Scout Investment Advisors
Economic and Market Outlook

Jobs, Pigs and Markets

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Market Update

DOW INDUSTRIALS:
10,012.20, -3.98% YTD

S&P 500:
1,066.19, -4.25% YTD

GOLD:
1,052.20, -4.01% YTD

US TREAS, 10 YR:
3.57%, -0.27bps YTD

Scout 2010 Economic Outlook

GDP GROWTH:
3.0%

UNEMPLOYMENT:
8.5%

INFLATION:
2.5%

FED FUNDS RATE:
1.50%

The markets – stocks and commodities – have been weak lately. What is happening? We view the recent downturn in stock prices as a normal, healthy correction that is long overdue. From the lows last March, U.S. Stock prices have risen by more than 60 percent. Markets, like trees, don't grow to the moon. With this in mind, a certain degree of profit taking makes some sense, as many investors are becoming nervous about a number of issues. Among these issues is the pace of the economic recovery, troubling news from Europe (Greece, Portugal and Spain) and continued discord between our leaders in Washington and New York.

Jobs

In what has become the most meaningful monthly economic release from Washington, the Bureau of Labor Statistics (BLS) released the employment report for the month of January. In this report, the nation's unemployment rate fell from 10 percent in December to 9.7percent. Nonfarm payroll data was essentially unchanged from December (-20,000 jobs). Nonfarm payrolls were shrinking by more than 700,000 jobs per month as recently as the spring of 2009. Consequently, while the economy hasn't been creating jobs, we have seen reasonably steady improvement in the employment picture over the last number of months.

Job losses continued in construction and in transportation and warehousing, while employment increased in temporary help services, retail trade and importantly, in manufacturing. Since the start of the recession, payroll employment has fallen by 8.4 million jobs, however over the last three months employment has shown little net change. Since September 2009, temporary help jobs have increased by 247,000. Some would say these are not good jobs, but businesses traditionally hire part-time workers prior to increasing full-time employment meaningfully.

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All of the above data is in reference to the "payroll report" which does not include major segments of small business activity. The "household report" does include small business activity. The household report showed that the employment picture improved nicely during January. As a matter of fact, it showed the nation added 541,000 jobs during the month of January. So, if this data is accurate, it appears many small businesses are starting to hire workers, albeit at a slow pace. For comparison purposes, the household survey showed job losses of 589,000 for the month of December and a total civilian job loss of 3,888,000 for the trailing twelve months. This is on a base of 138 million people who currently have jobs in the civilian workforce. So, while these numbers are big, it is good to keep them in context.

Pigs

What? Are pigs running amok in New York? Well, maybe some would say so, but we are actually referring to the new moniker on Wall Street "PIIGS" – Portugal, Italy, Ireland, Greece and Spain. As compared to others in Europe (Germany and France) these countries tend to have historically higher overall economic growth and higher levels of government debt as compared to the size of their economies. Over the last few weeks, Greece has been in the news, and now Spain and Portugal (to a lesser degree), are joining the negative fray.

Greece has been in the news recently, as their financial markets have been pounded after the release of their projected budget deficit – 12.7 percent of GDP – more than four times the EU allowed ceiling of three percent of GDP. What is a country to do when the controlling central bank is not sovereign to that country (Greece is a member of the EU – consequently, they no longer have their own currency or central bank)? Default on their sovereign debt may be an option – but obviously one that has a long tail and severe negative ramifications in worldwide banking circles. What is a country to do when they can't devalue their currency to effectively balance their budget?

Interest rates in Greece have been increasing. It appears the Grecian problems may indeed affect the European Central Bank's efforts to remove liquidity measures which have been in place for some time. In December, the European Central Bank was taking steps to rein in excess liquidity. This policy change may now be on hold.

The same problems appear to be possible in Portugal and Spain. Spain represents more than 10 percent of the Eurozone's GDP, so the possibility of default in that country is significant. Hypothetically, a case can be made that if Spain defaults or the market senses the possibility of default, Italy may indeed fall into the same mess. What does all this mean?

To us in the U.S., this primarily should mean the anxiety regarding debt creation and excessive leverage which hit the world's economic environment and markets over the last two years is still in play. Markets will continue to view excessive leverage in a negative light. Also, the issue of "contagion" is starting to take hold. Contagion is a term that is similar to you contracting a cold from your neighbor. With the financial markets being global in scope, as one problem pops up, many investors look for the next problem, with like characteristics, and start to focus on the next "shoe" that may drop. In the past when smaller countries have been faced with debt/balance of payment problems they may have devalued their currency. This is not an option currently available to the PIIGS, as they all are members of the EU, with the Euro as their currency. Consequently, one "solution" to their current problems indeed is not available to them. Effectively, the problems in Greece and the Iberian Peninsula are now problems for much of Europe to wrestle. These problems are impacting currencies (dollar strong, Euro weak), and having a negative impact on the U.S. stock market.

Markets

The problems in Europe and the growing dysfunction between Washington and New York appear to be driving the stock market to the downside. How long is this going to last? That is anyone's guess. However, during times such as these, we need to ask ourselves a couple of questions:

1. Fundamentally, what has changed over the last few weeks?
2. If something has changed, is it truly impactful, and will it last for some time?
3. Does this impact change the outlook for U.S. economic growth, and subsequent corporate profit growth rates?
4. Does the impact change the outlook for U.S. interest rates?

First, regarding what has changed, the employment picture in our minds, is at least equally important if not more so, than what is happening in Greece. The jobs picture is becoming better, not worse. Will the problems in Europe last? Perhaps. But, as we view it Greece is economically in decent shape. The problem is government spending, not the fundamentals of the private sector. We believe the discord between Washington and New York may have a longer-lasting impact on stock market values than what is happening in Greece.

Will what is happening have a meaningful impact on either interest rates or corporate earnings? It is probably too soon to tell. However, on balance we don't believe activities in Europe are going to have a meaningful impact on domestic, U.S. earnings flow. As a matter of fact, companies that have reported 4th quarter earnings so far have exceeded estimated earnings in 74 percent of occurrences. Additionally, revenue growth – which tends to add to the sustainability of earnings growth – has exceeded estimates in 71 percent of companies which have reported. In other words, earnings are growing more rapidly than many believed. Over the last 20 years, the stock market rose 76 percent of the time when corporate profits rose. We like those odds.

This all leads us to think that the downside shift in stock prices may prove to be temporary in nature. The Fed hasn't been contracting money supply, economic momentum is turning positive (remember GDP grew by 5.7 percent during the 4th quarter of 2009), unemployment is not getting worse, and corporate profits are growing swiftly. All of the above should continue to positively impact the overall stock market as the first half of 2010 unfolds.

During times such as these when stock prices are moving down and fundamentals are improving, it makes sense to sit back and calmly address the situation, weighing factors which really matter. Those factors, in our opinion, are corporate earnings and interest rates. We don't see a major impact to our outlook by anything that has happened over the last two weeks.

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