

# Nicollet



INVESTMENT MANAGEMENT, INC.

## **Newsletter** **August 5, 2011**

In our letter to clients this past month, we summarized our thinking on the markets. The sell-off in stocks this past week warrants an update on what is going on and where we stand. We know the sell-off was unsettling, largely because everyone was told the market's direction hinged on the debt ceiling debate in Washington. That was resolved and stocks still sold off.

We did not view the debt ceiling debate as the critical issue for the markets. We viewed it as inevitable that a game of brinkmanship would give way to a deal. Neither Congress nor the President stood to gain any advantage risking a debt downgrade during an impasse or by shutting down the government. That debate will be taken up with the electorate in fifteen months.

While attention was diverted, more important things came to light.

### **Slowing U.S. Growth.**

In late July, the government released preliminary forecasts for Gross Domestic Product (GDP) growth in the 2<sup>nd</sup> quarter. The release showed a significant slow-down in consumer spending and a continued drag on GDP growth from state and local government budget cuts.

The only "robust" segment in the economy was business spending. But business spending also happens to be the most volatile component of GDP. The concern now is that if other segments of the economy slow, businesses will follow suit and cut back. That would be enough to push the economy back into recession.

### **Slowing China Growth.**

Embedded in companies' 2<sup>nd</sup> quarter earnings reports was a fairly universal message. Chinese economic growth is slowing. Chinese policy-makers have been raising interest rates and restraining credit for a while now, in an effort to take some of the frothiness out of their economy. They were concerned about an overheated real estate market and easy credit creating structural inflation.

Companies with operations in China reduced 2<sup>nd</sup> half revenue estimates noting the slowing business activity there.

### **European Sovereign Debt**

We have expressed our concern that the government debt problems in Greece, Portugal, and Ireland would roll into the marginal finances of the Spanish and Italian governments. Our read has been that the problems of the smaller three countries could be contained by the European Union (if the Germans continue to go along with it). We believe European leaders could delay the inevitable bankruptcy of Greece until the worldwide economies are more stable. We felt there was a possibility Portugal and Ireland could be stabilized.

A recent deepening of the problems in Spain and Italy take the risks to a whole new level. In the past week, problems are arising with government debt in Italy. Europeans understand the risks. Cash is now flowing out of Europe into the U.S.. In fact, yesterday we saw major U.S. banks announce that they are going to charge customers for cash accounts. In other words, you can forget about earning a yield on your cash, it's going to cost you money to keep it in the bank!

## **Corporate Earnings**

Throughout all of July and now continuing into August, companies have been reporting their financial results for the 2<sup>nd</sup> quarter. In summary, earnings look pretty good. Companies continue to generate strong profitability in spite of the muddled environment.

We are starting to see the effects of higher commodity price on corporate margins, creating some concern about future profitability. Companies are trying to offset this inflation by passing along the cost increases to customers. They have also been spending to improve productivity. The question at hand is whether those actions will offset cost inflation.

In projecting the balance of the year, managements are being cautious in their outlooks. The risk is that a slowing economy coupled with higher input prices reverses the current strong trends.

To that we would overlay our belief that current stock prices reflect a cautious outlook for corporate profitability. In short, the overall value given to stocks is not high by historical standards.

## **Putting it Together**

We cannot predict whether the U.S. economy goes into another recession. The most probable case is continued slow growth with a heightened chance we see a quarter or two of economic contraction. Yet it's important to remember that the forces causing this slow recovery are not new, they are the same problems we have confronted since the real estate market collapsed and pushed us into a recession.

We have spoken at length about the sources underlying the slow recovery. In a nutshell the issue is debt. Too much debt held by households and government entities is impeding the recovery. In the 2<sup>nd</sup> quarter, we learned that households saved 5% of their incomes, in light of the fact that incomes barely grew. What this means is that consumers are working at repairing their finances. This will just take time.

This fact is well incorporated into expectations. In other words, one reason stock valuations have stayed at the low-end of the historical range is the recognition these drags on the economy will be with us for a while.

As noted above, China's slow-down has led companies to become more cautious in their view of 2<sup>nd</sup> half growth. China and all the emerging Asian markets are an important source of worldwide economic growth. What we have to keep in mind is that the current slow-down has been a policy choice, and it is doubtful the Chinese will have any interest in sustaining restrictive policies. Here is where keeping a longer term perspective will be important, China and most of Asia are on a multi-decade growth path. It is very difficult to time the cyclical ups and downs, so a longer term perspective must be maintained.

But Europe is a different story in our view. As we sit here today, the single biggest issue in our minds is the debt crisis in Europe. It has the potential to set off a pretty serious shock to the world economy. The crisis has heated up with surging rates on Italian debt, and the European Central Bank is trying to stem a "run on Italy" by buying the debt on the open market and flooding the economy with cash.

In our stock strategies, we have maintained between 8% to 10% cash positions. This is well below the almost 40% cash we held going into the 2008 financial crisis in the U.S.. We would like to emphasize how difficult it is to time markets, especially when stock valuations are not excessive. Nonetheless, we are monitoring the situation closely recognizing further deterioration in Europe would warrant becoming more defensive and sitting this out on the sideline.

The structural problems in the U.S. economy and the near term weakness in China do not warrant taking drastic action. We just do not believe we can consistently move in and out of stocks based on short-term projections for economic growth. That risk is addressed by owning a mix of stocks and bonds that ensure money held in stocks is long-term. Cyclical downturns reverse. The structural impediments in the U.S. are well known. Europe is what bears watching.