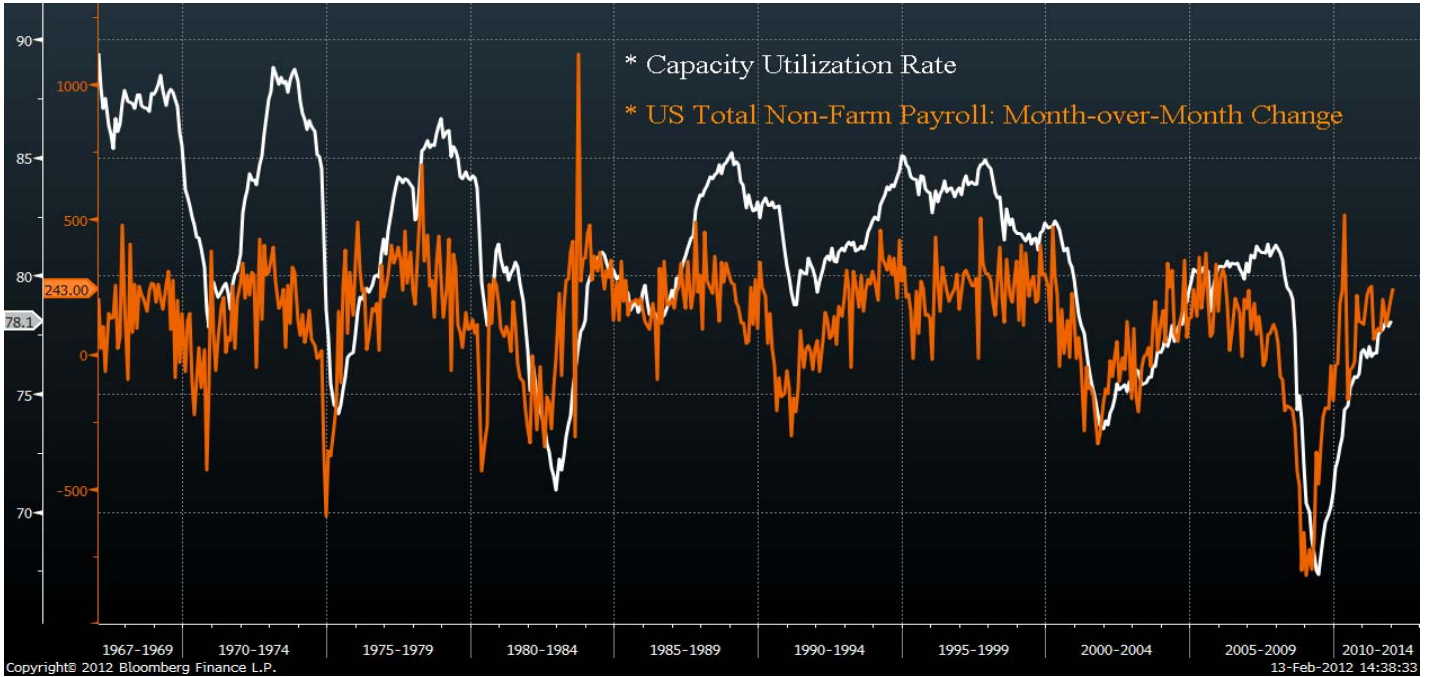
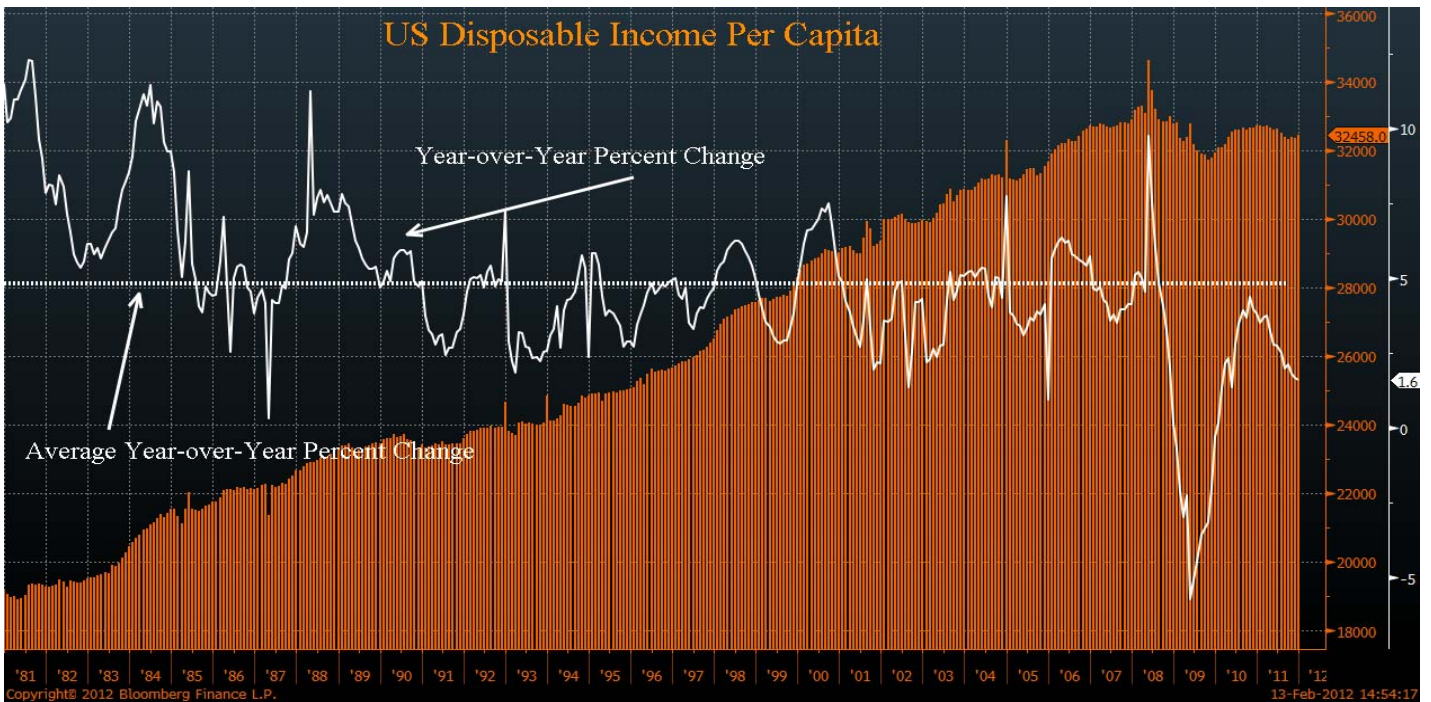


Chart 4



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