SMITH CAPITAL

Quick Update – 7/9/2010

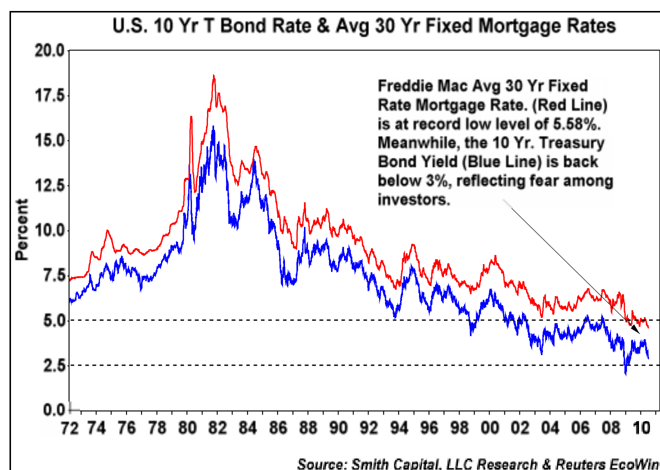
Greetings Clients & Friends:

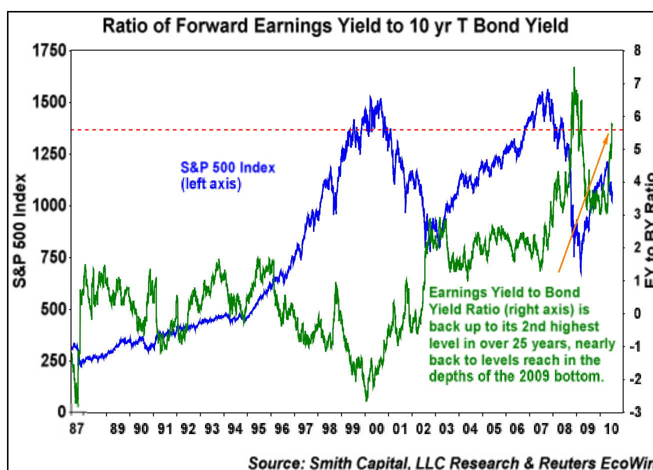
As June closed out on a very weak note for global stocks, the mood among investors turned even more sour. Going into this week, on the heels of the 4th of July weekend, investor sentiment was approaching almost ubiquitous negativity. While Americans mustered the patriotism to celebrate our country's birthday, it was almost as if we were acknowledging its demise at the same time!! The polls now show that more Americans believe our economy is headed in the wrong direction, and a higher number of Americans disapprove than approve of President Obama's job thus far. With all the negativity surrounding so many issues recently, the latest fad seems to be discussion about whether we will experience a double-dip recession. In fact, data from Google's Insight for Search database shows that Google searches for the topic "double-dip recession" have skyrocketed higher since the middle of June (thanks to Barry Ritholz's blog The Big Picture for this data source). With the general populous so concerned about a double dip recession it is no wonder the stock market is struggling to find its footing.

The pertinent question is how reliable and accurate is the broad crowd of individual investors and the general populous at predicting anything economically? The answer is horrible. When fear is as rampant as it is now, and everybody is pre-occupied with this supposed forthcoming "double-dip recession," markets tend to have already priced in this potential looming recession in advance. Furthermore, the economic data and indicators that I track, and which are the best prediction metrics, are showing that a soft patch is coming, where economic growth slows a bit from its recent rate, but no double dip recession is on the horizon at this point. So, if the market is already pricing in a double-dip recession, which I believe it is, but we end up not getting one, then prices in the stock market today are very attractive for longer-term investment horizons.

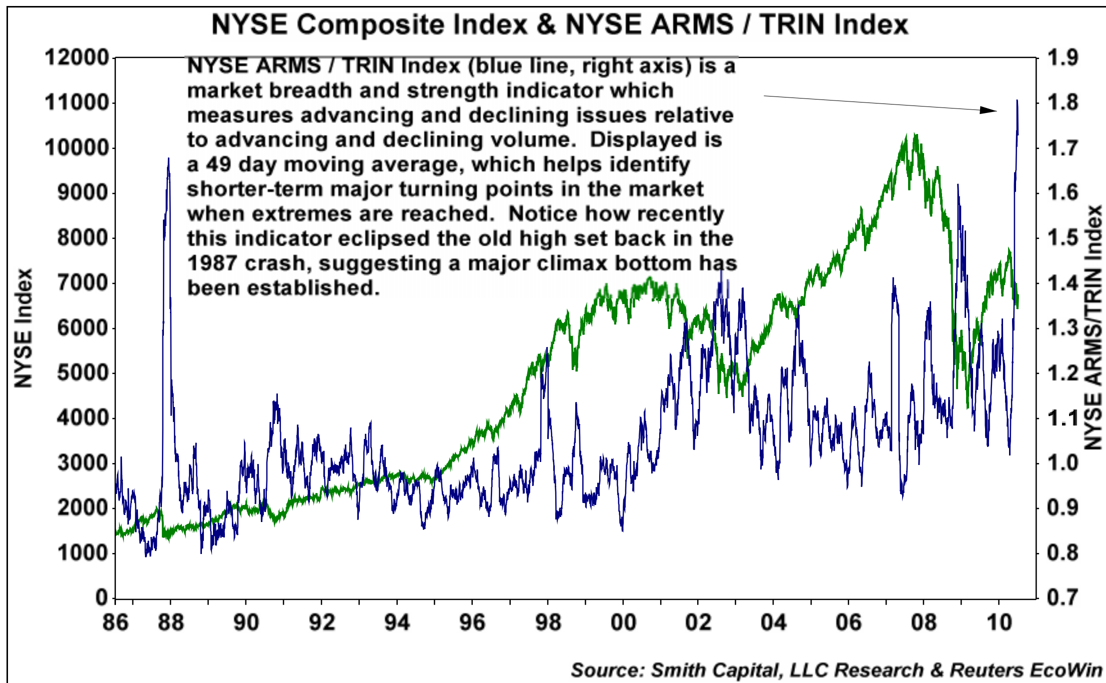
As I discussed in my June 15th Quick Update, the level of fear and anxiety among investors is at extreme levels, which I believe is being influenced by a still lingering "post-crash fear syndrome" that is causing investors to worry that 2008 will be repeated soon. So, rather than evaluate the economic, corporate earnings and valuation data objectively, there remains this short-term trading mentality that is highly emotionally charged right now within the psyche of investors of all types, causing a sell first and evaluate later response to headline news.

Meanwhile, the economic data continues to improve, albeit at a slightly slower pace, and is pointing to a continuation of global economic expansion with low inflation. In fact, I would suggest that moderate growth rather than highly robust growth is preferable, as it is keeping inflation suppressed, thus allowing central banks to keep short-term interest rates low, which in turn is supporting a gradual improvement in the health of the banking sector and housing markets. Case in point, with the 10 year Treasury bond yield falling below 3% for the first time since late 2008, mortgage rates have fallen to record low levels again. This dropping of the long-term yield structure will continue to support economic recovery and expansion. It also makes earnings yields on stocks look that much more attractive when comparing against alternative places for investment. Observe the following charts:



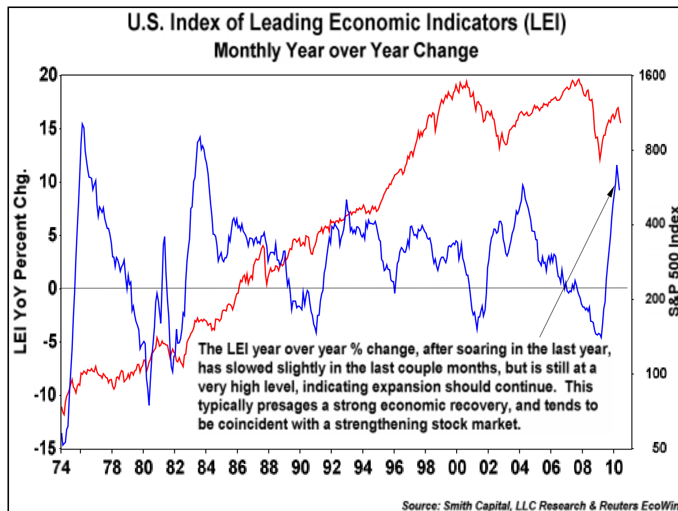


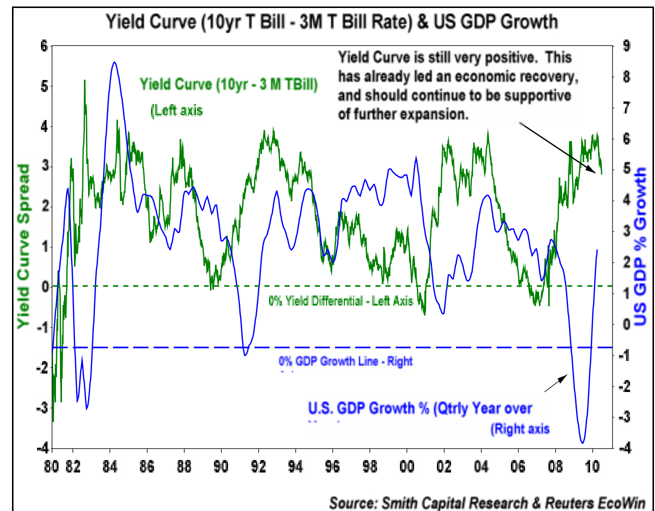
The recent round of fear-induced selling in the stock market has once again created an opportunity to go against the prevailing sentiment, and scoop up high quality stocks at attractive valuations. The chart below depicts a technical indicator that is designed to track advancing and declining shares versus advancing and declining volume on the NYSE. It is highly reliable for use as a contrarian indicator to flag when the market has moved to exhaustion extremes at either bottoms or tops on a shorter-term basis.



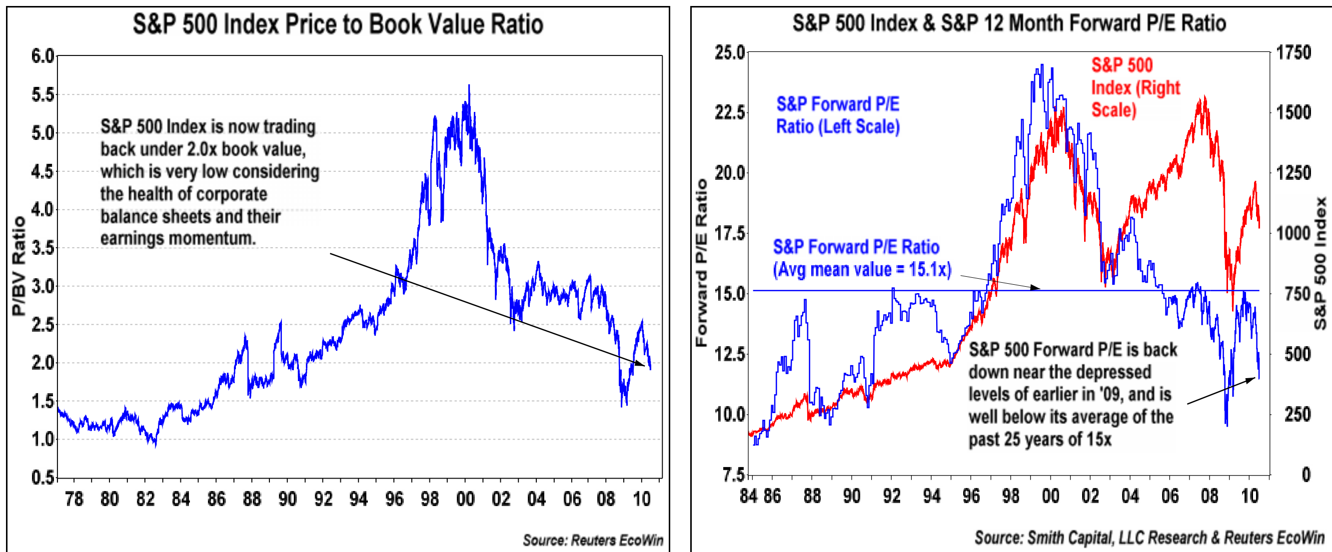
As you can see from the chart above, the current selling wave has surpassed that of the 1987 crash, yet the U.S. stock market is only down 15% from its high. Historically, it is very common for the market to experience a mid-cycle correction in the midst of a new economic recovery which is maturing into a new growth cycle. So, while what we have seen since May in terms of a correction in stock prices has actually been routine, because of the already existing negativity, the normal corrective action scared many people into extreme selling and has pushed the ARMS index to flashing buy signals.

Yet, while this fear-driven selling is occurring in global stock markets, the economic data and picture remains fairly strong and robust. The following charts display some compelling evidence that the underlying backdrop for the economy remains healthy:





While economic data continues to support further economic expansion, valuations within the U.S. stock market and really global stocks as well, remain very attractive. With the recent correction from May through the end of June many valuation metrics have declined back to near the spring of 2009 levels. See the valuation charts below:



Conclusion

In summary, I continue to have the same view and outlook as I articulated in the June 15th Quick Update. I believe the market weakness, volatility, and overall negativity that have dominated the capital markets, news headlines, and investor psychology since early May has produced a short-term correction that has run its course. While the broad public and most "market pundits" have become consumed with the idea of a double dip recession, the data and underlying economic backdrop support an on-going expansion that should be sustainable. Leading indicators continue to remain at high levels, the yield curve remains very positively sloping, PMI and ISM manufacturing surveys across the globe remain at expansionary levels, and leading employment data suggest on-going modest improvement in the job market. Furthermore, even with signs of growth, inflation remains very tame, keeping interest rates very low, which in-turn supports economic expansion. Corporate earnings and cash flow continue to exhibit strength, corporate balance sheets are very strong, stock buybacks are rising, and dividends are being increased at a healthy clip. Yet, despite all of these positive factors, stocks remain highly undervalued due to rampant investor fear. This unique situation is creating great opportunity for longer-term focused, value-oriented investors.

Considering my viewpoint and thesis I have discussed herein regarding stocks, you can see that I am favorably inclined toward putting capital to work within global equities. Across each of the Smith Capital model portfolios wherein we have some level of stock exposure, I have been progressively putting money to work in selective stocks, stock ETFs, and stock mutual funds, based on the strategy of each model. As you may recall, we headed into this recent downturn with highly elevated cash levels across each of the Smith Capital model portfolios, driven by our short-term concerns back in April. This positioned us well to take advantage of cheaper valuations that have surfaced over the last month. For Smith Capital models that are more income focused and conservative, I have continued to overweight high quality corporate bonds, but I have recently been adding back in some foreign bond exposure and a small amount of high divided paying equity exposure. I continue to believe that in due time U.S. government bonds, and even corporate bonds, which have performed so well during the last year or more, will begin to underperform other asset classes. This eventually will spark a cycle of interest rates rising, and could further restrict bond performance. Equities should outperform in such an environment as well, so long as inflation is not out of control.

Thank you sincerely for the continued privilege of serving you and your family.

Chad Smith, Managing Director
chad@smithcapital.org
www.SmithCapital.org