December 11, 2009

The Capital ReCap

ReCap

Economic Activity

- Consumer's debt load lessens for 9th straight month.
- Initial claims rise more than expected.
- Trade deficit shrinks, lifts 4Q GDP prospects
- Retail sales were stronger than expected.
- Preliminary Michigan Sentiment spikes for December.
- Business Inventories buck long term trend, rise in October.

Equity Activity

- FedEx boosts fiscal 2Q earnings guidance.
- MCD sees global same store sales grow slightly; U.S. same store sales drop.
- MMM disappoints the street, keeps earnings guidance, instead of an expected increase.

Other Market Activity

- Moodys cut its ratings on some Dubai government controlled companies; Fitch cut's Greece's credit rating.
- Moody's warns of possible downgrade on U.S. and Great Britain debt, due to deteriorating finances.

Inside the Numbers

It was a light week on the street, but investors were able to get some further insight into the health of the global economy and the stability of the economic recovery. Markets, as expected, reacted negatively to the downgrades to some sovereign debt by Moodys and Fitch, but the nerves were calmed after some positive economic data. Consumer's cut back on their debt in October. This is a double edged sword in our opinion. It is good because consumers are paying down the debt that got us in this mess, but bad because it shows that tight credit conditions still exist and the consumer is not willing to borrow. Remember, we want the debt levels for consumers to shrink in order to decrease the absurdly high leverage, but we need the consumer to spend to stimulate GDP growth. These are conflicting desires and we need to reach equilibrium; right now it is swayed heavily toward reducing the debt levels. The trade deficit shrunk due to a greater than expected rise in exports; the sixth straight monthly gain for exports. We saw retail sales rise 1.3%, this gives investors confidence in the consumer during the current holiday shopping season. Economists were expecting a rise of only 0.6%. The preliminary reading of the Michigan sentiment poll spiked almost 9% for the month of December. The consumers more favorable view of the economy is most likely due to the better than expected employment data. Employment data has been the driver for this economic report and has been steering its direction for the past few months. Lastly, business inventories rose 0.2% in October, this was better than the expected 0.2% decline.

The Capital Course

We are winding down trading for 2009 and we have seen light volume on the street during the past couple of weeks. This week we received some data that gives us insight into how the final quarter will end and the news we can expect in the New Year. We touched on the affect of the contraction with consumer debt in our Inside the Numbers section. Let us now take a look at this from a different angle and the affect it will have on interest rates. We have seen that, based on Ned Davis Research that total domestic nonfinancial debt is near 3% through September. The minimal percentage is one of the reasons that we have been able to keep interest rates low. The composition of this data point is made up of household, business, government and municipal debt. We have seen a huge increase in the government debt number, giving us a reason to believe in interest rates spiking substantially. This has not happened though and it is due to the contraction in private sector debt. The amount that the private sector has cut their debt loads has nearly offset the amount that government has expanded theirs. This offsetting by the private sector has helped to keep interest rates from jumping higher; this is good news right now. If we see private sector borrowing begin to pick up, whether it be slightly or a major spike, than we will see interest rates rise with that. The only way to keep interest rates at their current level with private sector borrowing increasing is to have government debt contract, which we don't see happening in the near future. So, this is another major factor to throw into the mix of reasons to expect higher interest rates in 2010.

We also received two economic reports that we feel give us some foresight into how 4th quarter GDP will turn out. The business inventories report along with the trade balance report show that we could see better then expected GDP growth in the 4th quarter. GDP is developed through the contributions from four different broad areas of the economy: consumer consumption, government spending, investment and net exports (exports minus imports). The trade balance gives us a reading on the net exports factor in the equation and business inventories is a part of the investment factor. The trade balance shrunk which means that we saw more growth in exports than imports. This has a positive impact on our GDP number, because exports are bringing money into the country, rather than imports which is sending money out of our country. For comparison reasons, the 3rd quarter GDP reading saw imports greater than exports, thus reducing this factors contribution to GDP. This latest reading on the trade balance shrinking due to greater export growth should help to allow this factor to contribute more to the GDP number for the 4th quarter, rather than weighing on GDP, as it did in the 3rd quarter. Lastly, the business inventories report came in better than expected. This economic indicator played a positive role in contributing to the 3rd quarter GDP growth. The reason for the positive contribution was not due to the fact that business inventories were growing; rather it was due to the contraction of business inventories slowing. In October we saw this number actually grow for the first time since August of 2008. We should, if business inventories continue October's trend, see this factor being an even larger contributor to positive GDP growth in the 4th quarter. This is one of the many economic factors that make up the broader investment factor, but the shift from declining inventories to growing inventories should not only give the investment factor a jolt, but overall GDP a jolt as well. These are just two factors of the many that compose GDP, but their reports from this past week give us and investor's reason to believe that 4th quarter GDP may be better then we initially thought. This is good news for investors and the U.S. economy.