

Scout Investments

Economic and Market Outlook

Our Stand

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William B. Greiner, CFA
President and
Chief Investment Officer
william.greiner@scout-ia.com

2011 Outlook

GDP GROWTH:
3.2%

UNEMPLOYMENT:
9.4%

INFLATION:
1.75%

FED FUNDS RATE:
0.35%

Now that both of our short-term and long-term outlooks have been published, it makes sense for us to compare our outlook to the “average” economic/market pundit’s view. What do we believe in relation to the average group – in other words – what is our stand for economic growth, etc.?

In summary, we believe our stand to be slightly more optimistic than the average outlook on “the street,” although we have witnessed many pundits have been moving their opinion closer to ours. We have been holding the view that consumption growth will be reasonable as 2011 unfolds. One big variable for the year overall will be business spending. We believe business confidence is improving – as witnessed by CEO Confidence surveys. This data is backed by recent readings of the ISM Indexes – which measure the health of the nation’s industrial manufacturing base. The latest read of this index is at 57.0. New orders, production, employment and supplier deliveries are all in positive, expanding territory. Indeed, we believe growth in business spending – for capital expansion, hires and acquisitions – will dwarf growth rates in consumption for 2011.

However, the real key to the sustainability of the current economic push will probably center on improvements in the job market. On Friday of this week, we will get the number of the month – the Bureau of Labor Statistics (BLS) December employment report, which includes the unemployment rate. The ADP report came out this morning, showing the private (non-government) segment of the economy created 297,000 jobs! This was a significant surprise. One needs to remember that the ADP report has overstated the BLS report in only 5 occasions. The service-providing sector of the economy kicked into gear in December (including seasonal adjustments) by hiring 270,000 new workers. We expect to see job gains in excess of 150,000 on Friday’s report, and expect to see the unemployment rate to slide downward but still hold around the 9.5 percent level.

Segmented Market Performance

Beyond our view, it is interesting how the market has been reacting to a renewed positive view of economic growth. All stocks, of course, are not created equally. Neither are stock “sectors” – segments of the stock market broken into broad business types. Following are standard economic sectors and how, on average, the stocks in each of these sectors are priced in relation to all-time high levels we last saw in 2007-08.

<u>Economic Sector</u>	<u>Discount to High Value in 2007-2008</u>
Standard and Poor's 500 Index	-19.50%
Consumer Staples Average	-0.75%
Consumer Discretionary Average	-6.18%
Information Technology Average	-8.28%
Health Care Average	-13.72%
Materials Average	-16.81%
Industrials Average	-20.66%
Energy Average	-24.98%
Utilities Average	-26.92%
Telecommunications Services Average	-28.81%
Financials Average	-57.67%

Since the peak in 2007-08, consumer stocks, technology, health care and materials stocks have outperformed the market. On average, all others have underperformed (industrials, energy, utilities, telecom and financials). For those investors who are “reversion to the mean” types, this information would lead one to consider purchasing the more financially-levered sectors (utilities, financial services) and eschew the less economically sensitive areas of the market (consumer, health care). We do not count ourselves in the “one decision” crowd of purchasing assets based on one data point. But, the deviation of return from one segment of the market to the next is highly interesting considering this data stream includes relative performance during very poor and very good portions of the cycle.

We believe the above data is best viewed on a “one-off” basis. The following are questions investors need to ask themselves.

- Consumer Discretionary Area – This segment of the market is loaded with companies which distribute products we as consumers do not necessary need to buy. Perhaps one reasonable question to ask is – **does the average consumer only feel “marginally” poorer now than was the case at the high in 2007?** We believe due to the destruction in consumer balance sheets which took place in 2008, discretionary consumer consumption will probably grow slower than it has in the past. Other issues which may have a dilutive impact on the sustainability of discretionary consumption:
 1. Unemployment is still above nine percent. This may continue to lead to soft consumption patterns;
 2. Housing. Are we out of the woods regarding home values on a national scale? We continue to hear of concerns regarding home prices; and,
 3. We believe consumption patterns are fragile. If (some would say when) we see another “Black Swan” event occur due specifically to over-leverage, one wonders about the sustainability of the current “burp” in discretionary consumption trends.

If these thoughts are valid, one has to wonder about the longer-term sustainability of consumer discretionary stock values, particularly in relation to the market.

- **Should a financial service company’s shares be selling at 58 percent less than they were in 2007?** This, in our opinion, is a mixed bag. We are finding a number of high-quality financial service organizations whose balance sheets are not over-levered with world-class franchises selling at deep discounts to values posted a few years ago. However, it is true that the necessary de-leveraging of the nation’s balance sheet (so far centered in the consumer and business segments) is going to hurt companies which prosper due to a rise in the use of debt. Additionally, many segments of the financial services industry are becoming commoditized. Lastly, we are of the opinion that the nation’s capacity within the financial services segment is simply too large. It needs to shrink, and has been doing so for a number of years. Now that shrinkage has become systemic, our experience tells us

that when an industry is consolidating, and capacity is being unwound, profitability suffers. With these issues in mind, it probably makes sense that much of the financial services business shares continue to sell at deep discounts compared to values in 2007.

Emerging from the Trench

On September 24, 2010, we published our piece “Emerging from the Trench.” At that time, the S&P 500 was trading at 1,148. On January 3, 2011, the S&P closed at 1,271 – up 10.7 percent from September. How much more upside does the market have prior to a serious correction? Of course, nobody knows the answer to this question. But in our recent piece, we outlined why we believe stock prices will continue to move to the upside for a period of time during 2011. Eventually, the market is going to become much more selective in which stocks will perform well. While we sense the market is becoming more vulnerable to a correction, we believe that correction, if it occurs, should be reasonably contained.

Now – about that Black Swan on the horizon ...



William B Greiner, CFA
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Scout Investments

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