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Economic and Financial Commentary 1st Quarter of 2010

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I believe we hit the bull's eye with last quarter's commentary, predicting a rising stock market, a weak euro but strength in the emerging markets and their currency. I said at the beginning of January that I see at least a 10% to 12% return in stocks by year-end. Now it looks like it will be even better. The two best developments in the first quarter are the surge in consumer spending and the high level of earnings.

It is very encouraging that consumption has increased without the artificial stimulus of tax cuts, supplemental social security payments, "cash for clunkers" or other fiscal stimuli (although the home rebate extended to the end of April). Consumption, the biggest component of gross domestic product (GDP), should be up about 3% in the first quarter and, since the first quarter has ended strong, second-quarter GDP growth looks to exceed a 4% annualized rate.

Stocks Still Undervalued

Earnings estimates on the S&P 500 Index have ratcheted upward, and they are now predicted to be over $80 for 2010 and over $90 for 2011. It is true that stocks are now selling about 15 times this year's earnings, which is the very long-run average valuation of the market. But there are good reasons why valuations should be even higher. First, the average price-to-earnings ratio of the market in the first year out of a recession has been 18.5. Furthermore, interest rates are extremely low. Stocks are not priced in a vacuum, they must be priced relative to the alternatives in the market place. The low interest rate on fixed income assets means higher valuations for stocks. Furthermore, earnings are still well below the levels that would prevail if the economy were further along in its economic expansion. Under these circumstances, price-to-earnings valuations of 20 or even higher are justified for stocks. Even if interest rates do rise, stocks still have a long way to go before they are considered pricey.

Fed Policy

Last January I thought that the Fed would have to start raising interest rates by this summer. But the extraordinarily good news on inflation makes me think that fall is now more likely. Whenever this happens, the rate rise will be gentle; the Fed will start by raising the discount rate and then raise the funds target along with increasing the rate paid on reserves. Stocks will squirm when the Fed begins to make its move, but Fed action will be in the glow of stronger economic activity that will propel equities upward. The early phases of central bank tightening rarely spell the end of a bull market. In addition, raising interest rates will not require a significant withdrawal of liquidity. It can now be done by simply paying more interest on reserves (a power granted to the Fed during the financial crisis), so that the Fed will be able to maintain its ample liquidity to the banking sector.

The Euro

I predict continued problems for the euro because of the developments in Greece. As I have maintained, it is not just a question of whether Germany or the rest of Europe bails Greece out and supports its bonds. Greece's cost structure is too high and can only be resolved by outright declines in Greek wages. This is a slow and painful process and could lead to high unemployment for quite some time. Problems in the other "peripheral" European countries, such as Spain, Portugal and even Italy, should keep the European Central Bank from raising rates. Nevertheless, I would not shun European equities, since European exports will be boosted by a weak euro and European stocks are selling at low valuations relative to earnings.

Administration Policy

The Obama administration needs to be careful about over-regulation and over-taxation. The economic crisis does not give them carte blanche to control the entire economy. I do feel some financial reform is needed: Most derivatives should be put on an exchange, and capital requirements need to be increased for large financial firms. Beyond that, little needs to be done.

The main job of Congress in the summer and fall is to hammer out tax rates for 2011 and beyond. The Obama administration had proposed a cap of 20% on dividends and capital gains before Congress added a surtax in the health care legislation. But the bill's 3.8-percentage-point surcharge on capital gains and dividends does not begin until 2013. We have two congressional elections and one presidential election before the higher rates take effect. Much can change. Even with a stalemated Congress, the capital gains tax will only rise to 20% over the next two years.

Summary

I expect that the U.S. economy will continue to surprise on the upside and that equities will continue to outperform, with full-year gains of 15% to 20% not out of the question. Although there will be setbacks along the way, both the economy—and the stock market—will emerge from the financial crisis stronger than before. In my opinion, even Washington's meddling in the economy will not stop this bull market.

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The S&P 500 Index is a capitalization-weighted index of 500 stocks selected by the Standard & Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

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

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