



# Sound of the Economy

NORRIS, PERNÉ & FRENCH LLP

*Investment Counsel*  
Established 1933



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## Introduction

Earlier this month, the world's most famous weather reading rodent, Punxsutawney Phil, predicted an early spring. We welcome spring here in western Michigan with robin sightings and the anticipation of blooming daffodils and crocus in the garden. The bare maple tree branches are showing signs of spring with red buds. Gardeners are reviewing the Burpee, Johnny's and Gurney's seed catalogs as they plan spring planting. The warming days and cold nights indicate it's almost maple syrup time as sap buckets wait the spring's sweet bounty.

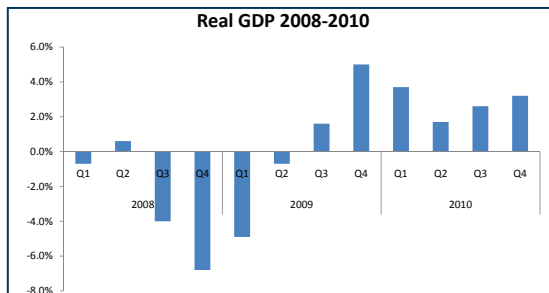
It's time to put the woolen overcoat in the cedar closet for the season. Like Punxsutawney Phil's

welcome prediction of an early end to winter, we look for continued improving economic conditions. Corporate profits are rising, economic data is better than expected, and stock prices are rising as investors look past upheaval in the Middle East, debt troubles in Europe and signs of budding inflation around the world.

Recent economic reports reinforce the base case that a recovery is developing in the U.S., and while the pace of the recovery has not been up to historical standards, the recovery does appear sustainable at this point.

## Fourth Quarter Real GDP

At the end of February, the Bureau of Economic Analysis released the "second" estimate of real gross domestic product. Real GDP increased at an annual rate of 2.8 percent in the fourth quarter of 2010 (that is, from the third quarter to the fourth quarter). In the third quarter, real GDP increased 2.6 percent.



Despite the sluggish recovery, the total output of the U.S. economy eclipsed the previous peak in the fourth

quarter. Current dollar GDP increased 3.2 percent, or \$115.9 billion, to a level of \$14,861.0 billion. This does not offer much comfort to the millions of unemployed or those whose mortgage debt exceeds their home's value. However, it does help explain near record corporate profits, the so-far resilient stock market and the recent climb in consumer confidence. Our latest forecast is for a sustainable recovery where real GDP will grow 3.0 to 3.5 percent in 2011.

For all of 2010, real GDP increased 2.8 percent (that is, from the 2009 annual level to the 2010 annual level), in contrast to a decrease of 2.6 percent in 2009.

Although consumer spending has failed to bounce back at the brisk pace experienced after severe recessions during the 1970s and early 1980s, real consumer spending has now reached its pre-recession

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## Fourth Quarter Real GDP Cont.

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peak of 2007. Consumer spending in the U.S. grew at its fastest pace in three years during 2010. The Commerce Department reported that spending grew by 4.1 percent, the best showing since a 5.2 percent increase in 2007. Economists expect that consumer spending will increase further in 2011, if the job market continues to improve.

## Housing

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The fragile housing market is threatening to hamper the U.S. recovery, just as consumers and the overall economy have been showing signs of healing. Among this wreckage, there are signs that the tide has turned and the bottoming process has begun. The National Association of Realtors reported sales of existing U.S. homes rose in January to the highest level in eight months. In January 2011, sales increased 2.7 percent (from December 2010) to a seasonally adjusted annual rate of 5.36 million. The share represented by foreclosures and short sales rose to a twelve month high, pushing the median price to the lowest level in almost nine years.

Home prices declined in all 28 major metropolitan areas. Weak demand and tight credit conditions reduced the number of potential buyers. The median existing home price fell for the seventh consecutive month, declining to \$158,800.

Inventory fell for the fifth straight month in January, dropping 5.1 percent to 3.38 million homes. At the current pace, that represents a 7.6 month supply, down from an 8.2 month supply in December. Markets are generally considered in balance when supply is around six months.

The housing market in Michigan continues to be weak as the state's 135,874 foreclosures in 2010 put it at number five in the nation for total home foreclosures.

## Employment

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Nonfarm payrolls rose by 36,000 jobs in January and were up 0.6 percent year-over-year. However, the January figure came in far below Wall Street analysts' consensus of 148,000. Private payrolls increased by only 50,000 jobs, also far below consensus. The unemployment rate declined to 9.0 percent from 9.4 percent in January. Given our outlook for a "modest" economic recovery, there is little prospect of any meaningful decline in the unemployment rate.

The U.S. labor Department recently reported that there were nearly five unemployed workers for every job opening. During the recession, the job market was hurt initially by a surge in layoffs. Currently, layoffs are at prerecession levels and the problem has become corporation's reluctance to hire workers. In 2011, the employment picture should improve as corporations, sitting on large amounts of cash, can no longer cost cut their way to earnings growth.

Corporations need to use cash to hire workers to increase production and earnings. Cash at corporations as a percent of total assets is at an all time high of 6.2 percent.

## Consumer Confidence

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Consumer confidence rose in February to the highest level in 3 years as lower unemployment and higher stock prices lifted the U.S. consumer's spirits. The University of Michigan's index of consumer sentiment climbed to 77.5 from 74.2 in January.

## Inflation

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Consumer prices grew at roughly the same pace in January as in December, although the year-over-year growth rate accelerated slightly. Headline CPI increased 0.4 percent month-over-month (1.6 percent year-over-year) in January and Core CPI (ex food and energy) increased 0.2 percent m/m (+0.9 percent y/y).

The inflation outlook remains benign. We expect inflation to stay near the 2.0 percent range that the Federal Reserve is comfortable with, both overall and for core components. Benign inflation is somewhat of a two-edged sword. It keeps interest rates low, which helps price/earnings ratios, but it also squeezes profits. Pricing power is rare these days. It is an environment in which the most efficient will prosper but the less efficient will struggle to survive.

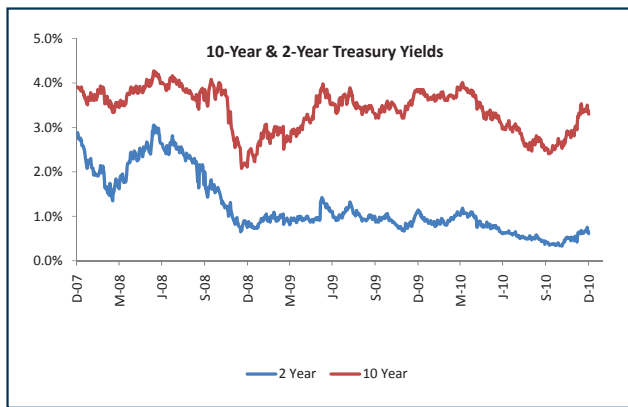
While broad based inflation remains a concern for the future, food prices have increased nearly every month since November 2009. Anyone that drives a vehicle or eats has seen higher prices. Gasoline, after increasing 3.5 percent from December, is up 13.4 percent for the year. Food prices are up 2.1 percent. The good news, anyone that heats their home with natural gas saw prices drop 6.4 percent for the year.

While food and energy prices have increased, prices on Chinese exports are down, good news for consumers of these products. The real inflation story in 2010 was commodities. Gold and silver received most of the headlines with returns of 29 percent and 83 percent, respectively. However, strong returns were not limited to the precious metals. Corn was up 39 percent, cotton increased 86 percent, copper rose 2 percent and oil finished the year up 6 percent.

## Fixed Income

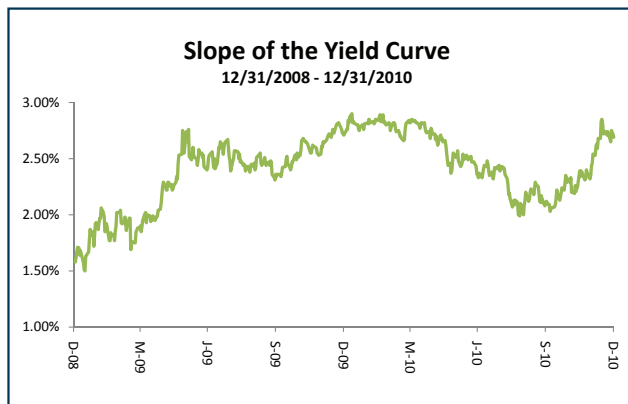
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During 2010, the yield curve experienced a lot of volatility only to end the year almost where it started. It was a very interesting year for bonds, with the European sovereign debt debacle, the flight to quality driving down the yields of U.S. Treasuries during the third and fourth quarters of 2010, only to see long-term Treasury yields rise in the last few months of the year.



The yield curve started 2010 with a steepness of about 275 basis points (bps) and remained in this area for the first few months of the year. The curve steepness is measured by the 10-year yield minus the 2-year yield. In April, the solvency crisis in Europe and weaker domestic economic reports renewed the flight to quality, sending rates lower and flattening the curve. The curve reached its flattest point of 195 bps on August 26th.

In the fall, the markets began to anticipate a better economy in 2011 and bond prices sold off despite the Fed's decision to embark on another round of quantitative easing. The curve ended the year slightly lower than where it began, resulting in a parallel shift. The yield curve steepened once again and closed the year at 270 bps, just 15 bps flatter than it began. Some Wall Street bond market strategists believe the slope of the curve will steepen to a fresh record this year, potentially exceeding 300 bps.



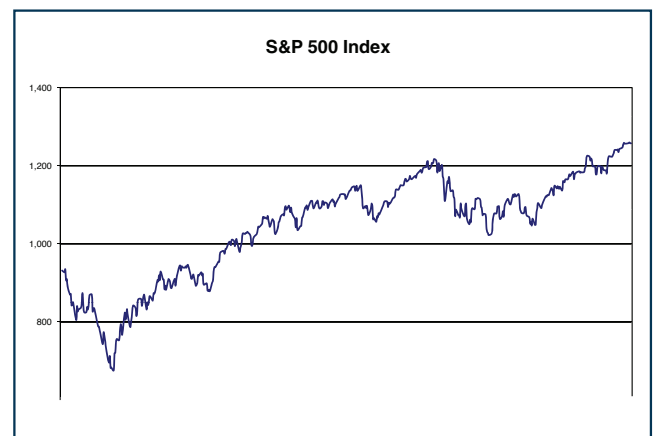
Higher interest rates are actually a sign the economy is beginning to recover. A steepening yield curve, signifying that long-term rates are climbing more quickly than short-term rates, is usually a positive indicator that reflects increased optimism for future economic growth. A longer term perspective is very important. Rates will move up and down on medium and longer term bonds but we still expect the Fed to keep short term rates low in 2011. We would not be shocked to see the 10-Year Treasury rise to the low 4 percent range this year.

Our focus on individual high quality bonds with stated maturities and defined, predictable cash flows will continue to provide comfort

to our clients even when the market value of bonds fluctuate. Investors holding individual bonds receive both the intervening coupon payments and the bond's redemption value at maturity, despite changes in the underlying value of the bond in the interim.

## Stocks

There were many global events filling headlines and affecting stock prices throughout 2010, including sovereign debt crises, the "flash crash", military transgressions, and election year outcomes. The S&P 500 Index finished up 15.1% for 2010. Stock prices continue to be driven by an improving economy, the benefits of Quantitative Easing (QE) and good fourth quarter earnings announcements. Year-to-date in 2011, stocks have continued the strong rally that began in September and intensified in December.



The fourth quarter earnings season is off to a good start, with more than 70 percent of the S&P 500 companies having reported, earnings are on pace to increase for the fifth consecutive quarter (+32 percent year-over-year). While earnings growth is expected to slow in 2011 (12-17% y/y) earnings growth should continue to support stock prices in 2011.

Stocks have had one of the greatest runs since the Great Depression. Stock prices as measured by the S&P 500 Index have nearly doubled since the March 2009 intraday low of 666.79 and have reached prices last seen in October 2008. Nonetheless, stock prices are still 15 percent off the all time high reached in October 2007.

The S&P 500 stock index is currently trading at about a 14x price/earning ratio on the expected \$94.00 per share earnings estimate for 2011. This year, we expect more modest returns for the S&P 500 compared to the outsized gains we saw in 2009 & 2010.

In the meantime, the equity market has begun to show modest signs that a correction is needed. In our analysis, a retrenchment in stock prices more likely represents a pause rather than something more sinister and would be an opportunity to add to equity holdings.

## Outlook

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Looking ahead, there is considerable evidence that a turn in the economy is at hand. The data continues to indicate that the economy has moved from recession to “Fed Induced” recovery. Nevertheless, problems remain (growing federal debt, high unemployment and weak housing market) which could affect the expansion.

As Chance the Gardener (played by Peter Sellers in *Being There*) so famously stated “As long as the roots are not severed, all is well. And all is well in the garden....In the garden, growth has it seasons. First comes spring and summer, but then we have fall and winter. And then we have spring and summer again ... there will be growth in the spring.”

Yes, the economic recovery will continue and we will have growth in the spring as sure as we will hear the high pitched calls of male popping peepers (sometime around the vernal equinox) that assures us that spring is hear to stay.

## John F. Wisentaner, CFA - Elected to Partnership.

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John F. “Jay” Wisentaner, CFA has been elected to partnership in Norris, Perné & French LLP. Jay joined the firm in 2008 after over 23 years of investment management experience, most recently as a senior portfolio manager at Fifth Third Private Bank, White Mountain Investment and Main Street America Capital Corporation. Jay is a graduate of the Wharton School of the University of Pennsylvania with a B.S. in Economics with a concentration in Finance. He received his Chartered Financial Analyst (CFA) designation in 1990, and is a member of the CFA Institute, the Boston Security Analyst Society and the CFA West Michigan Society.

Jay resides in East Grand Rapids with his wife Mary Agnes and daughter Elizabeth. Jay has been a youth soccer and tee ball coach in East Grand Rapids, a catechist aide in faith formation at St Stephen Parish, co-chair of the University of Pennsylvania Secondary School Committee of Western Michigan, a member of the University Club of Grand Rapids, a member of the The Economic Club of Grand Rapids, and an active member of Rotary Club of Grand Rapids.

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