Are We There Yet?

In my younger years, I remember seeing comedians and various movies illustrate the impatience of young children in dealing with anticipation. A few weeks ago, Colleen and I packed our family into our van and headed off to Nonny and Poppy's for an annual Easter Egg Hunt. Down the driveway we went, turning left, and another left and progressed about one mile from home when I hear Nico utter the fabled words "Are we there yet?" followed by a much younger voice, Devin, uttering some semblance to "Are we there yet?" I thought it was a myth. The question continued throughout the journey. At this point, I feel like I'm part of a comedic drama. Even though we have gone to Nonny and Poppy's numerous times and Nico certainly knew the landmarks that marked each leg of the journey, the anticipation got the better of him and he lost his way.

I hear this same question being asked of economist from the myriad of media sources regarding economic recovery. Much like our journey to Nonny and Poppy's, I felt compelled to tell my sons that we would be there very soon even though I knew we had another 15 minutes or so depending on whether or not we would get behind a tractor or some other slow moving vehicle or hit a perfect sequence of red lights. I just wanted the question to stop! So now that the question is out there, are we there yet?

I know that we have packed up the family van and we left the driveway. We are on our way. What is in front of us can slow us down, but we will get to our destination. In the interim, the media will still ask the same question – "Are we there yet?" And believe me, I want to be there! So let's look at what is getting us there and what can slow us down:

Consumer Confidence: In April 2010, the survey illustrates confidence to be at 57.9 – the highest level since September 2008. This is critical to economic activity. As the index rises, so will economic activity.

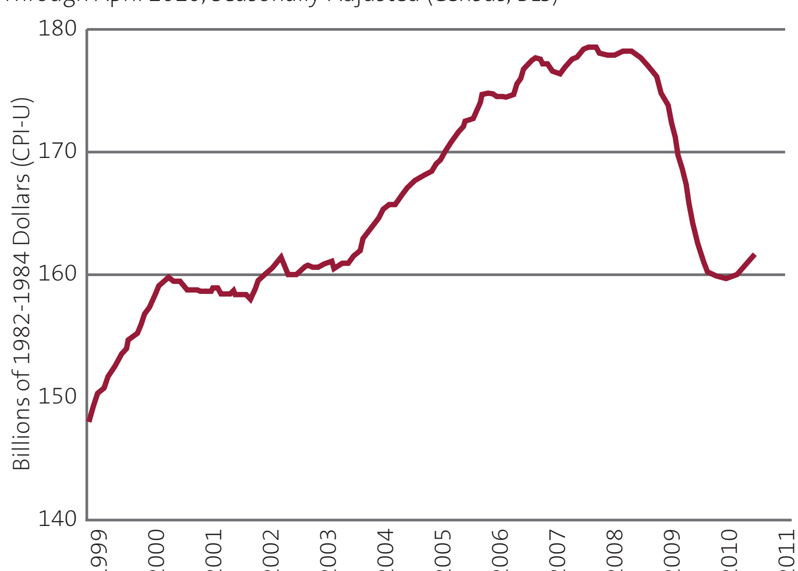
Retail Sales: Retailers reported a 9% increase in sales at stores open at least a year for March (biggest gain since March 1999). Careful on this one as February was a virtual shut down for the nation due to inclement weather. April will help to identify a trend, although I do hear from a few very informed sources that retail sales are, in fact, doing very well. The below graph illustrates inflation-adjusted retail sales[1].

Employment Worries: The Conference Board survey in April shows job worries were easing with those saying jobs are "plentiful" rose to 4.8% from 4.0% and those sayings jobs were "hard to get" decreased to 45.0 from 46.3. This coincides with consumer confidence.

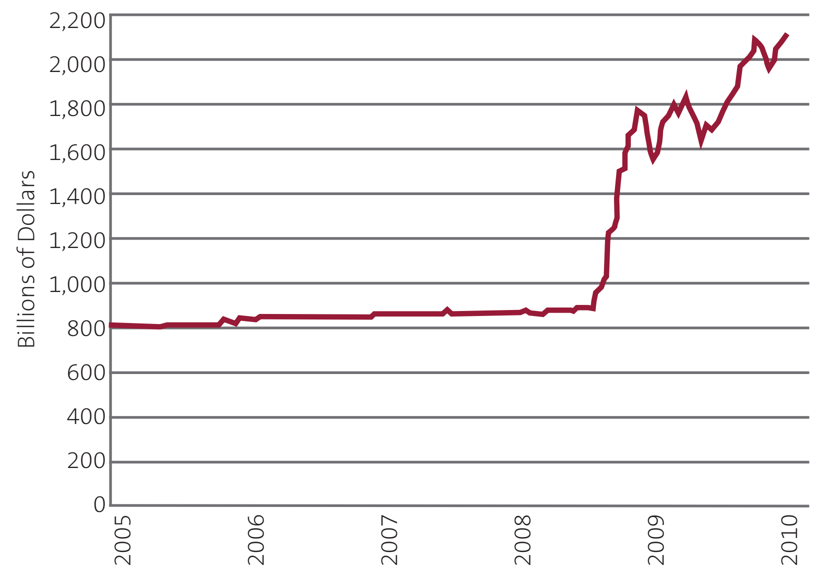
Earnings Reports: Many of the recent earnings reports have exceeded analyst expectations. While this is great news, it is important to know that cost cutting and inventory replacement has been a major part of the equation. It is also important to frame earnings in the context of a few years. For example, GE reported earnings that exceeded analyst expectations by 28.05% for the first quarter of this year, but earnings are

Inflation-Adjusted Retail Sales (6-Mo Moving Avg)

Through April 2010, Seasonally-Adjusted (Census, BLS)

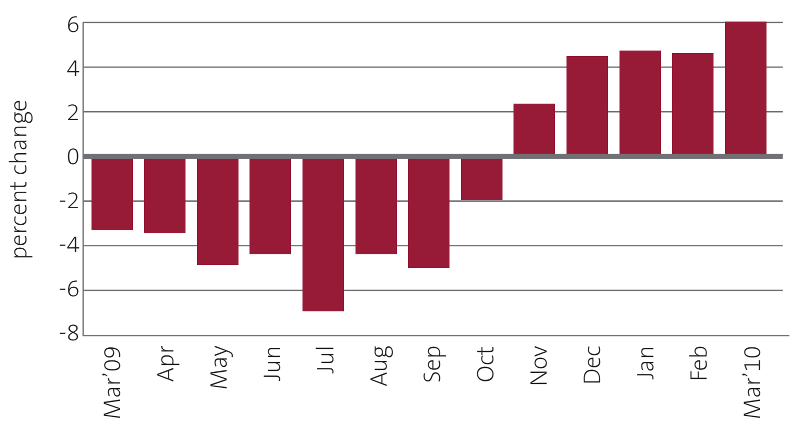


St. Louis Fed Adjusted Monetary Base



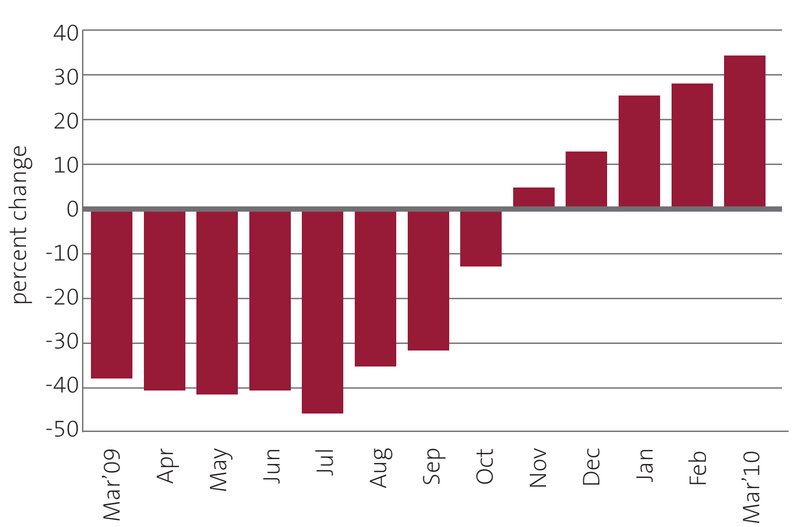
The Rising Cost of Finished Goods

12-month percent changes in the Producer Price Index for Finished Goods, not seasonally adjusted: March 2009-March 2010



The Rising Cost of Crude Materials

12-month percent changes in the Producer Price Index for Crude Materials, not seasonally adjusted: March 2009-March 2010



still 58.2% below 2007 earnings. Ann Taylor beat expectations by a whopping 600% but earnings are still down 116.3% from 2007 earnings, Time Warner beat estimates by 26.29% but is down 29.16% from two years ago. Of course there are also companies that have maintained and even increased earnings since the beginning of this recession. Companies such as AT&T, IBM, Merck, and Microsoft saw a continued earnings increase. Lastly, I have it from other well-informed sources that manufacturing activity is quite strong and expected to be stronger throughout 2010. These examples are all indicators that we are moving in a positive direction.

Inflation: As we move forward, inflation will become a very real concern. I now hear on a daily basis about inflation concerns from the financial media. The top left chart illustrates the increases in our monetary base since the market meltdown[2]. Should this money make its way into the economy, the value of the dollar could plummet.

Additionally, the Producer's Price Index has shown a renewed vigor in price increases[3].

As of late, finished foods have experienced a 49.3% surge in prices for fresh and dry vegetables. Part of the increase is due to the harsh winter we just witnessed. A few nations such as China, Australia, Norway and Brazil have all increased their interest rates in response to their respective economic activity.

By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens.

- John Maynard Keynes, *The Economic Consequences of the Peace*

Sovereign Debt: Greece and Portugal have seen a lot press lately due to their debt problems. Spain is next as they must start rolling over their debt in June followed by Italy. The Greek riots are in response to the austerity measures Greece must take in order to receive loans from the ECU, i.e., reduced pay and employment. The unfortunate solution and response may become more widespread as governments must make the difficult choices to reduce spending. Closer to home, Moody's has stated that the U.S. and U.K. have moved substantially closer to losing their AAA credit ratings as the cost to servicing their debt increases. Translation – It will become more expensive to borrow money with lower ratings.

Gold: This precious metal has had some perplexing moves as of late. Even as the dollar strengthens, so does gold and is nearing previous highs. It may very well be responding to sovereign debt issues and impending inflation. Warren Buffet was right regarding the utility of gold. It has no utility, it only preserves purchasing power (reference Gold versus Wealth Creation in November 2009) and prevents theft of your labor. I expect gold to test previous highs.

> *It gets dug out of the ground in Africa, or someplace. Then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head.*
> - Warren Buffet on Gold

Commodities: Great inflation hedge but not without risk. This sector has been range-bound for some time now. The promise of future inflation has driven it upward only to be deflated by current economic uncertainty. With that being said, I have made a change to the portfolio's commodity holding in order to control the downside risk.

Healthcare Reform and Taxes: The new healthcare reform promises new taxes. The following are just a few of the new taxes[4]:

Individual Mandate: Penalties for not having qualified health coverage ranges from $695/year up to a maximum of $2,085/family

Medicare Payroll Tax: Incomes over $200,000 (single) and $250,000 (married) will see an additional tax of 0.9% (2.35% in total) .

Medicare Payroll Tax Extended to Investments: Incomes over $200,000 (single) and $250,000 (married) will have a 3.8% tax imposed on investment income to include interest, dividends, royalties, rents, income from passive activities, and net gain from disposition of property

Medical Deduction Expenses: The floor will move from 7.5% to 10.0%.

Limit reimbursement of over-the-counter medications from HSAs, FSAs, and MSAs.

Limit FSAs to $2,500/year.

Excise Tax on Indoor Tanning Services: A 10% excise tax on indoor tanning services to be paid by the patron.

Home Equity and Bank Lending: Very little movement since my last update.

In summary, there are some encouraging signs in the economy that offer the promise of recovery but we need a bit more to get there.

So here we are, we packed up the van, the windows are down, we left the driveway and we are on the open road and the little bit of hair I have left is blowing in the breeze. I don't know what kind of slow vehicles may be ahead of us (as long as it isn't the manure spreader that we got stuck behind on our last journey!) but I do know that Nonny and Poppy will be there when we get there. And one thing for certain, I know that we aren't there yet but we are moving in the right direction!

1 – Source: John Williams' Shadow Government Statistics

2 – Source: John Williams' Shadow Government Statistics

3 – Source: Bureau of Labor Statistics, U.S. Department of Labor

4 – Source: Ary Roepcke Mulchaey P.C. May 2010 Newsletter