

An Investment in America's Future

- The stock market's ability to advance in the face of negative surprises is a good sign; despite the report of huge job losses in November and substantial upward revisions to layoffs in prior months, the market proved its resilience. After stumbling on the news, the market gained strength steadily from the mid-morning lows and closed nearly +4% higher on the day. We are encouraged by this result and expect stocks will lead the economy out of the recession, as they typically do.
- Nearly 0.5% of America's workers (excluding farms and government) lost their jobs in November; the cumulative decline over the past year is nearly 2% (see chart overleaf). But market participants appear to have been prepared for downbeat news of widespread job losses. After all, official confirmation that a recession had begun a year ago arrived earlier in the week, and the Federal Reserve's Beige Book confirmed there are very few bright spots for the U.S. economy. *USA Today* devoted a half page to documenting the depressing news, district-by-district. Congressional hearings about the precarious position of the auto sector invaded living rooms all week; the nationwide sales rate of new cars has fallen by a third so far in 2008. Surveys of consumer confidence and purchasing managers' intentions both reinforced the notion that it has been a long while since we have seen such a sick economy. Nor is the news any better outside the U.S.
- President-elect Obama's massive infrastructure plan to stimulate the economy and create jobs is an important jump start, but it will require the eventual participation of businesses and consumers before we recover the wealth lost in this bear market. A stabilization of home prices is a critical precedent to a sustainable recovery.
- Investments in transportation, communications and technology infrastructure were widely anticipated, but the size of the program and its apparent broad support will likely provide a boost to a wide range of companies in the industrial, materials and technology/telecom sectors of the market. The focus on making public buildings and schools more energy-efficient is a welcome surprise. Heating and cooling (HVAC) equipment is 30%-50% more efficient than it was 10 years ago, according to the Department of Energy. Nationwide, only 30% of commercial buildings have had their main heating equipment replaced and only 37% have had their main cooling equipment replaced since 1990. It's a good bet that public buildings have been slower on the uptake, so this investment should begin paying a reasonable dividend soon. The Carrier division of United Technologies (UTX-\$49.01-NYSE) and Trane division of Ingersoll Rand (IR-\$15.44-NYSE) (among many others) will likely benefit from increased demand for HVAC equipment.

On a separate note, last week marked the twelfth anniversary of the speech in which Former Federal Reserve Chairman Alan Greenspan's posed a rhetorical question about "Irrational Exuberance." Ridiculed in the late 1990s for the apparent poor timing of his comments, Dr. Greenspan and his warning both deserve an upward reevaluation, in our view. The S&P 500 has provided an annualized total return of only +3.1% since the following comments were given by Dr. Greenspan on December 5, 1996:

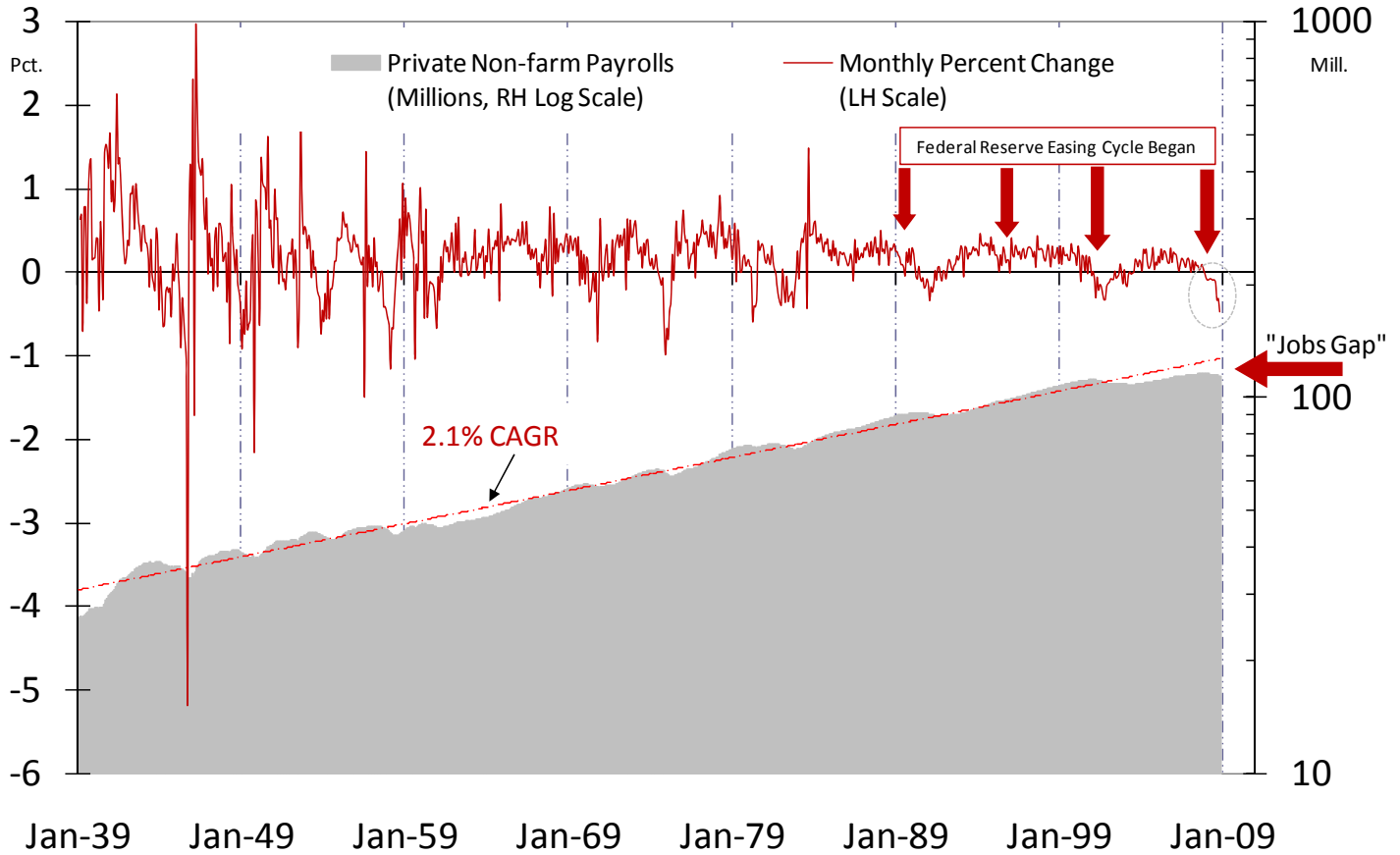
*"Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. **We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade? And how do we factor that assessment into monetary policy? We as central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability. Indeed, the sharp stock market break of 1987 had few negative consequences for the economy. But we should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy. Thus, evaluating shifts in balance sheets generally, and in asset prices particularly, must be an integral part of the development of monetary policy.**"*

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Tom McManus

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Employment Has Been in a Long-Term Uptrend, But Subject to Ups and Downs



Note: Greenspan/Bernanke-era easing cycle start points are shown; excludes emergency easing of Sept. 1998. Source: Bureau of Labor Statistics, Federal Reserve.

Friday's employment survey report for November was a negative surprise on its face, especially as the payroll figures for the prior two months were revised substantially lower. The chart shows the month-to-month percent change in private (i.e., non-government) payrolls since the start of the survey, together with the long-term trend of the labor force.

What can we conclude? First, several meaningful dips in the trend (which compounded at a +2.1% average annual rate) were eventually "corrected" with the help of expansive monetary and fiscal policy. Second, over the past eight years, the labor force seems to be gaining ground more slowly (note the "jobs gap"); it is important for us to understand and address the reason(s) behind the downshift as the growth and participation rate of the labor force, together with increasing labor productivity, are the fundamental drivers of economic growth, profits and equity returns.

Third, the steep, deep drop in employment during this recession (shown in the oval area within the figure) is already worse than anything we have seen in a generation. Luckily, the Fed has been extraordinarily accommodative over the past year. With the help of Obama's infrastructure investment program, we expect to see an improvement in employment and profits. The stock market is becoming more encouraged at the prospect of the plan's enactment, and we concur.

Tom McManus

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