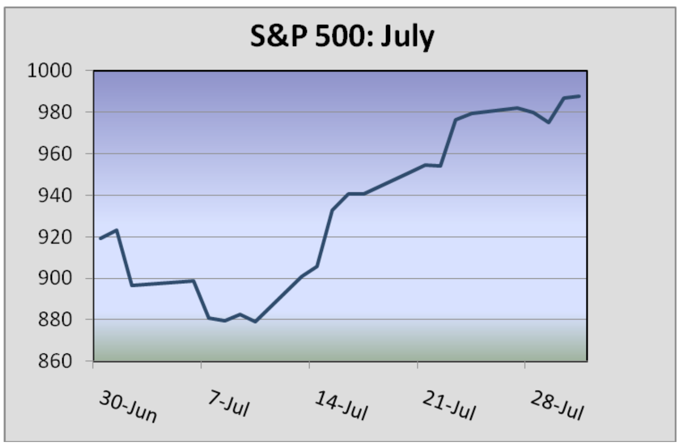
Evidence of Recovery?

Market Summary July 2009

Named for (and by) Julius Caesar, a man who knew the value of a steady march, July brought steady – and apparently sturdy – progress in the capital markets. In a month often set aside for vacations, the markets took a needed respite from the toxic volatility – the sudden jerks, dramatic reversals, skyrocket rallies and heart-stopping dives – that have become so tediously familiar through the long recession months.

After pausing to collect its breath, the stock market turned its nose northward July 13 and moved steadily forward to a monthly gain of just more than 108 points on the S&P 500. It was very much as if the market were discounting an economic recovery that was clearly in sight. In contrast to earlier rallies, this seemed an orderly ascent, rather than a prelude to a flame-out. At month's end, it was still purring on all cylinders, like a new cream puff from a "cash for clunkers" trade-in.



Evidence of Recovery

The presumption that economic recovery is on the horizon gained a measure of high-level confirmation in late July from the Federal Reserve Beige Book, and the Department of Labor's monthly employment report.

The decline in economic activity has "moderated" and "begun to stabilize" said the Beige Book, although it also warned of "factors" – principally continuing high pressure on household incomes – that could cause the recovery to develop more slowly than those following previous recessions.

The decline in non-farm jobs was reported at 247,000 in July, the lowest in a year. More important, a trend seemed in evidence: The average job losses from May to July (331,000) was half that from November through April (645,000). The unemployment rate, which was expected to nudge up toward the dreaded 10% level, instead ticked down in July, from 9.5% to 9.4%, which was received as good news, though of slight statistical importance. Of clear significance were the raw numbers for unemployed July 2009 persons, which grew to 14.5 million in July, and the number of "long-term" jobless (27 weeks or more) which grew 587,000, to 5 million.

More Good Bad News

Manufacturing and housing data were much in the same vein: Still bad, but the trend is firmly up.

Manufacturing Activity, as gauged by the monthly survey of the Institute for Supply Management (ISM), continued to contract in July, but at a slower pace than in June (48.9% vs. 44.8%). The activity level, creeping up all year, has at last come close to the break-even point (50%). New Orders rolled right past the break-even point into expansionary territory, gaining 6.1 percentage points to 55.3%. Likewise, Production rose 5.4 points to 57.9%, making July the second straight month with an expansionary rating, after nine months of contraction.

The ISM maintains that a sustained reading above 41.2% in its basic activity measure implies that the overall economy is growing. The index now has been above 41.2% since May, and just missed it in April.

The results in the ISM's survey of the non-manufacturing sector were not as upbeat. Overall activity declined in July from 47.0% to 46.4%. Prices declined 12.4 percentage points to 41.3%, whereas prices in the manufacturing sector rose 5 points to 55.0%.

Employment activity contracted in both sectors, but improved during July in manufacturing (up 4.9 points to 45.6%) while slackening further in non-manufacturing (down 1.9 points to 41.5%).

Home prices in major U.S. cities rose for the first time in nearly three years, according to the July report of the S&P Case-Shiller index, a closely watched benchmark for the housing market.

The index that concentrates on 20 metropolitan real estate markets ticked up 0.5 percentage points for the three-month period ending in May (vs. the period ending in April), interrupting a run of 34 consecutive declining monthly measures. Although this was greeted as good news, prices remained 17% below those of the previous year, and the tiny advance for May disappeared when prices were seasonally adjusted.

Economists Take Heart

Optimism nonetheless took hold, and spread even to the dismal science, as economists revised forecasts upward for the third and fourth quarters of the year. GDP projections were increased in a range from fractions of a percent to nearly two full points, putting forecasts in the 2%-2.5% range for the third quarter and 2.5%-3% for the fourth quarter (annualized).

These forecasts were revised partially in response to the upward restatement of the official figure for second quarter GDP (now -1.0%), and the lower than expected job losses reported in July. But the most important impetus seems to have come from the federal “Cash for Clunkers” program, which put $1 billion into (and out of) the hands of car buyers in a week. The allocation was supposed to last until November, so Congress, impressed by its own success, promptly approved $2 billion more.

Economists are predicting a substantial “payback” after the program expires. But that will not come in the third quarter, and likely not in the fourth.

Consumers Not Aboard

Consumer confidence, after staging a strong recovery from February’s all-time lows, now has fallen for two consecutive months. Consumers showed a resounding indifference to July’s good-bad news, and polled only 46.6 (1985 = 100) in the Conference Board’s July poll. That’s down from 49.3 in June and 54.9 in May.

The Numbers: Equities Glide

As mentioned, the S&P 500 Index advanced smartly in July, gaining 7.6%. Other large-cap benchmarks also did well: The Dow Jones Industrial Average gaining 8.8%; the Russell 1000 7.6%. As with U.S. stocks generally, value issues out-paced growth in the large-cap category. The Russell 1000 Value component advanced 8.2%; its sibling, the Russell 1000 Growth, gained 7.1%.

In mid-cap stocks, the S&P 400 Index gained 8.7%. Small-caps: The Russell 2000 rose 9.6%, with its Value component gaining 11.6%; its Growth component 7.8%.

International issues were very strong, as the MSCI EAFE Index gained 9.1%. Smaller-capitalization Emerging markets did even better, the MSCI Emerging Markets Index climbed a whopping 11.2%, and is 51.3% higher year-to-date (but down 16.8% year-over-year).

Bonds Advance Across Categories

Bonds were on their better behaved in July. As in previous months, higher risk again was rewarded richly, but not in gross disproportion. And none of the purportedly safer categories was pilloried.
The Barclays U.S. Aggregate Bond Index gained 1.6%; its U.S. Government Index rose 0.5%. The Citigroup Treasury Index gained 0.4%.

The Merrill Lynch High Yield Master II Index gained 6.2%; its Global High Yield Index (USD hedged) gained 6.6%. The highest gain among bond indices we track was from Barclay Capital’s Ca-D US High Yield Index, which gained 12.1%. This index is up 71.1% year-to-date, and 30.1% year-over-year.

REITs Strong; Commodities Demure

The Dow-Jones Wilshire REIT Index gained a very robust 10.4% in July and now is down only 4.1% year-to-date. The Dow Jones-AIG Commodity Index gained 3.2%, and is up 8.0% year-to-date. The GS Natural Resources Index rose 7.6% in July and has gained 18.3% YTD.

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