MKG Financial Blog

[March 9, 2011—The Second Anniversary Of The Last Market Bottom]

March 9, 2011 by mkgfinancialgroup

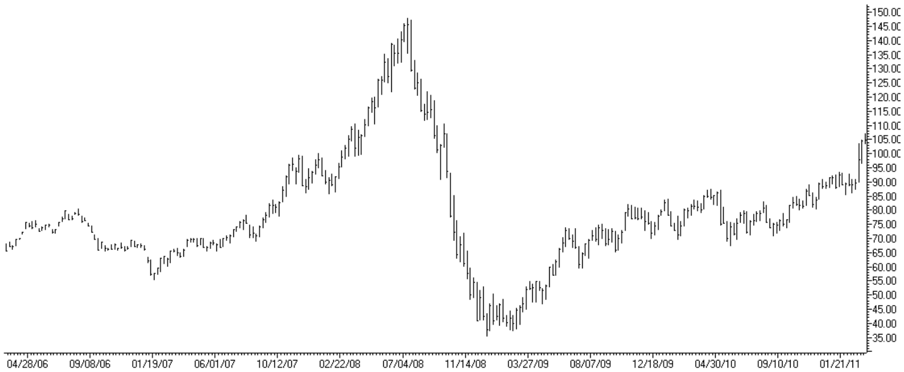
March 9th is a very important date: the anniversary of the bottom of the last market disaster that left a wake of financial destruction and tattered emotions in its trail. The market, as measured by the Dow Jones Industrial Average, had already fallen from its all-time closing high of 14165 on October 2007 to 10325 by the end of September 2008—a 3840 point decline. What followed over the next five months was another 3778 point drop to 6547 at the closing bell on March 9, 2009. The market had then fallen 7618 points from its high in a drop that stunned the world.

This year's anniversary is noteworthy in that the DJIA closed yesterday on March 8, 2011 at 12214—less than 2,000 points away from its all-time high and nearly 87% higher from where it stood just two years ago. In spite of the swiftness and intensity of the 2008-2009 decline which had global elements that have had a significant and lasting effect, the market nevertheless has recovered to a large extent. The reality of better-than-expected corporate profits and rising valuations in the underlying companies has prevailed in attracting investors back into the market. Happy Anniversary!

And Now, All That Is Heard Is A Discouraging Word: Oil!

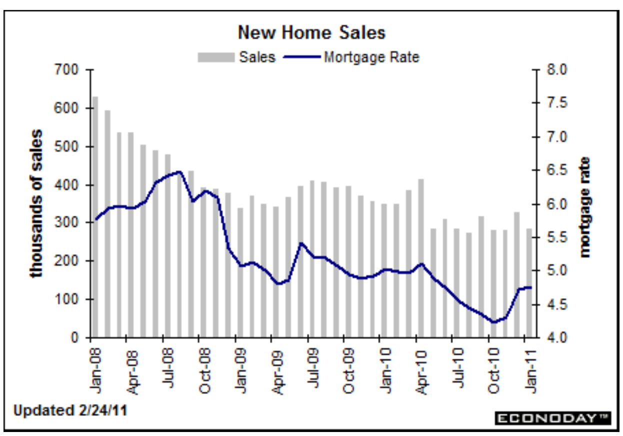
We are hearing a lot of chatter about how rising oil prices will send us back into another recession, similar to 2008, drive down growth in the U.S. economy and derail the economic recovery. I have even read that rising oil prices are going to cause job losses as consumers curtail their spending.

The past offers opportunities to learn from, yet the future is never exactly as the past. The past – 2008 in this case – displays some similarities to today, which may bias investor sentiment, yet today is quite different from 2008, in our opinion. Whereas the U.S. economy experienced rising oil prices in 2008 and ended that year with a massive shock to the economic system brought on by earlier excesses in consumerism, today such struggles as rising oil prices and geopolitical issues coincide with a more stable global economic system that is recovering from the imbalances and lack of supervision that was prevalent in 2008.



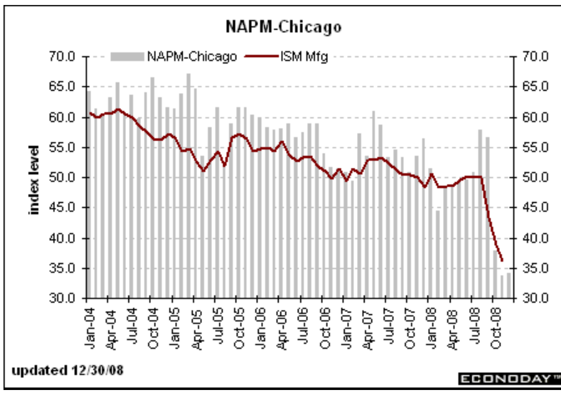
Crude Oil

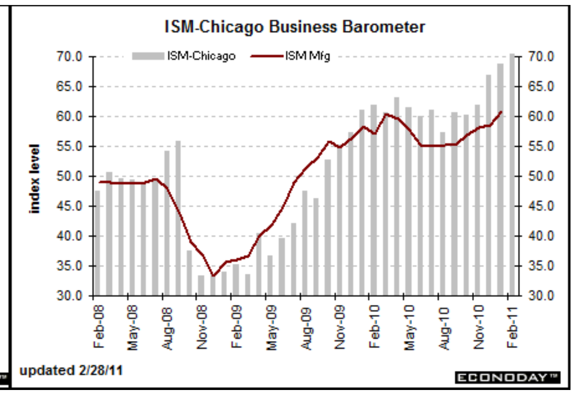
Today, we observe a better positioned U.S. economy. Many weak corporate players have shrunk or left the marketplace all together with the strong ones remaining able to take advantage of a more rational business climate to expand, make acquisitions and utilize their strong balance sheets to seek greater-than-their weighted-average-cost-of-capital returns. These benefits have been exaggerated to some extent due to significant declines in corporate expenses. These characteristics make today much different from 2008 in that companies are better prepared for sudden changes in demand or costs.



In 2008, new home sales were still declining at a fast clip. Existing home sales, however, had actually leveled off at the time and were beginning to slightly rise—an oddity considering the recession was suppose to have started in December 2007. In addition, payroll jobs were only slightly declining at a very low level. More importantly, manufacturing, as measured by the Chicago ISM Index, was rising and had actually spiked well above the expansion line in both August and September in 2008, before "*the great decline,*" and the national ISM Manufacturing Index was rising, as well.While counterintuitive, we actually appeared not to be on the verge of disaster at all. Instead the U.S. economy appeared to be stabilizing—except for new homes sales and housing starts—which had been correcting since 2005. Corporate earnings growth had began to stall, but remained at a historically high level and oil prices had declined about a third from its peak. While at the end of 2008 there was a sudden and dramatic fall off in business and consumer consumption, it would be hard to attach oil prices as the reason at that point in time—more as a casualty as the world moved into a decline together. This was a credit issue.

One of the key differentials today, as mentioned earlier, is the wrenching out of excessive business expenses in conjunction with the global expansion that the historic downturn during 2008-2009 actually led to. China was growing rapidly earlier on, just as so many commodities were rising rampantly, but globalization was not nearly the playing field that it has now become—a key component to our development of the concept around "*size, momentum and velocity*". In addition, companies from the developing countries, as well as the more matured nations, are using greater top-down attention to the details of managed growth, rather than unbridled growth. This is leading the way to innovation and new corporate entrants in the global marketplace.

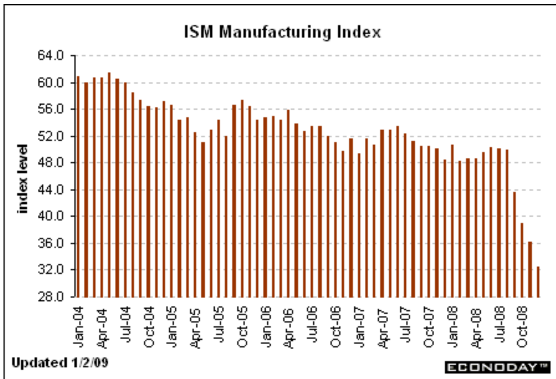


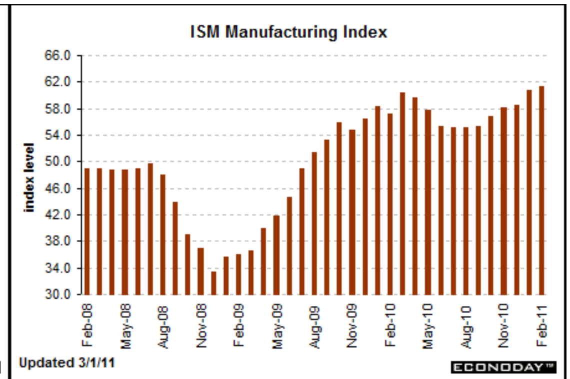


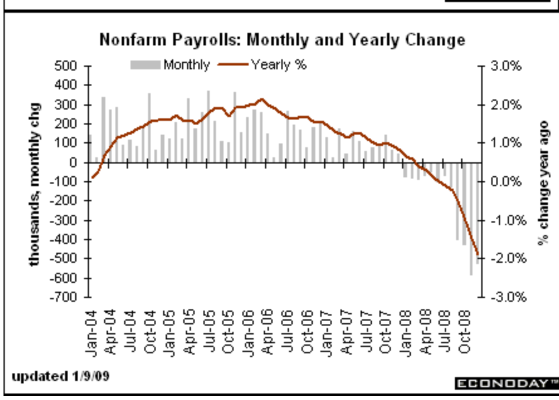
It is therefore interesting to hear the assertion that energy was responsible for the 2008 downturn, let alone pin a future decline in economic activity on rising oil prices. While it did exacerbate the growing dislocations in markets, the reality is somewhat different. Energy tends to be one of the key elements of demand wherever economic growth factors are in motion and therefore oil prices, in our opinion, have been more a reflection of the state of affairs, both geopolitically and economically. There are always concerns on what that impact will be from higher energy prices, but the price of oil itself is very sensitive to economic conditions.

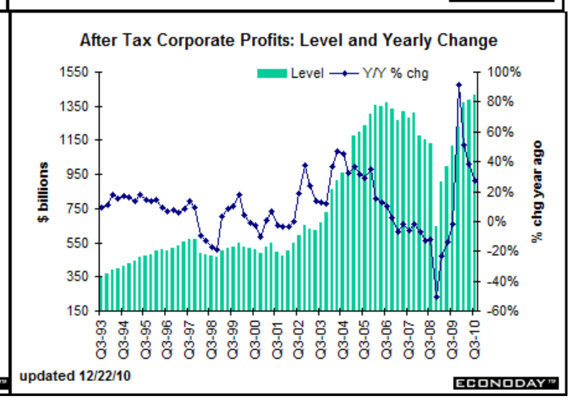
In 1997-98, during the Southeast Asia crisis and global currency issues, oil prices fell to $10 per barrel and gas to under a dollar per gallon, later rising as global economies recovered. Today, in the current recovery, oil prices are on the rise again, just as copper and other commodities are. The difference we see today versus 1997 and 2008, is that the increase in commodity prices, including oil, is simply a natural consequence of the emergence of a stronger and more stable developing global economy—one that is seeing rising consumer spending within a growing middle class. This leads to an increase in the demand for energy in general, and a specific requirement for more oil as car sales climb in these countries, as well. Size, momentum and velocity in this instance means to us that more people around the world today are gradually seeing a rise in their standard of living. The United States, on the other hand, is benefiting from increasing business with these developing countries, and U.S. consumers will likely move toward more substitution, prudence and variable consumption patterns in addressing rising energy price levels, similar to what has been seen in Europe.

In summary, we see such positive economic numbers, retail activity and rising commodity prices as steps in a process that may be lumpy, but moving forward—not as forward steps that are about to turn down. Geopolitical risks and financial risks, particularly in terms of public debt throughout the developed nations and turbulence in the Middle East, will likely continue to dampen expectations. Yet so long as these issues are productively addressed, we continue to view today's events as *the best is yet to come*.









~Mark Gaskill, Chief Investment Officer
~Julie Bryan, CFA, Director of Research

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