The Week

WACHOVIA SECURITIES

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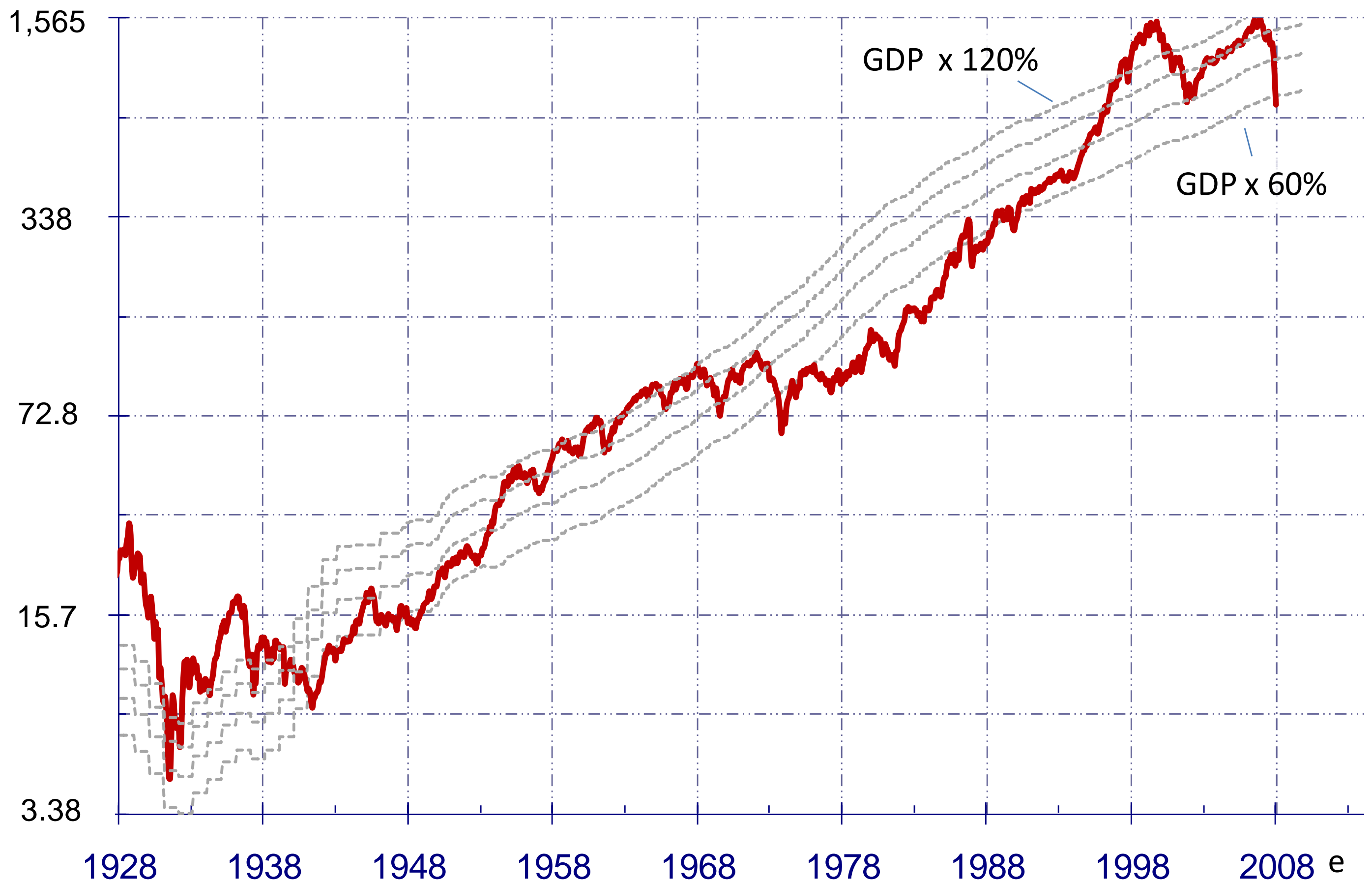
The Moral Equivalent of War

- Last week's pre-announcement (the official news is due today) of President-elect Obama's economic team – including New York Fed President Tim Geithner as Treasury Secretary and former Treasury Secretary Larry Summers as chief White House economic advisor – has soothed some frayed nerves and could help form a base for at least a short-term rally. But the intermediate-term outlook depends more on the ambitious economic stimulus plan emanating from this group, in our view, and its path through the legislature toward the Oval Office. The new administration is supporting an all-out attack on the forces of economic stagnation; Federal debt will rise.
- The spending initiative is likely to be a good deal larger than the $162 billion stimulus plan passed earlier this year, and may span a period of two years. Despite oft-heard concerns that the U.S. is sliding into a more socialistic structure, it is our sense that the stock market will respond positively to forward progress of this plan.
- The disclosure that a large money center bank had repurchased $17 billion of Structured Investment Vehicle assets appeared to be the most troubling news that undermined the fragile support level of around 800-840 for the S&P 500 last week, and ushered the index to a new low at 750. "Uncertainty ruins markets not because of the worry that debtors can't pay, but because of the fear that creditors can't afford not to be paid," writes Martin Meyer of the Brookings Institution in an excellent piece about repairing the credit markets, in this week's *Barron's*.
- Now that the U.S. Treasury has stepped in again to inject more capital into a major bank and to backstop its troubled assets, one of the most irritating aspects of last week's market breakdown now appears under control. But the market was also disappointed by two other indications that further government economic support was not quickly forthcoming. The first was the announcement by the Bush Administration that it would not request additional funding for the Troubled Asset Recovery Plan ("TARP"), beyond the $350 billion that has already been disbursed. This decision was a surprise to market participants, who had expected the Bush team to formally request additional funds that were approved in the emergency law that passed six weeks ago.
- The second disappointment was the insistence by congressional Democrats that the leaders of the "Big Three" automakers present detailed plans for their respective turnarounds before their pleas for government help are shown further consideration. The stock market cheered news of an interim compromise by a small group of Senators, but swooned when it became clear that House leadership would not support a bailout for a "concept turnaround," and would insist on seeing more detailed blueprints. The wide distribution of preliminary hearings may have served to undermine consumer confidence even further, by publicizing the plight of the automobile industry and its interdependence with the U.S. economy.
- Equity markets are dependent on healthy growth in Gross Domestic Product (GDP, see chart overleaf), and U.S. GDP growth depends importantly on consumer spending. GDP increased $5.5 trillion (to $14T) over 10 years ending 2007, a +5.2% annual rate. (The chart shows the path of GDP growth has helped define the path for equity markets for the past 80+ years; we expect this relationship to persist. Each of the dashed lines represents a fixed multiple of the level of GDP. The drop in stocks reflects increasing pessimism about the outlook for GDP.)
- Personal Consumption (which climbed +5.8% annually) was responsible for three-fourths of the $5.5T increase in GDP since 1997, and – bolstered by an increase in borrowing – has outpaced the rise in incomes. Household debt (largely secured by residential real estate) increased nearly +10% annually over the same 10 years, according to the Federal Reserve. No wonder the sharp decline in home prices is pressuring consumer spending.

Growth in Nominal Gross Domestic Product Helps Define the Path For the S&P 500 Index



Note: Past performance is not a guarantee of future results. An index is not managed and is unavailable for direct investment.
Source: Blue Chip Consensus (for 2009 estimates), Bureau of Economic Analysis, Standard & Poor's.

We recognize the market's steep decline has shaken the confidence of even the most seasoned investors, but we believe there are numerous bargains available to the stout of heart at current levels. We continue to favor the shares of large capitalization companies with stable businesses and high quality balance sheets, whose consistent cash flow makes their operations less dependent on short-term financing markets. Companies in the consumer staples and health care sectors have outperformed meaningfully – for good reason – amid the market turmoil. Recent energy price declines have improved the valuation of companies in the energy and utilities sectors, too.

A history of dividend growth is only a starting point for deeper analysis; it is no guarantee of future success. Dividend sustainability and potential growth depend importantly on economic trends such as consumer spending. We expect more companies will reduce or cease dividend distributions in upcoming quarters. We figure that companies within the S&P 500 that are dependent on financial businesses are responsible for one-fifth of the total dividends paid on the index constituents. As dividends decline for companies in industries most exposed to consumer spending and the credit squeeze, it is likely that companies with sustainable payouts will continue to outperform the broad market averages.

Tom McManus

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