PACWEST
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Mid-Month Market Cycle Monitor

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Less Bad

The path of the business cycle follows a regular pattern. However, the timing, extent, and duration of each cycle can vary widely.

In January we wrote that the economy was in an over supply condition. We explained how such a condition would correct itself once excess inventories were sold because cuts in supply would overshoot the actual level of demand.

In February we explained how cutbacks in housing construction below the long term level of demand would eventually lead to a recovery in the housing market once the excess inventory is absorbed.

In March we explained how cutbacks in oil production along with increasing demand for oil in Asia was leading to the absorption of excess inventories and firming in the price of oil.

This month we are beginning to see signs of similar progressions occurring in semiconductor chips, copper, and steel.

Semiconductor chip production collapsed last year due to the sharp drop off in demand. Chip inventories have been falling. But now **average chip prices are rising** despite continued economic weakness because the excess inventories have been absorbed. Production that was cut back too far while excess inventories existed now needs to be increased to meet demand. Intel's CEO said in their latest earnings announcement earlier this week that they believe that PC sales have bottomed out in the first quarter and that the industry is returning to normal seasonal patterns.

Copper is often used to gauge and forecast economic activity because demand for copper is closely tied to the industrial cycle. **Copper prices have rebounded** and steel prices are holding steady after plunging last year, implying that inventories and current levels of production are not sufficient to meet global demand.

Much of the demand for oil, copper, and steel is coming from China. China was the first country to implement massive stimulus polices to support their economy. Data suggests **China's economy is recovering,** with industrial output growing 8.3% last month from record lows, and new lending and money supply rose to record highs. The velocity of money (the money multiplier) in key emerging markets (including China) has rebounded to prior year peak levels, implying that credit expansion is healthy.

As many commodity prices have held steady for more than 4 months, and the price of oil have been rising, the currencies of countries with commodity based economies have been rebounding along with their equity markets. Historically, rebounds in such markets have often preceded business cycle bottoms.

Expectations in the U.S. have improved. The U.S. equity market has **rebounded strongly for five straight weeks**. While **many believe** that the recent advance is another **bear market rally**, there are some **important differences** between the latest rally and prior rallies.

In this latest stock market upswing, the level of short positions rose. This indicates that the **advance was not due to short covering** (buying by short sellers to close their positions) but instead, due to additional money flow from longer term purchasers. Also, the **rally was broad** based with more stocks advancing than declining which often implies a healthier advance. The volume associated with rising stocks far exceeded the volume associated with declining stocks. This adds credence to the view that many longer-term buyers were willing to purchase rising stocks at higher prices.

In addition to **improving psychology**, there are also some fundamentals supporting the rise in stock prices. So far in 2009, **net earnings revisions have been rising**, implying that earnings expectations were cut back too far at the end of last year. The U.S. durable goods orders report revealed that new machinery orders rose 13.5% in February. This is consistent with the rebound in China's purchasing manager's index, as China still purchases much of their machinery from U.S. industrial companies.

We are continuing to watch for signs of a thawing credit markets, loan expansion, and upticks in leading economic indicators. **The recent modification of mark to market accounting rules** make it easier for banks to extend credit. Continued quantitative easing by the Federal Reserve along with the TALF program, the fiscal stimulus package, and resumed growth by emerging market economies are all contributing to actual economic conditions coming in "less bad" than prior expectations.

ASSET ALLOCATION: With cash continuing to yield very little, and our current over allocation to investment grade bonds in place, **we expect to increase exposure to equities as we see more evidence of improving conditions.**

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