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U.S. economy exits rehab

Let the talking heads in the press go on about volcanoes, government spending, and Greek debt. Good for them. These issues are important, but they are not central to our discussion of economic recovery. Their continued mention reminds me of the family discussion about what the weather will be like during vacation — forgetting that there will be no vacation if the family automobile does not run or have fuel in its tank.

Think of this scenario as a metaphor for the U.S. economy. The engine powering the U.S. economy is the corporation, and that engine is in powerful shape. Look at cash, cash flows, costs, revenues, and profits. Our engine is running fast and strong in April 2010. And, what is fueling that engine? Corporate profits, which in the United States are rising so fast that it is possible they may surpass the previous peak in annualized Standard & Poor's 500 Stock Index profits within a year.

The patient, the U.S. economy, is out of rehab and moving ahead.

With that in mind, let me give you a rundown of some things to watch in the weeks ahead.

- **Jobs, jobs, jobs**
  Job growth just turned positive for the first time in this down cycle. Historically, the labor market picks up four to five months after gross domestic product per worker hits a high. The previous peak was in November, and job growth turned positive in March. So, the recovery is on track. More jobs mean more consumers.
- **Business spending**
  We are seeing pent-up demand and available cash everywhere. Businesses have underspent throughout the whole cycle, based on historical relationships of capital spending and depreciation compared to existing assets. This has boosted free cash flow. So, look for increased big business spending in IT, plant, property, and equipment. If this occurs, it further sustains the expansion.
- **Company profits**
  We are witnessing a massive V-shaped recovery in earnings. Unit labor costs have been falling as revenues have been rising. This trend has opened the way to the upside surprise that we are seeing in the current earnings season. For the first reporting period of 2010, these upside surprises have outstripped all estimates. If this trend continues, 77% of all companies will exceed estimates, and the pattern set in the last two quarters of 2009 will be surpassed. Why is this happening? Companies prepared for a crash in activity that did not occur. Hence, costs are low, and more dollars are flowing from top line to bottom line. Some 60% of companies are now beating revenue predictions. Skeptics doubted that follow-through demand would support the recovery.

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Well, it looks like the skeptics were wrong. Revenues are pointing to strong follow-through demand.

- **Interest rates**
  Rates are on hold for now, but the yield curve points to future rate increases. The U.S. Federal Reserve Board has been known to hold off on rate action until it sees convincing, positive sustained labor and gross domestic product data. In fact, historically, the Fed has not moved to raise short-term interest rates until payrolls sustain positive momentum for at least four months. If that remains the case, the Fed may remove some liquidity measures in the coming weeks, but I think it will be many months until the central bank raises the all-important federal funds rate target.
- **Health care**
  Health care stocks are not all the same, but the market is painting, and therefore punishing, the sector with a broad brush. The bottom line is that the new laws will add to demand for health care without increasing supply. We do not have to go back to Economics 101 to know what this means. Some companies will be hurt; some will be helped; but almost all companies now suffer lowered price-to-earnings ratios compared with other sectors in the S&P 500. Historically, this trend is abnormal for a growth sector. Our health care analysts are sifting through the reactions to, and the impact of, this legislation on the various companies.
- **Taxes**
  The fog persists. If taxes are raised, tax-free bonds could end up with an increasingly attractive after-tax equivalent yield. If dividend taxes and capital gain taxes are raised, price-to-earnings ratios could fall. Right now, markets remain in a period of uncertainty because no one knows what the U.S. Congress will do.
- **My biggest worry? Gas and energy prices.**
  If anything is a stumbling block for the ever-resilient U.S. consumer, it is energy prices. Watch events affecting the oil and gas industry. Increasing demand and political turmoil can push prices higher. Faster growth in emerging market countries has put upward pressure on commodity prices in the early part of the cycle instead of at the end, as is normally the case. I think consumers will begin to feel the pinch and be forced to cut back on spending if we see gas prices rise above $3.25 per gallon. We have not hit that level yet, but I will be concerned if we do.

Source: MFS research

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