April 13, 2009

MONTHLY SUMMARY FOR MARCH[1]
IS INFLATION INEVITABLE?

Discussing inflation when job losses average 2 million every three months and industrial capacity is the most under-used since the Great Depression appears to be a non-starter. Virtually every producer is trying to cut costs. This includes closing less productive facilities, trimming staff, changing benefits (who still gets a 401K match?), seeking financing and leasing concessions, and sometimes even scrubbing the business with the aid of the bankruptcy court. While not that many wages have been sliced, most have been frozen. Even senior management is suffering lower pay and benefits. The average CEO took a pay cut in 2008 (though the shareholders who hired him/her took much more than that in most cases). In short, deflationary pressures are almost everywhere.

Commodity prices may have bottomed, especially for the lesser metals and wheat, but petroleum prices are struggling to rise to the $70-$75 range that Saudi Arabia believes to be appropriate. The dollar may have stalled, though a testing of those dollar highs is not out of the question as investors become more concerned about recession progress in Europe and Japan than in the U.S. Remember, only a few months ago, the primary concern was deflation.

Frankly, some deflationary signs still are intense. Import prices other than petroleum fell for the 8th consecutive month. Core inflation grew at a slower rate in the past three months than in the past year. Certainly, a round of wage cuts could restore deflationary concerns. In short, all the short term factors dictating price movements are weak. A strong dollar, solid productivity gains, moderating commodity prices, substantial labor excess which is growing, and the lowest capacity utilization in decades all indicate inflation will slow further. Crude material prices less food and energy are rising modestly, but all other inflation indicators that I follow continue to suggest lower price gains ahead.

Nevertheless, inflationary worries are being spawned by the enormous stimulus programs on both the monetary and fiscal side of the ledger. Money growth as measured by M2 remains well into double digit gains on a 13 week comparison to the previous thirteen week period. This surge in money balances has been occurring since the crisis heightened in September. These outsized gains in money are justified by the inability of banks to make loans and create bank money. Fears have pushed currency demand to double digit levels as well.

The fiscal stimulus seems even more remarkable. The deficit for this fiscal year, with the TARP, TALF, special drawing rights for several financial entities and the stimulus program, could approach $2 trillion dollars. All the government debt accumulated from colonial times to the beginning of the Reagan presidency will be doubled in this single year. (Reagan and Bush II also added debt to push the grand total to $11 trillion by the end of this year.) Most economists assume that government debt crowds out private investing. Thus, deficit financing should be pursued only if the gains from the deficit program are greater than the costs from less private capacity. Under normal conditions, such "crowding out" probably occurs.

However, bill rates would not be near zero and yields on ten year treasuries would not stay below 3% if private activity was being crowded out. While government still has an obligation to effectively use its resources, the best time to finance the government through debt is when borrowing costs are unusually low. Not only does that reduce the cost of borrowing, but it also suggests that a void exists in capital markets, so accelerated (not unneeded) spending for government investment could provide low costs of capital and create jobs.

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[1] The Monthly Summary is prepared by Dr. Donald Ratajczak, PhD., Morgan Keegan's Consulting Economist. Additionally, this report is a transcript of comments made by Dr. Ratajczak and should be read in that context. Additional Information Is Available Upon Request.

Indeed, some papers on the "crowding out" thesis have responded by saying private capital is "crowded in" because investment would not happen without the expected returns that only a healthier economy could generate. Up to a point, I believe the "crowding in" argument has merit, and that point certainly exists today when unfilled orders are plunging and capacity utilization is falling below 70%.

Indeed, if the low interest rates for government borrowing are generated by disincentives from the economy for private capital spending and if the high growth of the money stock is caused by unreasonable demand for currency and precautionary balances, all of which I do believe prevails today, then these outsized gains in deficits and money growth really are not inflationary.

However, they become inflationary when the private economy begins to work normally again. In theory, deficit financing can be stopped and accelerated government investment can be curtailed when normal growth rates return. Also, money growth can slow to sustainable, noninflationary rates when the fear factor in financial markets ends. In other words, there is justification for the current rapid money growth and high government borrowing. (Remember, I am dealing with a financing of government, not with a size of government issue. To the extent that government functions are increasing, they must be justified against the alternative uses of those resources and should not stand merely because the economy is weak.)

Thus, the question shifts from whether stimulus in monetary and fiscal policy is inflationary (it need not be) to whether the stimulus will be withdrawn before private conditions rebound and begin to be crowded out by large government borrowing. To answer that latter question, we need to know when normal returns.

Unfortunately, both politicians and business people wrongly assume that normal is when we return to the days prior to the correction. Remember, there is nothing "normal" near a cyclical peak because the economic sickness leading to the downturn is created then. Instead, my definition of "normal" is when the economy has regained a sustainable growth path. Of course, if resources remain under-utilized at that point, growth can easily jump more than the sustainable path for a period of time without serious repercussions. Unfortunately, if we wait until the stimulus clearly creates inflationary pressures, the magnitude of the next inflation cycle will be rather large (the lags are long and variable).

Thus, the dilemma. The current deficit and monetary stimulus need not create inflation, but only if it is withdrawn while the patient is mending, not when the economy is whole. The inflation of the 1970s was spawned because economists thought they could continue to stimulate the economy until "full employment" was reached. In fact, they need to begin withdrawing stimulus when sustainable growth is reached. Prior to reaching that point, growth is insufficient to absorb all the new entrants into the labor force. This means that the withdrawal needs to begin right after the unemployment rate peaks.

Now we turn from economic theory, which clearly suggests that even these dramatic injections into the economy can be withdrawn before inflation becomes an issue, to political reality. Will any politician tolerate the removal of stimulus while the unemployment rate remains in double digit territory (a level that almost certainly will be reached in this downturn)? Will this administration's government initiatives create or preserve enough efficiencies to maintain competitiveness between U.S. and international producers? If not, will they seek alternative enhancements for economic efficiencies in the private economy?

As a forecaster, what should I do? First, I need to determine when normal growth resumes in the private economy. Second, I need to determine the political response. Third, I need to evaluate how economic variables respond to that action or lack thereof.

When unemployment is rising, I seriously doubt that wage pressures will intensify. Only a dramatic upward shift in inflationary expectations (say, caused by an oil embargo as in 1973) could create such pressures, and I see no such jump in inflationary fears (even if the "sophisticated bond investors" are fretting). Frankly, the $26 billion trade deficit in February probably has restored the balance needed to provide world reserves without creating currency imbalances for a reserve currency like the dollar. Also, companies are trying to pay down debt, meaning they will deal to get some returns from their increasingly idle capital. Thus, inflationary fears are not justified this year and probably not next year either. Only after unemployment has peaked should such concerns even start to stir.

With 2 million job losses per quarter, this economy is far from normal. I still see very large job losses in April (possibly approaching 700,000). After that I am hopeful that the losses in construction will slow, manufacturing will continue the moderating loss trend, retailing will not lose jobs any faster and temporary employment slowly loses jobs at a diminished rate. If so, job losses may occur all year, but then begin to stabilize early next year. By midyear, the return of discouraged workers will be at its zenith so unemployment finally will begin to fall (though from 11 percent). That is when a slow withdrawal of stimulus and moderating deficits would be necessary. Before the economy returns to high levels of employment (in the 5% unemployment range), the deficits should be vanishing.

In fact, we know that the best Obama case still has 4% deficits in those "normal" years. Also, the growth of government may undermine private efficiencies (will the health initiatives further benefit the less productive at the expense of the more productive, or will it relieve cost pressures from productive entities. The latter is possible, but the former is likely.) Moreover, I cannot see money growth at nominal GDP growth after 2010, as interest rates probably would be rising rapidly (we soon will be talking about a trillion dollars of interest expense). Therefore, after a couple of years where core inflation rates are safely in the 1-2% growth range desired by the Fed, a breakout to the 3-4% range is likely by the beginning of 2012. By that time, the rebound in commodity demand will have absorbed the slack that the recession is creating. So, commodity inflation would add to core pressures, causing inflation to jump above the 5% range.

None of this need happen, but without a political will to fight inflation when the recession ends, it probably will.

On another note, almost everyone has decided that the economy is approaching a bottom. I will grant that conditions are more favorable than last fall. However, of the four indicators I observe for current conditions, only two are turning favorable (which is better than the zero positive readings in the fall). Inventory declines have overtaken the drop in sales and should soon empty the warehouses (excepting SUVs and a few other items). As goods are needed to make even reduced sales, production declines should slow this spring and turn sometime this summer.

Stock prices now are rising faster than housing values are falling. Thus, the wealth effect no longer is plunging. Of course, the stock market may be premature (and probably is if it sees a bottom at this time). Nevertheless, having wealth stabilize following a one third clip for those households with wealth certainly is a good sign.

While the order books are thinning at a slowing rate, suggesting the rate of decline is slowing, they are still thinning. We need more production for inventory, but less production for capital goods.

Finally, job loss remains intense. The latest initial claims are improved, but only marginally. For all practical purposes, job losses have stalled at an eight million annual rate. That's better than climbing further, but how can anyone be happy about such misery?

Apparently, investors were picking more than losers when they sold off shares in the first quarter. They were trying to identify zombies. Some very viable companies had market prices on equities that suggested those companies could not meet any increase in finance costs. Two things happened. Investors discovered that the zombies were not as prevalent as they expected. Second, managements got the message that survival was at stake. Cost cutting surfaced that never would have happened in mild recessions. While that added to job woes, it increased the corporate survivors and helped those managing resources to outperform investor fears.

I think the surge in the value gap during the first quarter reflected unjustified fear. Removing the fear factor probably means that 6,600 is the bottom (or the slightly lower actual number) and probably will be tested only if fear again bubbles to the surface. However, those believing a bottom to the recession is near and that profits are rebounding will be disappointed. We probably remain twelve months away from any profit growth, suggesting that stock values will stabilize near current levels until a bottom becomes more certain.

Current research indicates that earnings for the S&P declined 10% in 2008 and are expected to rebound by 20% in 2009. (Operating profits for all corporations actually fell 8% in 2008, but almost certainly will be off by nearly 20% in 2009. Clearly, macroeconomic conditions are inconsistent with profit estimates at this time.) Thus, after the fear factor dissipates, as it almost surely has, a long pause in stock values should be expected before profit visibility finally justifies further upside to this market.

CREDIT MARKETS

The growth of government debt remains the major driver of uses of funds. In the first half of this fiscal year, deficits approached an annualized $2 trillion. That number will moderate slightly in the second half, but deficits of more than $1.9 trillion now seem likely for the year. Although Obama says that deficits will be cut to $550 billion before the end of his term, that remains a higher deficit than at any time before this downturn began. There are two take-aways from this discussion. First, deficits are unusually high, averaging well over 13% of GDP. Second, they will be coming down, sometimes rapidly, but remain very high even after four years.

The good news is that the worst of the federal government use of funds is now. Lower demand upon savings will develop as the years progress. Of course, state and local governments are aggressively using rainy day funds, meaning they effectively are running operating deficits and also need funds. Moreover, capital spending by state and local governments probably will remain intense into next year. Thus, total government use of funds will fall more slowly than the Federal use of funds.

Of course, the low government rates suggest that investors desire protection of principal more than yield at this time. Thus, they are attracted to government issues. When fears decline, as they are now, the attractiveness of low yield federal debt will diminish. Of course, the lower rated corporate bonds may benefit from this shift in sentiment, but those entities also will be raising funds when yields descend. The net effect of all this shifting will be upward drift in treasury rates and downward drift in lower grade corporate rates with declines slightly exceeding advances, at least until the beginning of next year.

The sources of corporate funds are rapidly evaporating. Inventory profits have become inventory losses as commodity prices decline. Also, operating profits are dropping sharply. This reduction in internal cash generation should persist into the fall.

Of course, the uses of funds also are dropping, but not so sharply. While corporations are reluctant to extend bank lines, they are aggressively seeking longer term borrowing when the markets provide opportunities. This will prevent major adjustments in corporate spreads. I do expect, however, that lower investment grade corporate yields will fall even as higher quality corporate yields rise modestly.

The household sector continues to resist home purchases but some evidence of increased desires to spend are surfacing. I still believe household savings will reach 7% by early next year, but the gains will be slower and combine with spending growth rather than take away from any further spending as in the past three quarters. Thus, the household sector will be a substantial supplier of funds, at least until housing begins to move late this year.

The dollar appears to bottom early this year, but has since rallied against most currencies. Along with confidence in government assets, the higher dollar has encouraged inflows of capital despite evidence of some selling by China. Until the ECB decides whether it will cut rates further, I expect the dollar to remain relatively strong. This should encourage international capital flows. Late this year and early next year, just as corporate and household needs are growing, the dollar could fall, leading to reduced inflows of capital at prevailing rates.

The bottom line is that rates will drift upward, but should not rise sharply. Of course, short term rates will show little change until employment growth resumes, and that is not likely to happen before the beginning of 2010.

EQUITY MARKETS

Despite some moderation in economic fear, the yield in lower investment grade corporate bonds has increased late in the quarter. I do not expect much further increase and would be looking for decreases later this year. Nevertheless, the impact of those rate increases has been some erosion in my estimates of equilibrium market values.

When declines in operating profits are added to the rise in interest rates, stock values no longer are as deeply depressed as many investors assume. After all, operating profits have declined by a third in the past year (though market values have dropped by half, so some fear factor has been built into stock price declines). Operating profits should continue to fall through the summer according to my projections. While interest rates should decline on the Baa securities by the fall, a return to enterprise values that appeared appropriate just two years ago is unlikely.

Indeed, my estimates suggest that the current rally, while justified to eliminate the fear factor, probably cannot be sustained until profits begin improving. Thus, I expect the markets to maintain values near current levels until the rally resumes in the fall.

My projections show that the brunt of the profit decline is in the financials, where the fear factor has been most intense. I suspect that profits continued to erode in the winter despite some announcements that profits were improving at a few major banks. I do believe the financials have been crushed and do not deserve the low valuations they are receiving. However, recovery in that sector is not likely to be intense until the fall.

There are few opportunities in manufacturing at this time. Jobs continue to decline and orders continue to sag. Computers are doing slightly better, but few other sectors show much strength.

The good news about technology is that most of the earnings are relatively cheap. The bad news is that earnings are hardly growing. I still would be long the technology sector, but should remain vigilant to take quick profits or cut losses if the markets shift direction.

The only strength in transportation is in maritime and that is largely because ships are being rented to store stuff. About 500 vessels are anchored off Los Angeles awaiting opportunities rather than berths. Traffic in trucking and courier services remains weak.

A little movement is evident in discretionary consumer spending. Especially interesting is the growth in restaurant values. The group still needs employment growth, but lower product prices and cost containment have aided profitability. Similarly, a few select retail chains are doing well, but just as many are going out of business.

World growth remains too slow to jump on the materials groups, including energy. The $1 trillion IMF fund for emerging markets certainly helps resolve problems in the emerging group. That sector could outperform the market in the next six months.

While investors have jumped on the high yields of REITs, many of those entities continue to suffer from falling rents, lower occupancy, and lower asset values. Until new building is more in line with need, I suspect that further erosion of values lies ahead.

Of course, the strong dollar is not beneficial to the multi-nationals. This explains why the Dow stocks have been lagging the overall market. I expect this to continue into the summer.

MORGAN KEEGAN UNIVERSE

Through April 9, the MK universe is down 1.3% as compared to a drop of 5.8% for the S&P. I already talked about the bad profit forecasts for S&P stocks. As profits fall short of those targets, stock values tend to dip. By contrast, our analysts assume a more realistic 9% dip in reported profits for this year, though I would still argue that decline is still short of reality. Nevertheless, the earnings surprises in the MK universe are not likely to be as intense as those for the overall S&P.

So far this year, the best performers in the MK universe have been semiconductors, restaurants, communications technology and energy infrastructure. The poorest performers have been regional banks, transportation leasing, health REITs and air freight.

Since the beginning of April, the best performers have been our lowly special situations, the REITs and oil exploration. Only transportation leasing has failed to provide any gain for the month so far. Other lowly single digit gainers included truckload carriers, energy infrastructure, and healthcare technology. Clearly, the Obama effect can carry overpriced stocks only so much higher.

While restaurants have been stellar since the year began, they will need employment gains to sustain much further gains in valuation. Other consumer activity will be spotty. Consumers remain cautious, but will buy deals and comfort.

The spurt in energy is not justified by pricing or inventory and probably will need to lag behind in the next few weeks.

Banking and Finance have rebounded strongly as profit forecasts began to surface for some important banks. They have a long way to go, which might suggest market outperformance for the next few months.

Healthcare services rebounded following a weak period. This might be a dead cat bounce. The gains in other healthcare sectors remain sluggish with the health REIT trailing overall REITs by more than 10%.

Safety and security was an average performer, but did create a gain. Not much is expected in this sector until government spending again is redirected.

Both the residential and other construction showed strong gains. The homebuilders may be early, but not wrong in their gains. The construction/industrial group is too strong and also wrong at this time.

Most of the technology is doing OK. The major problem with this group is the lack of earnings visibility. Our analysts see no profit growth except in the transaction processing space. Even the semiconductors have slowed to a yawn with falling profit estimates. Late this year, I expect this group to break away from the pack as next year's profits become more visible.

The railroads did surprisingly well in the transportation sector as did maritime, as explained earlier. I would like to see stability in industrial production before jumping on this group.

As I mentioned earlier, our special situations finally were special. (Actually, they also were special last year as they lost 75% of their value, but that is not the direction we want.) Again, this may be a dead cat bounce, but it also may represent seriously oversold conditions (and I am voting on the latter).

With a strong dollar, our offerings can do well relative to the market. Our consumer offerings continue to outperform their benchmarks and I suspect that the oil exploration may again do so as well. Our banks continue to lag their benchmarks but I suspect that they will rebound when the rally in large cap banks persists, as I think it will.

Current forecasts for several key economic variables are shown below (they reflect the chain weighted measures of GDP):

	2008	2009				2010				Ann.	Ann.	Ann.
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2008	2009	2010
Real GDP	-6.3	-5.6	-2.8	-0.5	2.0	2.0	1.9	2.6	2.9	1.1	-2.9	2.0
GDP Deflator	0.5	1.6	1.8	2.0	1.8	1.9	2.2	2.3	2.5	2.2	1.2	2.1
Nominal GDP	-5.8	-4.0	-1.0	1.5	3.9	4.0	4.2	4.9	5.5	3.3	-1.7	4.2
CPI-U (annual rate)	-7.6	-2.0	2.6	2.5	2.4	2.4	2.5	2.6	2.8	3.8	-0.2	2.3
91-Day Bills	0.0	0.2	0.2	0.2	0.3	0.4	0.8	1.3	1.6	1.3	0.2	1.0
Prime Rate	4.0	3.3	3.3	3.3	3.3	3.3	3.6	4.1	4.3	5.1	3.3	3.8
Federal Funds	0.3	0.2	0.2	0.2	0.2	0.3	0.6	1.1	1.3	1.9	0.2	0.8
2-Yr Note	0.8	0.9	1.0	1.0	1.1	1.2	1.6	1.9	2.1	1.9	1.0	1.7
5-Yr Note	2.0	1.9	1.9	2.0	2.0	2.2	2.6	2.9	3.2	2.8	1.9	2.7
10-Yr Note	3.1	2.7	2.9	3.1	3.2	3.3	3.6	3.8	4.0	3.6	3.0	3.7
LT-Average	3.7	3.6	3.7	3.8	3.9	4.1	4.3	4.4	4.6	4.3	3.8	4.4
Aaa	5.9	5.3	5.6	5.6	5.7	5.8	5.9	6.0	6.1	5.6	5.5	6.0
Baa	8.8	8.2	8.5	8.5	8.5	8.2	8.1	8.0	8.0	7.5	8.4	8.1
Corporate Profits ($bil)	931	853	826	825	851	882	914	953	984	1231	839	933
Operating Profits Adjusted ($bil)	1001	912	865	844	862	885	908	935	970	1110	871	925
S&P 500	910	809	836	911	980	1043	1089	1146	1195	1220	884	1118
S&P 500 Equil.*	1077	1053	963	940	959	1020	1060	1105	1146	1489	979	1083
Value Gap (%)	-16	-23	-13	-3	2	2	3	4	4	-18	-10	3
Dow Jones	8796	7774	8069	8684	9238	9882	10469	10933	11399	11253	8441	10670
Nasdaq	1600	1485	1608	1729	1854	1968	2059	2168	2283	2162	1669	2120
Trade Weighted Dollar	109.2	112.4	110.4	110.6	110.5	109.8	110.3	110.6	111.2	100.7	111.0	110.5
												Updated April 13, 2009