

Messy Middle.

Commentary

Old Mission Investment Company LLC

Any period of transition is messy. The economic climate is in a state of flux, with a common theme of ‘show me’, echoed during the most recent earnings season. Has the market proven that it is resilient? You bet. Is there still an improvement that needs to happen? Sure thing. But let’s take a look at the environment for stocks in a different light, giving the economy the benefit of the doubt.

In 2008, investors didn’t believe that a recovery was possible. Everything was in doubt. Corporate earnings weren’t to be trusted, balance sheets provided ‘sketchy’ details on the assets held by corporations (especially banks), and the earnings visibility was terrible. Investors weren’t willing to make a bet on American stocks, let alone those across the globe, without the proper conviction that a real and sustainable growth pattern can be re-established. Through the downturn of 2008 and 2009 (and we use the word ‘downturn’ lightly here), companies shrank balance sheets and income statements. Sales figures were poor and the consumer was down for the count.

We made it through the third quarter 2010 earnings season relatively unscathed. Companies reported earnings that were better, on average, than analysts and investors had expected giving the world a surprising view from the inside out – that things weren’t nearly as bad for corporate America as they seemed. Have things actually improved? Could it be that the stimulus has actually worked? We will be the first to admit that one good quarter doesn’t make a trend, but we have had more than just a few good quarters.

Companies have reported earnings well in excess of what was expected. This is what is normally referred to as a ‘positive earnings surprise’, something that many people would like to see happen, but it generally doesn’t happen with regularity. Eventually the markets

‘get wise’ to a company that continuously under promises and over delivers. Apple Computer, among other companies, reported profits that were almost 15% higher than most had expected, something that seemed to happen with regularity with many companies during the last earnings reporting period. These types of reports caused many investors pause, asking the question ‘is it really improving, or just a temporary return to profitability?’ Based on the past earnings season in addition to those in the recent past, one might conclude that the earnings situation has improved substantially from a few years ago. The consumer is not dead, and companies have managed their balance sheets and income statements effectively to take themselves to a more efficient and ‘lean’ position that they haven’t seen in decades. Necessity, as you could imagine, is a great motivator. Companies found ways to mitigate the lackluster banking and lending environment and are better as a result.

Much like many policies and initiatives, there is always a ‘stage two.’ What is the second stage to this recovery? In our opinion, companies have made significant and substantial changes for the better concerning the governance of their balance sheets – we mentioned this earlier. The consumer has begun to save again, which is something that is also a positive step, fundamentally, for our economy. Banks, however, are still drum tight in their lending practices, and until that changes, consumers will still be learning to do more with less. But, what about when the tide turns and businesses and consumers find the lending constraints less of a burden to capital expenditures and banks begin to lend again?

The ‘stage two’ concept looks at things this way. Companies will eventually have access to capital once again. Consumers will also have access to bank lending capital in due time also. But until then companies are still able to generate

additional sales, trim their bottom lines and make the necessary adjustments to their business patterns to ensure their success during temporary periods of an economic downturn. Businesses never want to fail and they will do what ever is required to keep their financial health from deteriorating into a negative death-spiral. Once lending is restored and jobs come back into the system individuals can begin to spend a bit more freely, we can work on the larger, more systemic issues that our government faces.

Until then, low interest rates will keep the wind at the backs of major corporations looking to secure low interest financing options from the debt market. As an example, it was reported that Johnson and Johnson just secured both intermediate and long-term financing for over \$1 billion in debt securities at an interest rate barely over 3.5%. IBM secured intermediate-term financing for a little more than 2%. These are hidden benefits that will have a much more permanent impact on the intermediate and long-term income statements for corporations and businesses. As interest rates rise they will have benefited and *will continue to benefit* from the low interest rate opportunities exhibited by this environment.

The ‘messy middle’ can’t be avoided. We are in between a period of restructuring for both corporations and our own personal balance sheets. In this case, when normality returns we feel that owning stocks might be profitable once again. As Warren Buffet has said ‘once the Robins have come, spring is over.’

Old Mission Investment Company is a fee-only registered investment advisory firm located in Traverse City Michigan. They provide wealth management solutions to individual investors. They can be reached through their website at www.omico.net. Old Mission Investment Company is neither a tax or legal advisor.