# J.J. BURNS & COMPANY, LLC

*Second Quarter Newsletter, June 2009*

We started our last newsletter (First Quarter, 2009) with a picture of green shoots and at best a skeptical view of the rally since. One of the points I made was "Beware, Compulsive Optimism." It's easy to get caught-up in a more positive conversation on the improvement of the stock market. Certainly, the volatility was un-nerving to say the least. To the well informed investor, the true economic data must be pondered a bit more. Real economic data is ultimately what drives all asset classes.

## Market Technical's

Recently the bears have been growling. Short interest (bets on stocks declining) on the Big Board rose 1.62% in the second half of June. All of the major indices are below their 50-day moving averages while the S&P 500 and the NYSE Composite are struggling at their 200-day moving averages. The industrial average (DOW) slipped below the 200-day moving average. This poses an ominous sign for many stocks. It's quite clear that the green shoot theory espoused by many, has had a nasty fight with a weed whacker. Investors are re-assessing their level of risk. The US dollar is in a bearish trend. Commodities have firmed up but are now giving way to some declines. Gasoline prices are down 35% from where they were a year ago, and consumers have become more frugal.

The initial market enthusiasm we have seen in the first half of 2009, is giving way to a more realistic assessment of the economic environment. The US and global economies may have avoided "Financial Armageddon" and we can argue that some stabilization has occurred globally. I think it's important to note some of the positives that other economists are noting, in so much as we have avoided perhaps the "worst – case scenario":

- Consumer spending - which plunged in the second half of last year, in the teeth of the worst of the housing and credit woes - appears to have stabilized. Households have made progress rebuilding their savings, and some



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of the factors that likely drove them to retrench -- declines in their net worth and tighter credit conditions- have recently begun to reverse, at least partly.

- A return to even modest growth in consumption should help business investment - which has fallen off a cliff in response to faltering consumer demand, tighter credit conditions, and heightened uncertainty.

- Fiscal stimulus is starting to kick in too, and will likely build into a significant boost to aggregate demand later this year and into 2010.

- Financial markets, which came close to seizing up, have improved dramatically, aided by a massive policy response. Credit spreads have narrowed, credit flows have improved, bank lending standards are being tightened less aggressively, and banks have returned to profitability.

However, there continues to be considerable uncertainty about the outlook. There are many dimensions to our economy. Historically, deep recessions typically were followed by strong recoveries. However, this is not a "garden variety recession." In past recessions, the economy slowed and the Federal Reserve Bank lowered interest rates to stimulate lending and thus restart a growth cycle. What makes this recession different is we have a credit bubble and a real estate bubble which lead to a "consumer bubble." A major part of the problem is we never took lower interest rates away from the consumer which lead to behavioral problems of lending that created the biggest real estate bubble ever in the United States.

## The New Frugality: Housing What A Drag…

During the 2002-07 credit bubble, auto sales were locked in a 15-20 million units annualized range the whole time, but now they are in a 9-10 million range. Many economists get excited over the monthly gyrations and what they might mean for the incoming retail sales data, but what is more important from a big picture standpoint is the fundamental trend, which is down. This did not just happen to autos but in housing as well. From 1980 to



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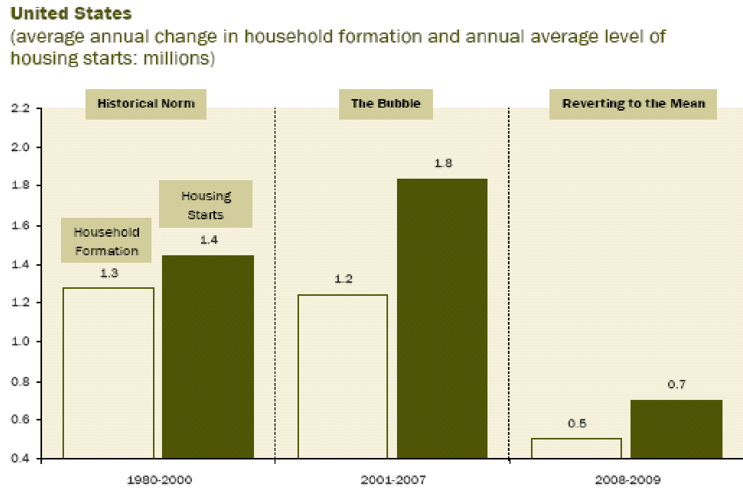
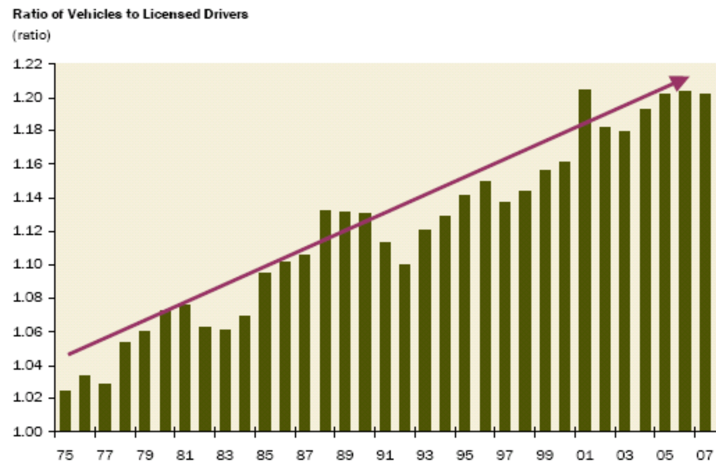
2000 US household formation averaged 1.3 million per year and housing starts came in at 1.4 million units annually. The 100,000 gap reflected the depreciation of the housing stocks. During the bubble from 2001 to 2007 even though the demographics became less constructive for the homebuilding industry, household formation slowed to 1.2 million at an average annual rate. Housing starts were running at an average of 1.8 million per year. Never before had there been such a gap between supply and underlying demographic demand – the gap was rampant speculation as real estate emerged as the asset class of choice. At the peak of the bubble, one in four households in the market to buy a home was doing so for investment purposes.




This bubble can also be seen in the automobile industry by the ratio of vehicles to licenses drivers. The average 3 car family will likely shed one car and become a 2 car or less family.



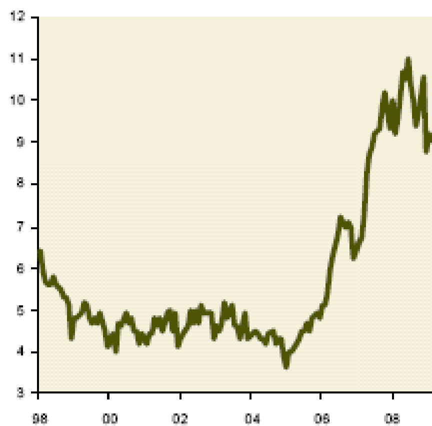

What makes this downturn different and more troublesome than its predecessors is the downside potential for consumer discretionary spending. The level of non-housing durable goods assets on household balance sheets, even after adjusting for the increase in the population and inflation, is almost 20% higher today than it was during the last consumer recession in 1990-91 and 40% higher than the consumer recession of the early 1980's. (1)

Many of the analysts, economists, economic strategists seem to be ignoring what "getting smaller" is for the US consumer. This new frugality trend of the consumer will show up under the guise of the "New Normal" of the US Economy. As was recently indicated by Dave Rosenberg, former Chief Economist and Strategist at Merrill Lynch, "Our advice for investors is to focus on the forest not the trees. We are forced to interpret the collapse in credit we are currently experiencing as a secular event. Correctly assessing that reality is undoubtedly the key to the success of our analysis over the next many years."

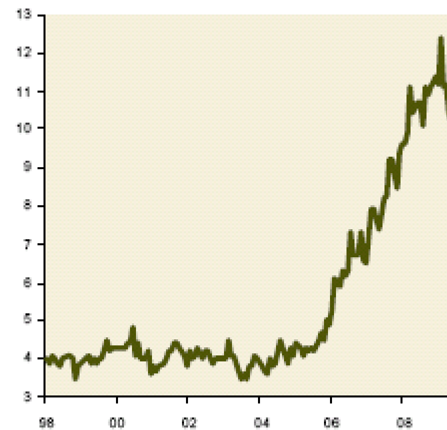
The level of unsold homes in the US is quite staggering at over two million. If you go back to post World War II lows it will take about 5 years to make up the excesses in housing inventory. The Case Shiller Index of Housing recently had securities listed on the NY Stock Exchange which imply a further decline of 8% for the next five years in the residential housing market. What this all means, is that house price deflation is here to stay for some time. Why is this important? Because this is an overhang of our credit markets and banking sector which from our view looks a bit cloudy for banks into the future. It's also an overhang for the debt strapped average consumer.

**United States: Single-Family Unit**
(months' supply)

Existing Homes on the Market




New Homes for Sale




## What About Jobs?

Unemployment has ticked up to nearly 10%. The current level of people filing for unemployment claims is still consistent with 350,000 drop in payrolls for the current month. What the current figures do tell us is the lack of job growth, as there is simply reluctance for businesses to hire. This means that 6.88 million people are without jobs. What we have learned though, is this figure is a lot higher. When you look into the fact that many employers have gone to part time hours, furloughs,



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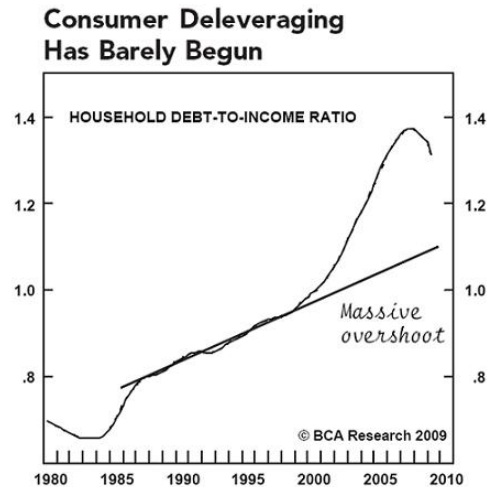
underemployed - unemployment figure grows to over 16% of our work force. Rosenberg illustrated to me there are some 9.2 million unemployed workers as 2.5 million people are still on the 2008 emergency unemployment compensation program, and many other stragglers that are not counted in the reported total. Average workers compensation has declined quite a bit as well as illustrated by the graph below.

## Consumer Deleveraging

The average American consumer is just in the early process of deleveraging their balance sheets. Some good news is that we have seen a large increase of mortgage re-financings, however, not nearly enough. Interest rates have overshot on the downside due to fiscal stimulus making the adjustment of adjustable rate mortgages lower than their origination in many cases. Therefore, if a consumer should be on shaky ground with their employment then why should he/she consider re-financing into a fixed rate mortgage making his payment higher when he has trouble paying the current mortgage now? This reasoning could potentially bring on another wave of foreclosures when interest rates ultimately rise.




## INVESTMENT CONCLUSIONS: Pulling it all together

One of the big uncertainties is the speed and duration of the US consumer to repair their balance sheets. Fortunately for the average consumer he/she cannot hide behind a large balance sheet filled with a questionable loan portfolio as many banks can. Households will be under immense pressure to save more and pay down outstanding debt. We will not be seeing the consumer utilize his/her home any longer as the proverbial ATM machine. If households try to move too fast, it could become self-defeating.

The more aggressively consumers try to boost saving, the weaker the economy will be, with bearish implications for employment and incomes, making it harder to boost savings. Meanwhile, it is hard to see a decent economic recovery without increased credit availability. Banks could remain reluctant lenders for some time. On the commercial mortgage level there is great concern for many more defaults as banks have not opened up to lending much in this area. We have already seen a couple of major shopping malls default on their commercial mortgages, needless to say the scores of foreclosures in the household sector.

While we don't rule out the possibility that economic developments will surprise on the upside in the coming years, it is easier to identify the downside risks. Equity returns are likely to be modest by historical standards. We see some value in the larger cap (mega-global) companies which have broad global diversification which is why we maintain exposure to stocks, however, to a smaller percentage. With continued fiscal stimulus and an improving credit market the values in corporate bonds, US Agencies; TIPS (Treasury Inflation Protection Securities) are too significant to pass up given the uncertain economic environment going forward. Once we are on a clear path of recovery the values in bonds will likely continue to improve and clipping coupon income while we wait is the better valor of preserving assets in ones portfolio.

We wish you and your loved ones a pleasant summer.

Warm Regards,

JJ

(1)Thanks to Dave Rosenberg, formerly Merrill Lynch's Chief Economist for sharing his thoughts and notes with me on a few of these matters.
BCA Research, July 2009



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