

June 19, 2009

Economic Recovery

Economic recovery is currently upon us. Housing starts have moved off the bottom and for the month of May 2009, increased to 532,000 seasonally adjusted with annual rates up from 458,000 in April 2009. In April the seasonally adjusted rate of 458,000 was the lowest monthly rate going as far back as January 1959, the month and year I was born. Back then there were a lot less people living here so I suspect we have probably hit bottom in the housing market.

Ford motor reported that their May sales were awful as compared to last years May sales but this years May sales were much better than this years April sales. It has been a while any car company was excited about their monthly sales in over a year. What this tells us is that consumer confidence is improving and people are starting to loosen up their purse strings which should be good for an economic recovery. Consumer spending makes up over two-thirds of the United States Gross Domestic Product so it is very important that they have confidence in the United States economy. Monthly car sales are an easy way to measure consumer confidence.

Markets

The S&P500 has discounted a portion of this economic recovery as it has moved up from the March lows of 666 to the current 916 or up about +37% off the bottom. Looking forward, by using an estimated \$75 of earnings for the S&P500 by end of 2010 and an average Price Earnings multiple of 16 times we can calculate a forward price target of 1,155 on the S&P500. Let me explain. Historically, the S&P500 has carried an earnings yield 290 basis points above the bond yield. The current 10 year yield is 3.8%; applying a 290 basis point premium implies an earning yield of 6.46% or a P/E of 15.4 times.

What matters from here in the short-term is this quarters earnings releases which will create some uncertainty through the month of July. Once this period is over we can get a better picture on the rest of the year directly from companies we have invested in.

Here is an interesting tidbit from Washington. The market for auto energy sources may become less efficient in the United States. The United States government wants to mandate 26% ethanol gasoline blend by 2026 up from 10% today. A higher ethanol blend theme conflicts with the more miles per gallon theme because ethanol produces 37% less BTUs of energy per unit versus gasoline. This may benefit sellers of ethanol and their suppliers but consumers pay the difference.

Interest Rates

The yield on the 10 year United States treasury is now 3.76% up from two weeks ago of 3.71%. Not much change to speak of.

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