

A Tale of Two Recoveries

Tiffany, “Big Corps” & Bankers Back to Good Times - “Main Street” in Slower Recovery

Corporate Earnings & Overall Outlook

Again, for another quarter overall corporation profits had strong gains. As of 5/26/11 with 491 of S&P500¹ companies reporting 1st quarter earnings, 68% beat estimates. Blended earnings growth was 18.8%. The estimated earnings growth for 2nd quarter is 12.2%. (Reuters)

Corporate earnings growth has far exceeded the growth of stock values, resulting in overall relative low current market valuations, especially for large company stocks.

GDP growth slowed in 1st quarter. While economic signals are mixed the outlook is mostly favorable.

Wealthy Are Spending - Especially at high end retailers such as Tiffany's which on May 26, reported its earnings rose 26% to \$81.1 million and had double digit sales growth.

Businessweek 5/26/11 – “Companies like Tiffany that cater to the more affluent have put up sparkling results, and we honestly think it can continue...The more affluent consumer feels better, and they're spending accordingly.”

The wealthiest in the U.S. who have benefited the most from our free enterprise system, continue to enjoy some of the lowest income tax rates in the world and historically in the U.S.

USA TODAY 5/31/11 discusses how the current recovery, now 2 years old, has been slower than prior recoveries. “Several key sectors are enjoying a strong rebound, particularly manufacturing, exports and business investment in equipment and software. The S&P500 stock index is up 43% the past two years on record corporate profits.”

“The economy has grown at an average annualized rate of 2.8% through the first seven quarters of this recovery, according to Barclays Capital. That's closer to the 2.7% average growth in a similar period of the early-1990s and early-2000s rebounds than the average 6.8% expansions in the months after the 1973-75 and 1981-82 recessions.”

“Corporate earnings are at record levels, but much of the growth is overseas, and efficiency gains have allowed companies to limit hiring. Small businesses are posting better sales, but many can't get loans to

expand. Consumers are opening their wallets wider, but they're constrained by 9% unemployment, still-heavy debt and high gasoline prices.”

Recovery May Pick up Soon Many economists predict better GDP growth in the 2nd half of 2011 and into 2012.

Ironically the tornado disasters may result in as much as \$10 billion in rebuilding spending and unlike the floods; losses are mostly covered by insurance. Insurance company reserves seem adequate. The disruption of supply from the Japan disaster should also be resolved and many companies will benefit from estimated \$300 billion of rebuilding in Japan.

USA Today 5/31/11 - “To be sure, the recovery has been picking up momentum. Job gains the past three months were the best in five years. Private-sector job growth has averaged 253,000 each of the past three months, up from 98,000 in 2010. ‘We're now in a self-sustaining economic expansion,’ says Mark Zandi, chief economist of Moody's Analytics.”

Foreign Growth Variations²

U.K. – The deep government spending cuts are drastically slowing the British recovery. The Financial Times of London 5/31/11 reports, “The UK economy is set to experience the slowest pick-up in consumer spending of any post-recession period since 1830.” Another article talks about “Seven years of sluggish growth forecast.”

Politicians don't seem to know or care much about economics. This of course is a risk in the U.S. if the political perceived “debt crisis” results in rapid spending cuts. Spending cuts will result in more government layoffs which spread to the private sector (multiplier economic effect.) So far, private job growth has offset losses in government but the prior Federal stimulus that went to keep school teachers and other local workers employed is also expiring. With a weak recovery this is no time to drastically contract the government sector. Long term debt reduction is needed, but when the economy is healthier. (More on debt see back page.)

Japan 6/1/11 – Bank of Japan reports that disruptions in supply chains and electricity

disruptions caused by the earthquake and tsunami were easing. This helps U.S. companies get needed parts such as the auto and electronics industry. The economy could stage a moderate recovery starting in the second half of 2011 after falling into recession in 1st quarter.

China 6/1/11- Manufacturing growth edged lower in May but remained stronger than analysts had expected to suggest that the world's second-largest economy was gliding towards a soft landing (as China tries to moderate its high growth as inflation hits a 3-year high.) - Financial Times of London

India 5/26/11 – Tata Steel in India, the world's 7th largest steelmaker reported 72% profit increase to quarterly profit of \$937 million, on strong sales growth both in India and its European operations.

India's strong growth reported 5/31/11 at 8.5% has driven up inflation. The Reserve Bank of India on May 3rd lifted its repo rate to 7.25 per cent. (This compares to our Feds "discount" rate of about 0%,) while the 10-year benchmark bond yield rose to 8.21 per cent. This rate increase resulted in stock market losses or more than 10% this year so far.

Stocks on the India Sensex are valued at an average 14.4 times estimated profit, down from 21.5 times in March 2010, last year's high. (Marketwatch 5/21/11)

As in **many emerging markets** including China and India it is "robust" domestic spending that is driving inflation as the middle class grows in numbers, increases income and moves from rural farming to urban industrialization which also rapidly increases energy demand.

The MSCI Emerging Markets Index is at a multiple of 11.2 times per Bloomberg (quite cheap with still high growth compared to developed markets.) – Marketwatch 5/21/11

Political Debt Crisis – Not Worrying Investors

With the renewed concerns about Eastern European debt, investors again poured into the safety of the \$US and Treasuries. U.S. Treasury yield's plummeted again with the strong demand. The government's \$29 billion offering of 7-yr notes drew the highest demand in 2 years on 5/27/11. The 10-yr Treasury yield fell to a near record low of 3.06%. Investors obviously see no U.S. "debt crisis."

Coverage ratios have remained at about 200% - 250% (twice the demand for U.S. debt than what the Treasury sells) for most auctions. The Feds buying of Treasuries and mortgage securities (QE2) seems to be minor compared to the excess demand for U.S. debt.

During some parts of May the rush to the safety of the U.S. dollar also hurt large U.S. multinationals since the stronger dollar hurts exports. But overall,

the dollar has had a gradual decline over the last few years, which benefits U.S. investors in foreign companies and U.S. company exports. A lower dollar also can help the trade balance since U.S. consumers pay more for foreign imports – thus favoring domestic spending.

While a technical default could shake up markets, many investors seem to realize the ratio of taxes to GDP is quite low in the U.S. and has fallen substantially with the tax cuts mostly for the wealthy. Investors seem to recognize there is plenty of room for tax revenue increases if needed. The political agenda's in the U.S so far have not diminished demand for U.S. debt.

Home Prices Fall More than in "Great Depression"

- 5/31/2011 - Robert Reich, former Secretary of Labor on CNN pointed out that the current decline in average home values from the peak is greater than in the 1930's Depression (33% vs. 31%). Mr. Reich pointed out that banks after being "bailed out" and with banker bonuses now at all-time highs, they are forcing home values down by foreclosures instead of doing mortgage modifications.

Many fraudulent foreclosures are alleged in lawsuits by state Attorney General's and class action private lawsuits. For example, Arizona vs. Bank of America (CV2010-033580) for consumer fraud shows the extremes of fraud the banks go to since they make so much more profit by foreclosing vs. doing loan modifications for those that qualify under the "HAMP" Treasury directives. See <http://www.scribd.com/doc/45714419/Arizona-v-Bank-of-America-Complaint-for-Servicer-Abuse>

Other states have similar consumer fraud suits against BofA and other major banks.

Congressional Oversight hearings have also dramatically pointed out the abuse by banks but since the Treasury has no enforcement power nothing can be done. The banks have lots of lawyers to delay and prolong the legal actions while they continue to make high profits on foreclosures with the losses borne by mortgage investors and the taxpayers via GSO's (Fannie/Freddie/Ginnie).

¹Investors cannot directly invest in indices. ²Additional risks are associated with international investing (especially in developing countries), such as currency fluctuations, political and economic stability, and differences in accounting standards. Past performance does not guarantee future results.

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