Quarterly NEWS
GHP Investment Advisors, Inc.
Third Quarter 2010

A Tale of Two Economies

by Brian J. Friedman, CFA

> *"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us, we were all going direct to Heaven, we were all going direct the other way…"*
>
> ~ Charles Dickens, "A Tale of Two Cities"

Is the economy recovering or on the brink of another collapse? Most people are not sure. The financial markets are volatile with the S&P 500 Total Return Index up 5.4% in the first quarter, down -11.4% in the second quarter and finishing this quarter with an 11.3% gain. Although the index is now up 3.9% for the year as well as 74.3% higher than the financial crisis bottom, very few people truly feel confident about the economy or their portfolio.

Our society is experiencing financial bipolar disorder or perhaps the economic equivalent of post-traumatic stress disorder. The steady stream of improving economic data is often drowned out by large financial crisis aftershocks. For example, European companies reported improving profits in the first half of 2010 while European governments were pressured by tumbling bond markets. Earnings at American public companies also improved but home foreclosures reached record levels. Bank balance sheets are healthier, but lending is shriveling. Home sales plummeted in August, but retail sales gained. How are we to make sense of these seemingly contradictory pieces of information?

One Quarter Depression, Three Quarters Recovery

The crippled credit markets explain most of the economic dichotomies we are experiencing at present. Some products, services or businesses are simply more credit intensive than others. In other words, if a product is so expensive that many consumers must borrow to purchase it, then the demand for that product is constrained by the weak banking system. Examples include homes, automobiles and college tuition. Similarly, businesses that require access to substantial amounts of credit for their operations will also remain weak. Examples include commercial real estate, airlines and banking. Credit-intensive industries comprise about one quarter of the U.S. economy and activity in these businesses could remain well below their former peaks for a considerable period of time (see **Chart 1** highlighting housing starts at a 60-year low). The remaining three quarters of the economy did not require as much credit during good times and these industries remain less burdened by banking problems now.

Another difficult to understand economic contradiction is that although credit-intensive industries are depressed, the threat to the global financial system is abating. **Chart 2** highlights loan write-offs by U.S. financial firms during the credit crisis. After peaking in the fourth quarter of 2008, losses finally declined to zero last quarter. This may surprise many people given the high level of foreclosures

(see **Chart 3**), but remember most mortgage securities plummeted in value earlier in the crisis and banks were forced to write them off at that time. Ironically, some banks actually "wrote up" some of these loans this year since recoveries from foreclosures exceeded the write-offs. Perhaps only accountants and government regulators understand the logic behind confusing accounting "principles" like these.

Bank balance sheets are healthier because profits are rising (thanks to the Fed's 0% interest rate policy), loan losses are diminishing (due to the accounting scenario discussed above) and because of new cash infusions from stock offerings. Banks are not lending, however, as foreclosures limit the attractiveness of real estate as collateral and regulators require larger capital cushions. Rather than borrowing more money, Americans are collectively reducing debt (see **Chart 4**). Some of this debt reduction is due to write-offs and foreclosures, but a great deal is the result of principal payments. Another economic irony is that our improving balance sheets are good for the long-term health of American businesses and consumers, but hurt credit-intensive industries in the short run.

Now for the Rest of the Economy

When the American economy was primarily industrial in the early 20th century, businesses employed fixed capital in the form of factories, land, warehouses and inventories that served as effective collateral for bank loans. Although the stock market crash of 1929 is often remembered as the event that ushered in the Great Depression, in fact the securities markets—both for stocks and bonds—were very small at that time. Instead it was the implosion of the banking system that caused credit to dry up and business activity to grind to a halt. The majority of business activity was credit intensive at that time.

Fears of another Great Depression were very real as the Federal Reserve took action to inject liquidity into the financial markets and the federal government passed the TARP legislation to save the banking system. The current structure of the U.S. economy, however, is radically different than the economy that existed during the Depression. Since that time, we shifted from an industrial, fixed-asset economy to a service and information economy. Service and information industries now account for more than three quarters of economic activity and employment.

Service and information businesses are generally not credit intensive. Either they employ few bankable fixed assets or their activities involve a higher degree of risk than most lenders are willing to accept. For example, few businesses borrow money to purchase expensive software systems. In some cases these systems cost significantly more than a factory for an industrial company or perhaps an office building, but the rate of obsolescence is far faster. Other examples abound in diverse areas such as medical equipment, telecommunications, even oil exploration (a highly risky activity that is only partly bankable).

We compiled data on the 112 large economic sectors represented in the U.S. stock market. The median debt ratio is only 39% of total capital and only 32 industries have debt to capital ratios in excess of 50%. A relative handful of U.S. industries are very highly indebted. They comprise all of the usual suspects such as real estate, airlines, some financial industries and automobile manufacturers. A much longer list of less indebted industries includes software, retailers, telecom, insurance, health care, energy services, consumer non-durables, etc.

Despite the persistent problems in credit-intensive industries, the remainder of the economy is already recovering. A key indicator of this trend is the rebound in corporate profits. As can be seen in **Chart 5**, earnings per share for the companies included in the S&P 500 Index are almost back to their former

peak in 2007. This is a surprising result given how far profits sank during the depths of the recession. Of course, improved profits came mostly from cost reductions rather than increased sales, which explains why unemployment soared and could remain high for a long time.

Chart 6 shows three large companies we selected to further illustrate the dichotomies and contradictions in the U.S. economy at the present time. We could have chosen many more, but we believe these companies illustrate the point adequately. D.R. Horton (DHI) is a large home builder. As you can see from the chart, earnings plummeted to a loss during the recession and are only now just breaking even. Based on the housing construction data in **Chart 1**, it is very unlikely that earnings will return to their former high in the near future. In fact, it may take many years for D.R. Horton to achieve the level of profits it earned in 2007.

Meanwhile, despite the fact that Target Corporation (TGT) is directly exposed to the stressed consumer, earnings dipped only modestly in 2008 and 2009, and already exceed their former high. Of course, Target is a discount retailer and benefits somewhat from consumers looking for more modest prices in a difficult environment, but many of their customers are also the same people facing job loss and home foreclosure. Even though Target's financial performance remained relatively steady during the recession, its share price plummeted -63.8% from peak to trough. It still remains 23.8% below its high even though earnings are now higher than they were back then.

Finally, PepsiCo, Inc. (PEP), which sells beverages and snack foods (they also own Frito-Lay), was hardly impacted by the recession. While sales growth slowed significantly, profits continued to grow. This did not prevent a -42.4% decline in its share price during the financial crisis, and the stock remains 15.8% below its all-time high. PepsiCo and Target operate with very moderate debt levels (both companies operate with a debt to capital ratio of around 37%), and their consumers do not require significant credit to purchase their products. D.R. Horton also maintains a modest debt ratio, but most of its customers must take out a mortgage to buy a new home.

The economy is recovering—on average—but credit-intensive activities will continue to struggle. Their recovery will only accelerate once the banks are fully recapitalized and home foreclosures abate. This will likely take several more years. Meanwhile, those who generalize that these are the "worst of times" because of credit related problems will continue to miss the rebound already underway in the remainder of the economy. Economic contradictions and dichotomies may continue to plague us with volatility and confusion, but they make more sense when dissected to understand their connection to credit availability. Reworking Dickens a bit helps us understand our economic future. "It was the age of foolishness but we are entering the spring of hope."

Chart 1

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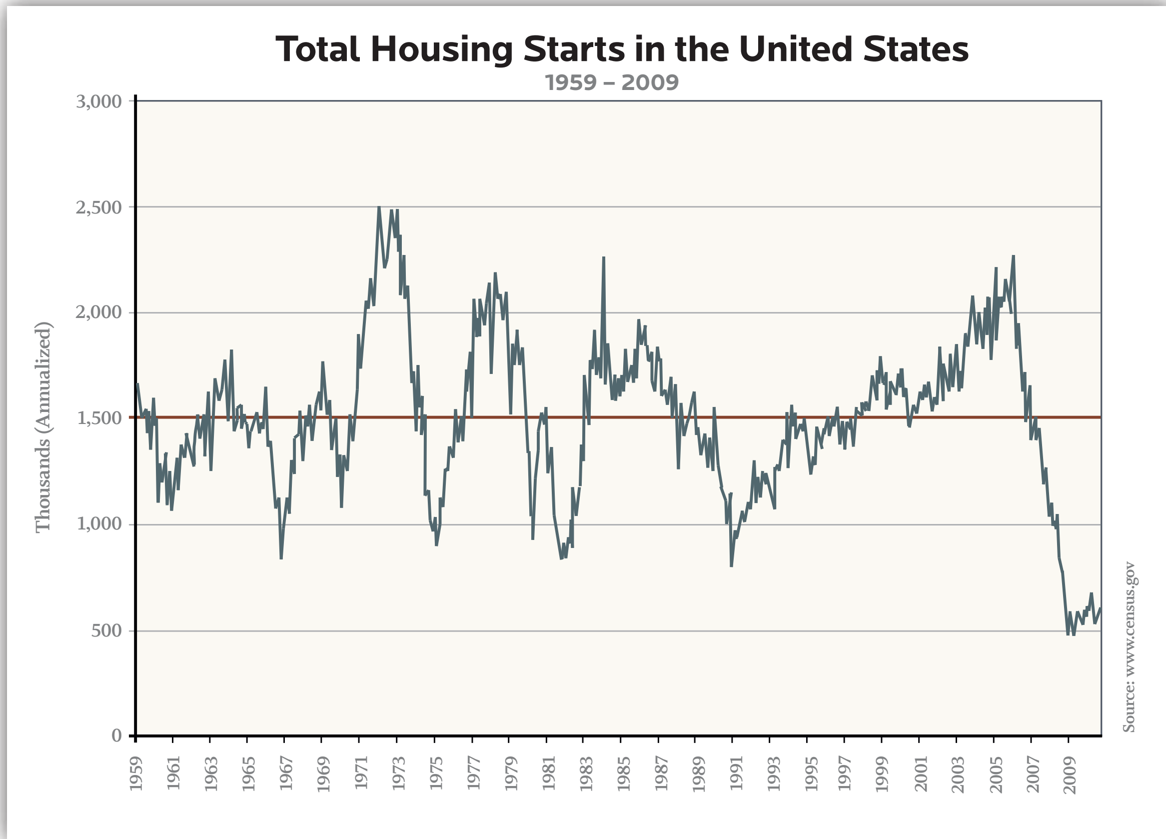

Chart 2

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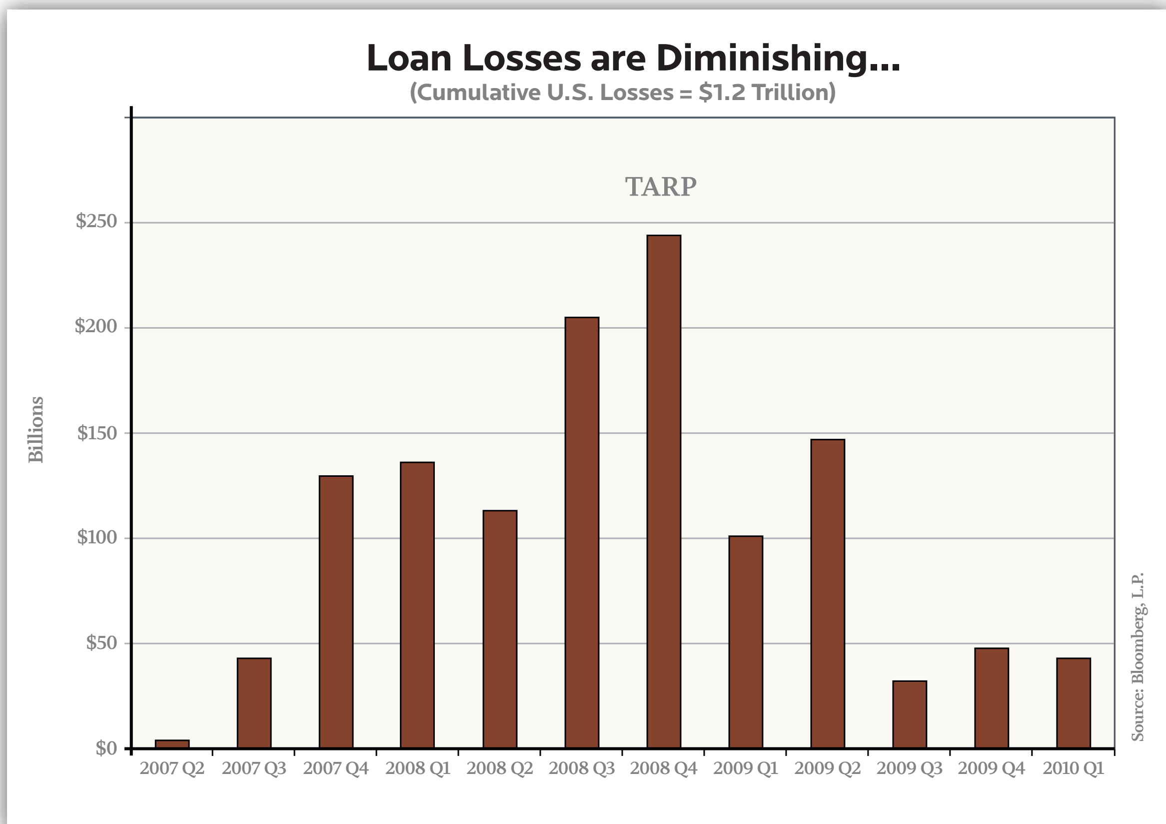

Chart 3

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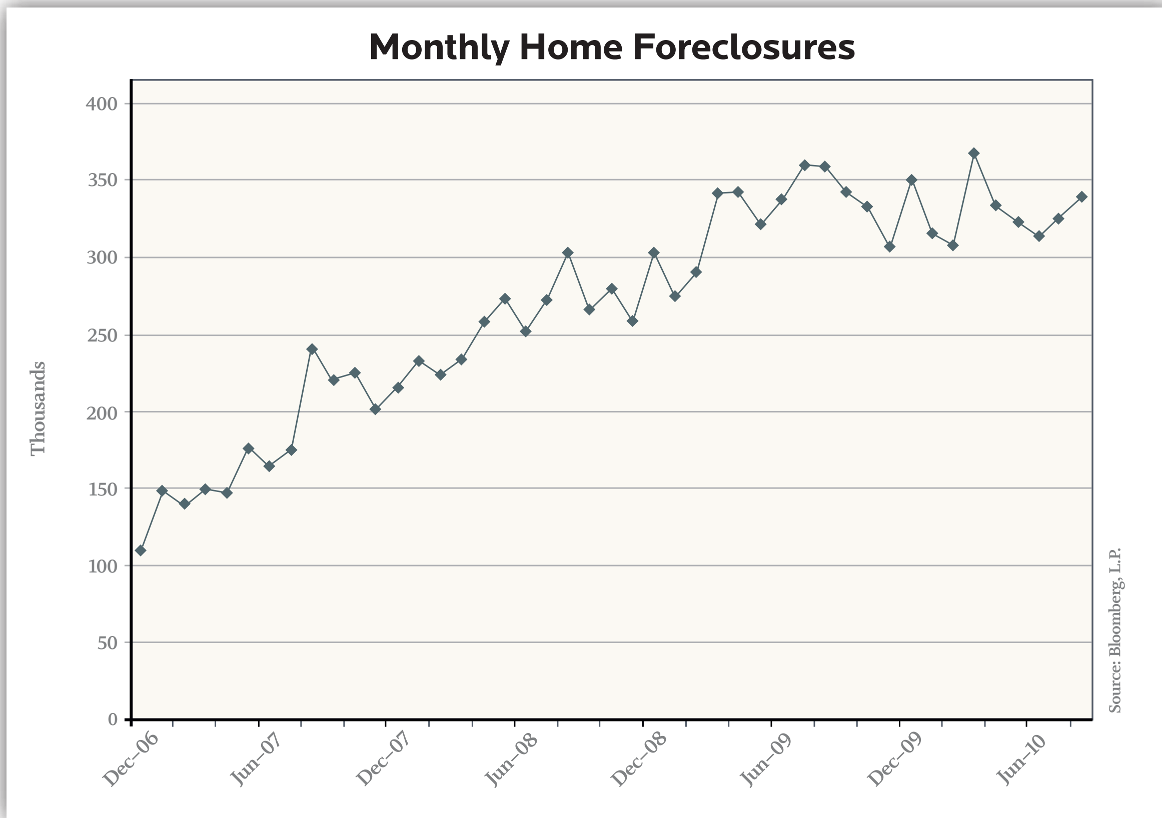

Chart 4

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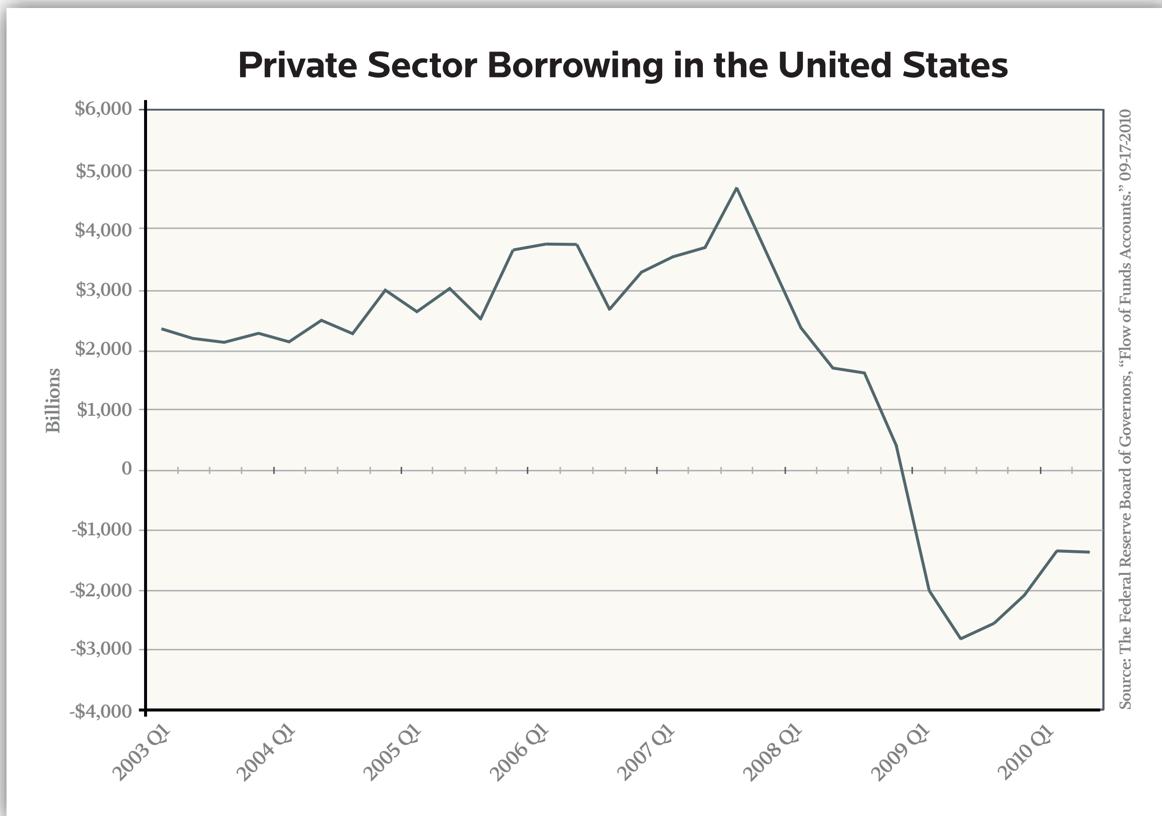

Chart 5

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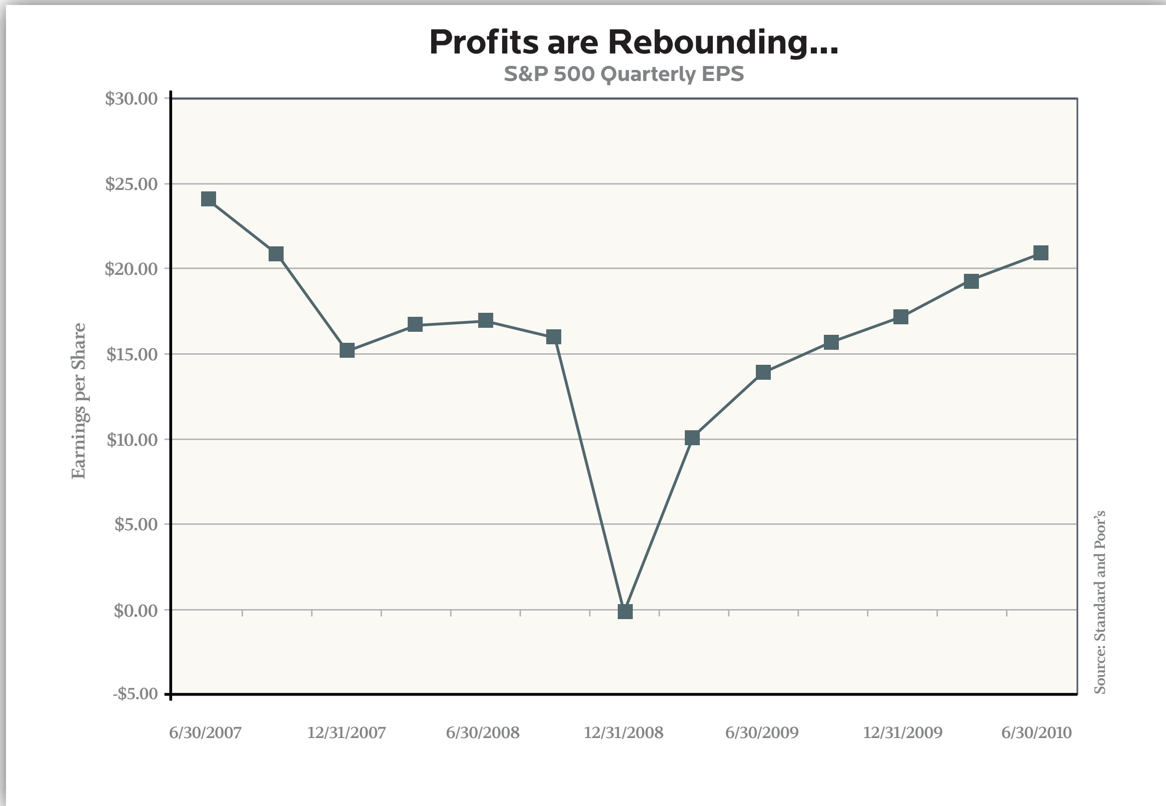

Chart 6

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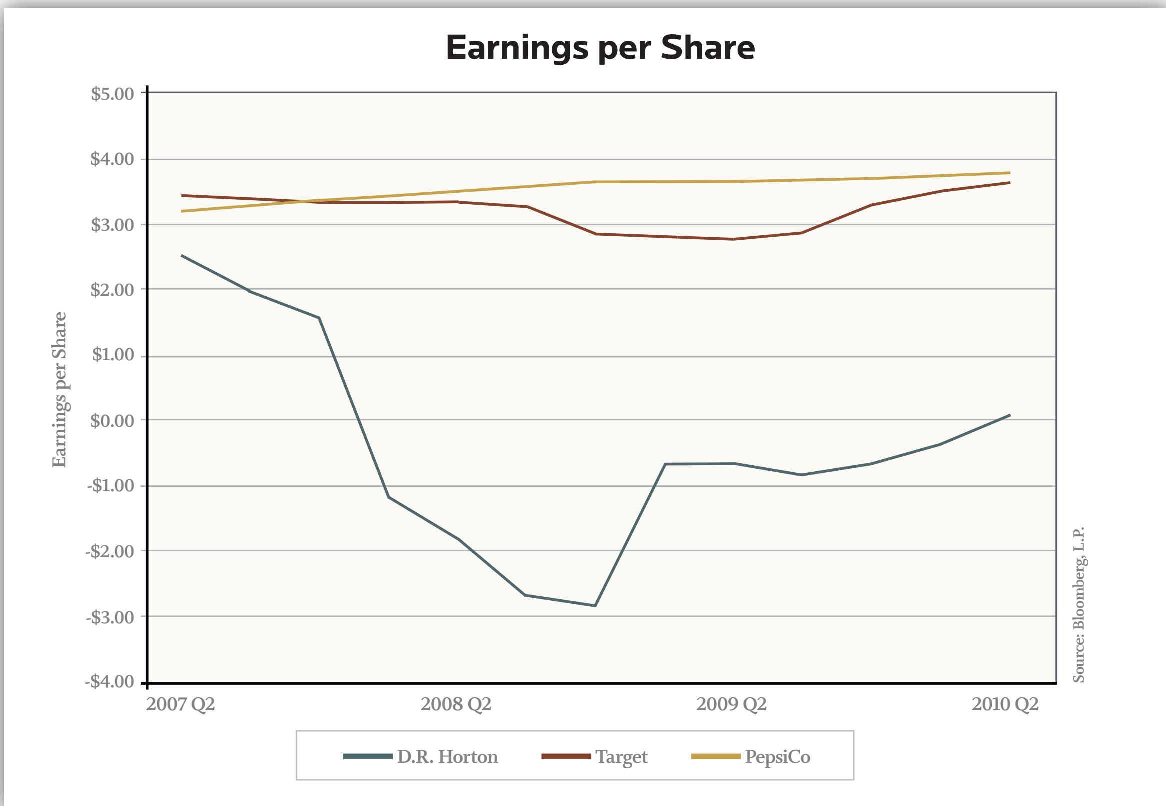

Market Summary

Key Financial Ratios for Domestic Asset Classes

Asset Class	Price/Earnings 2010:Q3	P/E Benchmark	Over/Under Valuation	Price/Book Value 2010:Q3	P/BV Benchmark	Over/Under Valuation
Large-Cap Growth Stocks	16.3	27.0	-39.6%	3.1	5.7	-45.6%
Large-Cap Value Stocks	13.9	20.2	-31.2%	1.7	2.5	-32.0%
Mid-Cap Growth Stocks	19.9	24.8	-19.8%	2.8	4.5	-37.8%
Mid-Cap Value Stocks	21.4	19.1	12.0%	1.5	2.2	-31.8%
Small-Cap Growth Stocks	21.3	23.2	-8.2%	2.2	3.5	-37.1%
Small-Cap Value Stocks	35.8	18.2	96.7%	1.4	2.1	-33.3%

**Please note that the P/E data reported above are based on "as reported" earnings information rather than "operating" earnings. "As reported" earnings include one time write-offs whereas "operating" earnings reflect the profitability of a company as a going concern. We believe P/E's based on operating earnings are a better long-term valuation indicator, but Standard and Poor's does not report this information for the style indexes used in our calculations. Amid economic recession, declining earnings impact price-related ratios and "as reported" earnings can be significantly lower than "operating" earnings (particularly in the Value segment of the market) due to large write-offs. As a result, the P/E ratios listed above are higher than they would be using "operating" earnings for the denominator. To address this issue we have included Price to Book Value (P/BV) data, which are less affected by the impact of declining earnings and large write-offs.*

GHP Investment Advisors, Inc. benchmarks are based on proprietary discounted cash flow models. P/E and P/BV data provided by Bloomberg L.P. as of 9/30/10.

Returns by Index

Index	2010:Q3*	YTD*
DJIA Total Return	11.13%	5.60%
NASDAQ	12.62%	5.17%
S&P 500	11.29%	3.89%
S&P 500/Value	9.98%	4.15%
S&P 500/Growth	12.63%	3.63%
S&P MidCap 400/Value	11.48%	9.25%
S&P MidCap 400/Growth	14.79%	13.99%
S&P SmallCap 600/Value	9.19%	7.54%
S&P SmallCap 600/Growth	10.05%	9.85%

DJIA & NASDAQ: Bloomberg L.P. as of 10/1/10.

S&P Returns: Standard & Poor's (October 1, 2010) Standard & Poor's Reports September Index Returns. Press Release.

**Dividends Reinvested.*

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