the
SUSTAINABILITY
GROUP

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During the slightly more than four months since I last wrote, the markets have continued their remarkable rise. Now, as the Senate takes on the Financial Reform Bill, some crosscurrents are becoming obvious. It is a good time to look at your overall asset allocation, reviewing safety versus potential appreciation, and be certain that you have the balance you want.

Why has the MSCI World Index, which I use as a proxy for global markets, risen by 82% since March 9, 2009, when it bottomed? It has to do with the nature of Wall Street. Stock buyers make purchase decisions based on what they consider to be improving outlooks for the company in question. These past months there has been quite a lot of information that led them (and me) to believe that improvement was underway. By the way, the Standard & Poor's 500 is up 80% over that period; American stocks have had a huge run.

Monday of last week (March 29th), consumer spending numbers spurred the buying. Marketwatch.com ran with the lead line, "U.S. stocks ended higher on Monday after another monthly rise in consumer spending offered further evidence of a sustained economic recovery."

The Institute for Supply Management announced April 1st that its Manufacturing Index rose to 59.6 percent in March. That is the highest the index has been since July 2004. According to the report, "The past relationship between the [index] and the overall economy... corresponds to a 5.4 percent increase in real gross domestic product.” That's a very robust improvement from the dismal predictions of a year ago.

One indication of how well some industries are recovering is the glee in automobile circles. Mike Jackson, CEO of AutoNation, said the industry is in store for a “Fat V” recovery. What he means is that the recovery is completing the V shape begun by the drop.

Employment figures were also encouraging (at least to market watchers). 162,000 new, non-farm jobs were added in March and the unemployment rate was held unchanged at 9.7 percent, according to monthly employment numbers released April 2nd by the U.S. Department of Labor. While improvements were boosted in part by the roughly 200,000 jobs that resulted from temporary hiring for government-backed jobs the census made necessary, the numbers were non-the-less welcomed as a turnaround.

Against this barrage of happy news remains the fact that most stock pricing formulas (the dividend discount model being most common) find that stocks are “fairly” valued. In other words, the market is neither a bargain nor a balloon-waiting-to-bust. What this implies is that stocks will rise if the earnings at underlying companies rise. And it looks like they will.

So why do I have this feeling that it is time to play it a little safe? The things that have me a bit on edge are outside the classic economic world and have more to do with political climes.

The financial reform bill released by Senator Christopher Dodd of Connecticut is better than nothing. However, it fails to address a great many of the root causes of the financial collapse. Rather, it states who will decide how and when to intervene. While in general I like to let smart people make decisions in the context of the current, this is just too problematic. After all, these same designated positions (Secretary of Treasury, Head of Federal Reserve, etc.) all existed three years ago and all were held by the very people who set in motion the collapse. Yes, I want to see this bill (or better) pass, but no, it isn't close to preventing the repeat next time.

And then there's what one reads about China. For the YouTube crowd, Al Jazeera English news cast covers the growth there in a way that frightens the economist in me. For fun, watch http://www.youtube.com/watch?v=Oh7Y3Twb-Ok. It tells a story that has been viewed by over 430,000 people. You learn of an entire brand new city, one that looks quite beautiful, that was built with Chinese government stimulus money, but is empty. Only speculators have been able to afford it. And we read about the wind turbines in China that have no grid to connect to. Now I believe that there is a Chinese miracle, but it is very possible that there is also a need for the Chinese government to slow the development of real estate and capital projects until the people's economy catches up. This may be a two or three year hiccup.

Finally, there is the question of inflation. For some time now, financial pundits have seemed obsessively worried about it -- and the ensuing increase in interest rates it would shepherd in. Slightly better job numbers for a couple of months could, in fact, be what pushes the Federal Reserve to raise rates. Higher rates would mean, amongst other things, that investors will have an even greater incentive to stay in cash reserve funds (they'd finally pay interest again) and not to enter the stock market. The silver lining for the market in the near terms is that to date, Fed officials appear more focused on ensuring self-sustaining growth (meaning without government stimulus) than concerned about inflation.

Putting all this together, I'm liking the highest quality companies, those with real dividend growth, and those companies that offer innovative solutions to real problems thus generating their own growth -- and not much else.

Sincerely yours,

Amy Domini

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