The lessons of 2010

Looking back on the year, we have to ask ourselves why debt crises in Greece and Ireland, the foreclosure crisis, the tax turmoil, and wobbly economic data didn’t kill the business cycle or permanently chill the market. Why did we believe this recovery would keep going?

Stories about the structural deficits in the United States and other large countries have captured headlines. However, we believe that these problems will play out over the long term and it is more important, in the short term, to focus on the current business cycle.

I would say that in the near term the forces behind the business cycles are more powerful than the debt and deficit problems on which the doomsayers and “double dipsters” like to focus. It is the power of these forces that have caused me to believe that the recovery and expansion is likely to continue into 2011.

What are the forces powering the current business cycle?

1. cheaper goods and services, i.e., affordability
2. pent-up demand
3. a reemphasis by corporations on productivity and profitability
4. international trade
5. cheap money provided by the central banks

These forces are the drivers of growth, and we need to watch them.

Rather than looking at the problems of governments, I think it is more important to look at where the money is and who is likely to spend it. The dramatic rise in profits of U.S. corporations was a clue to me that the business cycle would be fed by very high-octane money. It is the profitability, the cash flow, and the resourcefulness of U.S. companies in reducing debt and becoming more productive that have helped push the recovery.

I try to focus on the ability of companies to continue to generate cash and profits. In 2009 many companies began to understand how to adapt to a crisis situation and still make money in a very weak environment. When the economy began to improve, these companies reaped the benefits in terms of operating leverage and profit margins. This cash in the hands of corporations is a very potent fuel for economic expansion and growth.
What about 2011?

Profit and cash flows rise again. The profit resurgence from the recession is not over in terms of absolute dollars, margins, or return on equity. While profits are not likely to achieve the same kind of percentage gains we saw in 2010, profit growth has not flattened out or reverted to the mean as many people had said it would.

But, we expect profits to continue to rise in 2011 for two reasons:

- **Capacity utilization rising.** Profit margins have not reached their peak in this cycle. Profit margins and profits don’t peak until we are running our plants and equipment at full throttle; that would be capacity utilization at about 80%. We are at 75% now.

- **Unit labor costs falling.** Labor is the biggest line item for U.S. companies.

So, when I look at capacity utilization and falling unit labor costs, it causes me to believe that profits will continue to move up in 2011 at a pace that should be slower than 2010 but still probably stronger than many people think.

My other themes for 2011:

- **Price/earnings multiples could expand along with rising profits.** Multiples in the market are low by historic standards, reflecting doubts about the viability of the recovery. As fears abate, the market could assign a normal, or higher multiple, than today.

- **The late cycicals become midcyclicals.** Metal, mining, energy, and chemical companies may rise sooner than in past cycles. In other words, the late cyclical companies that often do well toward the end of a cycle may this time do well earlier in the cycle. This shift may result amid pressure from emerging market countries, which are experiencing the rise of a middle class. Such countries are intensive users of these basic materials.

- **Sectors.** Technology (again) and health care (again).

- **Interest rates and bond prices may stay range bound.** I believe the bond market has already priced in much of the fear about growth and possible inflation. I don’t think bond prices can fall much further. Why? Because as much as the market wants rates to go up, the U.S. Federal Reserve Board is adamant about putting a ceiling over them. To this end, the central bank intends to use its balance sheet to crush the bond “vigilantes.”

- **Credit.** Credit is supported by low default rates and easy access to the bond market; the fundamentals are strong, but valuations, by historic precedent, are not compelling.

- **In general, growth rates outside the United States are stronger.** I believe international growth will be stronger than U.S. growth, but this trend does not favor international companies. U.S. publicly traded companies are tapping into international growth like never before, and investors should keep in mind that U.S. unit labor costs are still falling. That trend is a big component of the profits story. Also, investors need to remember that many U.S.-based companies sell to high-growth foreign markets.
Some final thoughts on the markets

• As companies put their cash to work, I expect to see a rise in dividend payout ratios, continuing stock buybacks, and a rise in merger and acquisition activity. The rise in mergers and takeovers should help smaller companies that have not on average reached their previous margin peaks.

• Moderate inflation returns, driven by better labor markets and production bottlenecks. I believe the bond market has already anticipated much of this. I think inflation should remain at moderate levels and not present a major risk. Slight inflation could actually help the economy. Inflation allows companies to increase prices. Workers feel better when wages are increasing as long as costs are not increasing as well. Historically, stocks performed best when inflation was between 3% and 4%.

And, of course, I have to explain my biggest worries for the year 2011:

• Gas prices at the pump. The consumer is indestructible; well, almost. Very little stops the U.S. consumer; however, higher energy prices, which result in higher gas, heating, and air conditioning costs, do take consumption dollars out of the system. Crude oil is rising now, and we should become more cautious once gas prices hit $3.75 per gallon.

• Bubbles in stock prices. Right now the rise in profits supports the price/earnings multiples in the U.S. and European stock markets. However, if cheap money, now being provided by the big central banks, continues and drives stock prices beyond those fundamentals, we will need to pull back our enthusiasm for equities.