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The Health of Markets
An analysis by David Kotok, Cumberland Advisers
By Jane Schneider

With a shaky U.S. economy still recovering from the 2008 recession, investors are eager for some good news. But any economist worth his salt recognizes that forecasting the stock market is like forecasting the weather: It's easy to get it wrong. So economist David Kotok, chairman and chief investment officer of Cumberland Advisers, likes to steer clear of too much prognosticating. Instead, he comes before audience members with a guarantee akin to the one he offered during the April Economics Club meeting.

"I come, I speak, I issue a forecast," he says. "And if I give you a forecast and you invite me back, I guarantee you — I'll bring a *new* forecast." Bullish times call for a little humor.

So began Kotok's presentation, a broad brush sketch outlining the health of the world's stock markets and the trends that provide insight into the direction the U.S. and world markets are headed. The first subject Kotok tackled was the buzz around the municipal bond market, which he claimed has actually experienced few problems with defaults, despite the volatile real estate market and much negative press.

Kotok assured investors that, despite the weakened real estate market, municipal bonds have staying power and the default rate on municipal bonds has been historically lower than that of corporate bonds.

"Munis are cheap. We like them. We would buy them," says Kotok.

Much more worrisome to Kotok is the nation's current unemployment numbers. One chart seemingly showed a bit of improvement. But Kotok warns that the federal government's unemployment rate doesn't reflect other realities American workers are facing, like shrinking pay checks and obsolete skills.

According to David Kotok, "it may take up to nine years to close the cycle, in part because the unemployment rate is double what we're used to." The other troubling part of the equation is the presumed 5 million unemployed workers who have quit looking for employment. In Kotok's view, these are workers with job skills that are no longer valued and who have "given up" looking for work. U.S. employment figures don't include this group. Another reality is that one out of every six or so U.S. citizens has less or zero labor income than they did three years ago. "And we haven't been like this in a very long time," says Kotok.

He continued on to say that the 8.8 percent unemployment rate includes people with a higher education, double the norm economists are used to. "That impacts the outlook for students coming out of college. The outlook is much different than several years ago. The economic recovery will be slow and tepid. It will take a long time to get that job gap closed. There are 8 million jobs that aren't there since the downturn. We must close the gap to get the country moving."

What will that take? Kotok estimates there needs to be the creation of 125,000 new private sector jobs per month. Instead, the market is contracting at a rate of 15,000 jobs a month. "Before we have a robust recovery, that must be fixed," said Kotok.

Complicating the employment problem is the mobility workers have enjoyed in the past to travel and move for new jobs is being hampered by the decline of the housing market. Labor mobility is hampered by the unwillingness to sell homes at a loss.

Finally, Kotok talked about the term "irrational exuberance" coined by former Federal Reserve Bank Chairman Greenspan when he was describing the continuing rise in the stock market despite the downturn of the GDP in 2001. Profit sharing was the highest we've seen in decades. Now the opposite is true. Very high profits are being earned because of the slack in the labor market, firms are not expanding hiring quickly and wages are staying low. Further, many of the jobs that are being created are being created abroad. US households are not yet able to increase consumption expenditures.

"There is a movement from the U.S. being the center of the business world; the center is now moving off to the Indian Ocean because of the rising Asian markets." The growth of the world's gross domestic product with China is gaining a larger percent of the world economy, while the U.S. portion shrinks. "We want to be in the share of the world market where the economy is rising not falling." Current trends anticipate these emerging markets will provide a much higher yield than the S and P 500 index. His advice to investors is to buy when the total equity market valuation is 65 percent of GDP and sell when it's at 100 percent GDP.