Commentary

The stock market continued its upward movement in the third quarter of 2009. Second quarter earnings had been a surprise, with over 70% of companies beating earning estimates, and that bullish signal fueled a continued upward movement in the markets.

As I have mentioned in recent commentaries, companies have been slashing inventories, payroll, and capital spending in response to the dismal economic climate. The quick response from companies probably magnified the initial steep drop off in economic activity, but also limited its duration and lasting affect. In the subsequent earnings season, companies were surprisingly profitable, but profits were fueled by cost cutting, and not by increasing revenues. However, cost cutting is limited, what we ultimately need to yield sustainable earnings power is revenue growth. As our current situation has been called by some “The Rally that Revenue Forgot”, it is quite possible that we will see yet another quarter of earnings surprises.

In mid-September, the Fed Chairman indicated that the recession is “technically” over, meaning that the decline in economic activity has very likely bottomed. That announcement further stoked market optimism. However, as the markets were closing the quarter, the Fed began to outline plans to exit its current programs supporting the Treasury and mortgage markets. This was not well received, as some of the Fed’s language was taken to suggest that interest rates could be increased at a far greater pace than anticipated. Any attempt to reduce the liquidity the Fed has been providing via low interest rates is deemed a threat to the current bull market as the economy is still very fragile.

The big unknown factor here is the consumer. Credit is still somewhat tight, unemployment is still on the rise, and consumers are not likely to open their wallets until they feel secure in the belief that they are not going to get laid off or fired. So in that light, the American consumer is not going to be the source of a global boom and, thus, will not drive a global recovery. Recent heavy job losses, coupled with weak but slightly improving housing indicators, weak revenue growth prospects for most companies, and the apparent inability of the economy to grow without help from the government, have created a difficult environment to navigate from a stock selection perspective.

So where do we see opportunity? Emerging markets are beginning to rebound, especially in Brazil. We will look for companies that promise to serve as engines for growth. Candidates can be found in banking and natural resource sectors, and we will continue to look at look at drug stocks (remaining cautious, however, of political reform risk). Despite the fact that the prices of oil and gas have gone in opposite directions, we are still very bullish on oil and gas stocks, and we feel that the natural gas stocks, in particular, are undervalued, thus creating opportunity.

A silver lining here is that there is a tremendous amount of stimulus money set to kick in during the fourth quarter and going forward. The stimulus money, compounded with an overall perception that the economy will improve, will hopefully help to promote additional gains we have witnessed thus far in 2009.

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