

Quality Watch

First Quarter 2010

How The Economy and the Stock Market Differ

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Key Highlights

- ▲ In 2009, many investors were surprised to witness a strong stock market while the economy continued to weaken. Meaningful differences between the nature of stocks and the economy account for the divergence.
- ▲ When compared to the economy, the stock market is a leading indicator, has more foreign exposure and is less reliant on the U.S. consumer.
- ▲ In 2010, we expect to see the stock market recovery slow down even as economic indicators pick up.

Executive Summary

Last year confused many investors as the economy continued to be mired in recession while the stock market soared over 60% from the low in early March. There were disastrous reports all year regarding the worsening employment situation, ballooning government debt, and weak dollar. Many quickly concluded that the stock market recovery was unnatural and unsustainable. That conclusion ignores fundamental differences between the stock market and the economy. Although related, they are not the same. For this reason, we highlight three key ways that the stock market differs from the economy in an effort to shed some light on 2009 and to help prepare for 2010.

First, the stock market is a leading indicator of economic activity and will move well in advance of the economy. Second, the stock market has significant foreign exposure. Third, the market has much less sensitivity to changes in domestic consumer spending than the overall economy. As a result of these differences, the trajectory of the stock market can deviate from the economy.

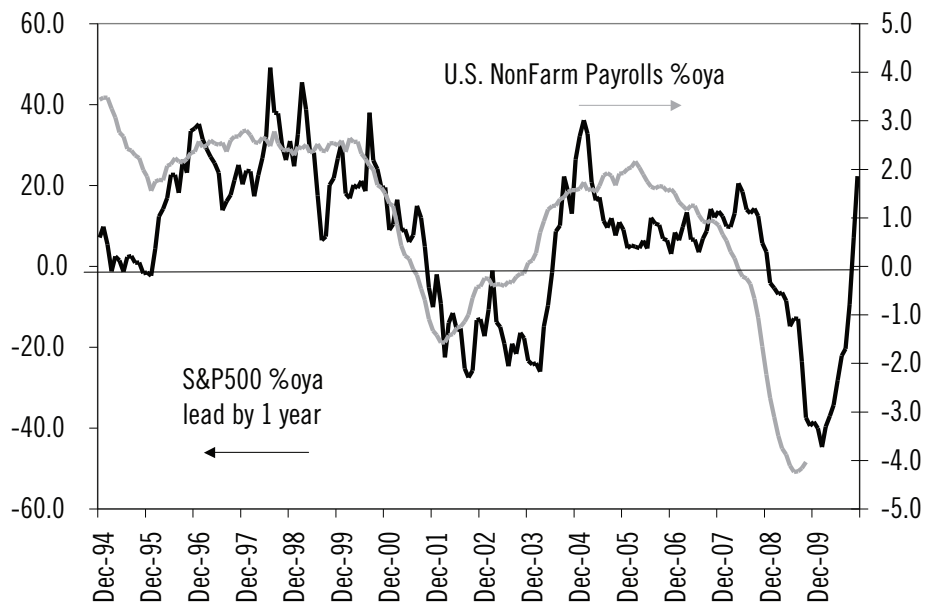
For the purposes of our analysis, we use the S&P 500 as a proxy for the overall stock market since it is among the most common investment vehicles used for exposure to equities. We expect the market to grind higher in 2010 but returns will be more tempered as the recovery ages.

The stock market leads the economy

One of the most striking differences between the stock market and the economy is the timing of their movements. The stock market is inherently forward looking and tends to anticipate changes in the economy in advance. The economy, on the other hand, tends to respond with a lag to the stock market. This difference can cause confusion. In 2009, for example, we saw the stock market soar even as the employment situation deteriorated. Many commentators were befuddled that the market would show such strength as the economic situation worsened for the majority of Americans. Some even viewed this divergence as a sign that “Wall Street” was profiting at the expense of “Main Street.” These perspectives ignore the fact that the market is looking forward while economic indicators are looking back.

Figure 1 shows the S&P 500 against U.S. Nonfarm Payrolls, the most common measure of employment. In this chart, we moved the S&P 500 forward by one year to show the close correlation between stocks and employment. As you can see, the stock

Figure 1: S&P 500 and U.S. Nonfarm Payrolls



Source: FactSet Research Systems, Bureau of Labor Statistics, Morgan Asset Management
“% oya” is percentage change over a year ago.

market tends to anticipate changes in the employment situation by about a year. This anticipation results from equity investors evaluating earnings projections for corporations in the years ahead. The information on employment, on the other hand, is calculated by the Bureau of Labor Statistics using data from the previous months.

Looking at the 2009 upswing in the stock market, investors appear to be expecting that payroll reductions by companies will result in a more competitive and efficient corporate landscape over time. A more competi-

tive employer should eventually create more opportunities for employees as the economic situation improves. But the process does not unfold all at once. Employers need to see better than expected demand for their products and gain a sense that the worst has passed. As employers gain confidence, they will first extend the hours for employees on staff. As the load on existing staff becomes too great, the employer will increase headcount. The timing of this process will differ across industries. Nevertheless, it is not unusual to see stocks heading in one direction while

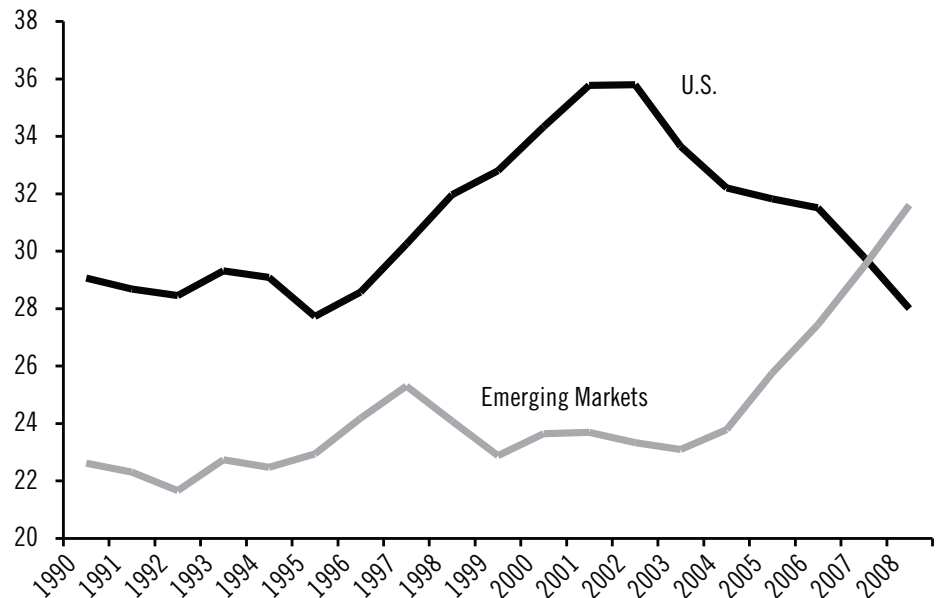
employment indicators point in an entirely different direction.

The stock market has significant foreign exposure

When pundits point to weakness or strength in the United States (U.S.) economy, they are usually referring to the growth rate of Gross Domestic Product (GDP). GDP is the most common measure of economic activity.

It captures the monetary value of all finished goods and services produced within a country's borders in a specific time period. GDP includes all private and public consumption, government outlays, investments, and exports less imports. Clearly, GDP is intended to be a measure of domestic activity. The stock market, on the other hand, does not pretend to be domestic. The S&P 500 is comprised of leading companies domiciled in the U.S. Some of these companies do all of their business inside the U.S., while others generate some or all of their earnings abroad. If prospects for economic growth shift more toward economies abroad, U.S. companies can shift their operations to leverage this growth. U.S. GDP, on the

Figure 2: Global Consumption Share U.S. versus Emerging Markets (%)



Source: JP Morgan Economic Research, Morgan Asset Management

other hand, is designed to ignore activity outside our borders. This difference helps explain why the S&P 500 can see earnings growth even as the U.S. economy struggles.

In years past, the U.S. consumer was the focal point of global economic activity. Even today, the U.S. consumer accounts for roughly 70% of U.S. GDP and an estimated 28% of all consumption worldwide¹. Of course, the U.S. is still a dominant force in the global economy but this position of dominance has begun to fade. Consumers

in emerging markets are becoming increasingly relevant. In fact, their share of global consumption has surpassed that of the U.S. consumer (see Figure 2). Emerging markets are experiencing a significant expansion of household purchasing power as more people rise into the middle class. This transition results from industrialization and more open economic policies. It also creates opportunities for U.S. companies

¹ "EM consumers: engine of global growth" December 4, 2009; JP Morgan Economic Research

to expand overseas and find receptive markets for their goods and services. Currently, 40% of all S&P 500 revenues are derived overseas². We may see this figure increase over time. As a result, economic headwinds in the United States will become less relevant to U.S. based companies doing business abroad.

Within the S&P 500, the areas with the most foreign exposure are Information Technology, Energy, Materials, and Industrials. These groups also happen to be the most cyclical areas of the market. As a result, even though the S&P 500 derives more revenue at home than abroad, foreign economies can have a tremendous impact on the volatility of S&P 500 earnings by impacting the most cyclical groups.

The economy is more U.S. consumer reliant than the stock market

As mentioned previously, U.S. GDP is about 70% driven by household consumption. This figure includes mostly stable purchases like shelter, utilities, food consumed at home, and health care. It also includes discretionary items like food consumed at restau-

rants, recreational goods and services, and jewelry. Similarly, the S&P 500 includes companies that produce basic necessities and discretionary items. However, the exposure of U.S. GDP to U.S. household spending is much greater than that of the S&P 500. We estimate that the portion of S&P 500 earnings driven by U.S. households is only 35% , much less than the 70% personal consumption component of U.S. GDP. Therefore, a change in U.S. consumer spending will have twice the impact on U.S. GDP than on the S&P 500.

To understand why the S&P 500 has less consumer exposure, consider health care. According to the third quarter GDP report, U.S. households spent \$1,633.0 billion on health care (11.5% of total U.S. GDP and 16.1% of total personal consumption). The report showed that this spending went primarily to hospitals, nursing homes, doctors and dentists. Most hospitals are privately-held, not-for-profit or government-owned. They are therefore not a part of the publically traded stocks listed on the stock exchange. In fact, hospitals account for only a very small portion of the S&P 500. Instead, global pharmaceutical companies dominate

the health care component of the S&P 500. These large global firms are less reliant on the U.S. consumer than hospitals. We estimate that U.S. households purchase about 44% of all goods and services sold by S&P 500 health care companies. This figure adds up to only 7% of all S&P 500 earnings. It is therefore incorrect to assume that changes in health care spending by U.S. consumers will have the same impact on S&P 500 earnings as on U.S. GDP.

2010 Outlook

In this report, we highlighted three key ways that the stock market differs from the U.S. economy. Figure 3 summarizes our findings and should help investors better evaluate how the market may behave as events unfold in 2010.

We expect that the stock market recovery that began in March, 2009 will

² International Strategy and Investment Group, Inc.

³ We approximated this figure by examining the S&P 500 earnings across industry groups and backing out the international portion. Next, using company samples as a proxy, we separated earnings according to consumer or business end-markets. Our 35% is a rough approximation but is still decidedly below the 70% U.S. consumer figure in the U.S. GDP reports.

⁴ Bureau of Economic Analysis, Department of the Commerce, Gross Domestic Product Report, third estimate, Table 3, December 22, 2009. Figures are nominal dollars, seasonally adjusted at an annual rate.

Figure 3: Difference between U.S. GDP and the S&P 500

U.S. Gross Domestic Product	S&P 500
Lags changes in the stock market	Leads changes in the economy
Domestic	Global
U.S. Consumer is 70%	U.S. Consumer is 35%*
Net Importer	Net Exporter
Service Oriented	Manufacturing Oriented

Source: Morgan Asset Management
 *Morgan Asset Management estimate

continue into 2010 but the returns will be more tempered than the 2009 rebound. The environment that led to the recovery remains largely in place as we head into the New Year. Namely, monetary policy from central banks around the world is still very growth oriented, fiscal policy remains accommodating, and market valuations are reasonable. Beyond that, corporations have taken measures to improve efficiency and are indicating that new orders are coming in better than expected at a time when inventories are lean. This backdrop should support the market and will eventually lead to an improvement in economic reports as well. We expect

that the first half of 2010 will bring improved payroll figures and increases in industrial production. Better economic news can often create a positive feedback loop as investors feel more comfortable with the overall environment and bring cash off the sidelines and into the market. We should see U.S. consumer confidence finally pick up after years in the doldrums.

Our concerns about the market are geared toward the second half of 2010. At that point, the stock market will likely anticipate the impact of more restrictive policies from central banks and the possibility of higher tax rates on capital gains and dividends⁵ in the

U.S. Clearly, news from Washington will be critical as the year progresses. Also, financial firms will need to follow through on their promises to payback government support and make bank reserves available for lending. Events in the financial sector will also be central to the market in 2010.

As the year unfolds, keep in mind the information presented in Figure 3. The stock market will continue to defy the expectations of those who believe that U.S. economic trends are the sole determinant of stock market movements.

⁵ Taxes on dividends are scheduled to rise from 15% to ordinary income and taxes on capital gains are scheduled to rise from 15% to 20% in 2011.

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We look forward to serving you. For more information, please contact us at 1-866-917-8730.

About the Author



Guillermo Araoz, CFA, serves as the Director of Equity Research for Morgan Asset Management and joined Regions Financial in 2003 after an eight-year banking career on Wall Street. Before Regions, he worked in the Investment Banking Division of Goldman Sachs evaluating high-tech start-ups that served the banking industry. Prior to Goldman, Guillermo worked for JP Morgan in the Economic Research and Investment Banking Departments. He holds an MA from the Johns Hopkins School of Advanced International Studies and a BA in Economics from the University of California, Davis. Guillermo is also a CFA charterholder and member of the Alabama Chartered Financial Analyst Society.



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