

# Dr. BOB FROEHLICH



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## KEEPING THE FAITH

"Keeping the Faith" is a song by rock singer and songwriter, Billy Joel, released from his 1983 album titled *An Innocent Man*. This rock-and-roll hit reached #18 on the main U.S. Billboard Hot 100 chart, and #3 on the U.S. Billboard Adult Contemporary chart (also known as old people's music). My favorite lyrics from this hit song go like this: "You know the good ole days weren't always good, and tomorrow ain't as bad as it seems." Wow—the same could be said about our markets. That is, as long as you continue "keeping the faith."

### JOBS MESS

I understand how hard it is as investors to "keep the faith" in our markets and our economy when we're faced with what may be the ugliest job market ever. I make no excuses for this jobs mess, as I don't see a light at the end of the tunnel any time soon. The most recent monthly employment number from August 2011 indicating that we created "zero" jobs was both shocking and alarming. It marked the first time ever in my 34-year career that we actually created "zero" jobs. You simply can't sugar-coat a bad number like that. I dug a little deeper, and this is actually the first time in my entire lifetime (58 years and counting) that we ever had a month during which we created "zero" jobs.

That's not all. Take a quick look back at the jobs market four years ago and you'll find two very disturbing trends. In the second quarter of 2007, our unemployment rate stood at 4.5%. Today, that unemployment rate has slightly more than doubled to 9.1%, and that's actually the good news from an historical perspective. In the second quarter of 2007, only 9.5% of all unemployed people were unemployed longer than 52 weeks. Today, 31.9% of all unemployed people are unemployed longer than 52 weeks. That's a 235% increase in the percentage of people that will be unemployed longer than 52 weeks. Now that's what I call a jobs mess.

However, while I'm really having trouble "keeping the faith" regarding the jobs market, I have no trouble "keeping the faith" regarding our stock market. As investors, the question we need to answer is: Can the stock market do well without the jobs market doing well? I believe the answer is yes.

Let me take your focus away from the weak employment market for a few minutes so I can show you a few reasons why like me, you may want to be "keeping the faith." Energy prices are falling, China's economy is rising, European interest rates may fall, machine orders are rising, and earnings here in the U.S. have already risen. If you can't keep the faith after that, then I don't believe you'll ever be able to keep the faith. Let me explain what I mean, starting with energy prices.

### ENERGY PRICES ARE FALLING

With all of the focus on the debt crisis in Europe, and the debt crisis in the U.S. leading to the loss of our coveted AAA credit rating, you may have missed what's happened to energy prices. Energy prices are, in a word, falling. When energy prices were soaring, all anyone could talk about was how these prices will cripple the U.S. consumer. Well, now that they've fallen, let's talk about how this will help the U.S. consumer. Let's remember that the consumer accounts for 70% of the entire U.S. economy, and that entire 70% just got something that I like to think of as an energy "tax cut" or an energy "pay raise."

The U.S. consumer, which accounts for 70% of our economy, just got the equivalent of an energy "tax cut" or an energy "pay raise."

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When energy prices fall, consumers have more money in their pocket to spend on other things. Also, if I had to pick one thing to get consumers smiling again, it would be lower prices at the gasoline pump—something that consumers see almost on a daily basis. These lower energy prices should lead to higher consumer confidence which, in turn, could lead to higher consumer spending. As consumer spending goes, so goes our economy—or at least 70% of our economy. As our economy goes, so goes our markets. With energy prices falling, I’m “keeping the faith.”

## CHINA'S ECONOMY IS RISING

Next up is China's rising economy. I'll make this one real simple. Almost everywhere you look in China, some important aspect of their economy is rising. Here are the most recent figures coming out of China for August 2011. On a year-over-year basis, vehicle production was up 13.5%, industrial production was up 13.2%, and retail sales were up 16.5%.

Everywhere you look in China, some important aspect of their economy is rising.

While many investors know that the Central Bank of China raised interest rates to slow their economy in order to fight runaway inflation, what many investors don't realize is that this is yesterday's news. Tomorrow's news can be found in these areas which are rising: vehicle production, industrial production, and retail sales. I also forgot one more thing that's rising in China: Starbucks. That's right, the world's biggest seller of coffee in the world, Starbucks, plans to increase its coffee shops by more than 200% by 2015, increasing the number of Starbucks coffee shops in China from its current level of 470 to more than 1,500. When looking at China, it's easy for me to be “keeping the faith.”

## EUROPEAN INTEREST RATES MAY FALL

Moving on to Europe, I actually believe their Central Bank may lower interest rates soon. There are so many complicated problems in this European debt-crisis debacle. Let me add one more. When the European Union was created they, in turn, created the European Central Bank. The European Union gave their Central Bank one, and only one, simple mandate: keep inflation under control. Any Central Bank that has a single mandate to fight inflation will always keep interest rates artificially high in order to slow the economy and keep inflation lower.

While the European Central Bank is winning the battle against inflation, they're losing the war. Europe is heading into a recession. Recent comments out of the European Central Bank indicate that it's considering lowering interest rates in an effort to help the struggling European economy. This would be the single best thing for all of the markets

around the world that sit on pins and needles worrying about Europe. If the European Central Bank lowers interest rates, their currency, the Euro, will weaken.

Once the Euro weakens, it will set the stage for Germany, the largest economy in all of Europe, to lead the way during this recovery. Germany, which exports \$1 trillion dollars of goods and services every year, is the second largest exporter in the entire world, trailing only China. As the currency falls, all of the products that Germany exports outside of Europe would be on sale due to the weaker currency. Remember, as Germany goes, so goes the rest of Europe. If we want to get Europe (including Germany) back on track quickly, we need to have some falling interest rates. I'm “keeping the faith” that this is exactly what's about to happen.

As Germany goes, so goes the rest of Europe.

## MACHINE ORDERS ARE RISING

Let's move back to the U.S. for a minute so I can give you some proof on what happens when your currency falls—in this case, the U.S. dollar. It makes all of your products more competitive (cheaper) around the globe.

The three-month average for U.S. machine tool orders stood at \$484 million as of July 2011, which is the most recent data available. In the early part of 2009, after the near collapse of the entire global financial system, that three-month average number stood at \$130 million. That's an almost unheard-of 272% increase in less than two years. How's that even possible? How about a weak U.S. dollar that makes all of our products more competitive around the globe? Oh—here's one more thing. That \$484 million three-month average is the highest level since the turn of the millennium in 2000. I said this once and I'll say it again: when you find anything at either a decade high or a decade low, pay attention because it's trying to tell you something. In this case, it's trying to tell you to continue “keeping the faith.”

## EARNINGS HAVE RISEN

Finally, let me move on to my favorite topic: earnings. (You better believe that I saved the very best for last.) Earnings have truly risen to unbelievable levels. Earnings growth for the 500 companies that comprise the Standard & Poor's 500 Index<sup>1</sup> was +19% for the second quarter of 2011. In fact, 97% of the 500 companies reported at least 10% earnings growth. At the same time, 70% of the companies had earnings that beat expectations. This is pretty amazing when you realize that these 500 companies are U.S. companies, and that for the entire first half of the year, the U.S. economy grew only 0.7%.

How did these companies do it? In a word, they did it with exports. Once again, the weak U.S. dollar makes all of our products more competitive around the globe. The more competitive we become, the more profitable we become, and the proof is usually in earnings growth.

Here's one more earnings number for you. For the second quarter of 2011, the earnings per share (EPS) for the Standard & Poor's 500 Index<sup>1</sup> was \$25.44. That, by the way, is the highest quarterly earnings per share performance number ever recorded in the entire history of the Standard & Poor's 500 Index.<sup>1</sup> If you need a reason to be "keeping the faith" I think I found it in these earnings numbers.

**For the second quarter of 2011, earnings per share (EPS) for the Standard & Poor's 500 Index<sup>1</sup> was the highest ever recorded in the history of the Index.**

Finally, regarding jobs, I get it. I understand that the jobs picture is a real mess. However, if you can look away from the jobs market and focus instead on falling energy prices, China's rising economy, the potential for falling interest rates in Europe, rising machine orders, and earnings that have risen here in the U.S., you'll see a much different picture. It will also be a lot easier "keeping the faith."

As always, let me bring this commentary to a close with my customary pearls-of-wisdom quote. This one's from Bill Blankenship, head football coach for the University of Tulsa: "Life is sometimes unfair, will you be bitter or better?" My good friend from Midland, Texas, Van Percy, sent me those words of wisdom along with a few others from Coach Blankenship. Whether you're bitter or better, remember to have a great day, keep a positive attitude, and please join me in resolving to remain a long-term investor in a short-term world.

P.S. I wanted to thank everyone for your thoughts and prayers regarding my prostate cancer. Since many of you have asked me, here's a quick update. I decided to take a two-pronged approach to attack this cancer. First, on October 14, I'll be undergoing a da Vinci prostatectomy, which is a minimally invasive robotic-assisted surgical procedure that removes the cancerous prostate gland and related structures. It's the latest, greatest, state-of-the-art medical technology. Second, I've already begun treatment using ancient Chinese acupuncture to help speed the recovery process, and get me mentally and physically prepared for the surgery. If I can continue "keeping the faith," so can you!

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<sup>1</sup> The S&P 500 Index is a composite of the 500 largest companies in the U.S.  
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