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MARKET MOVERS

# Companies vs. Consumers: An Endgame

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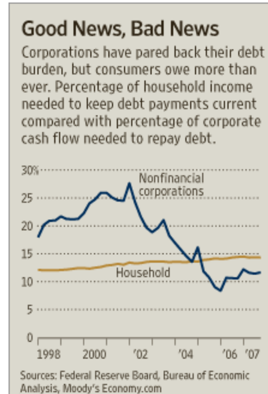
The stock market's fate could hinge on an important split in the economy: Corporate balance sheets are healthier than they have been in decades, but consumers appear to be retrenching under the weight of record levels of debt.

That could leave financial stocks in limbo and consumer stocks such as high-end retailers, travel-and-leisure, and home-furnishings companies vulnerable. But industrials and technology stocks, many of which are at least a step removed from U.S. consumers, might be in a better position to withstand a possible U.S. consumer-led downturn.

With stocks already down by double-digit percentages, the ability to rebound will depend on how companies absorb the effects of weakened consumers. Two-thirds of U.S. economic output comes from consumer spending, and many foreign companies depend on selling to the U.S. It will be hard to hide from this. Some, such as David Kostin, a stock-market strategist at Goldman Sachs Group, think the market still is vulnerable on this front.




"Consumer-credit deterioration is not priced into the market," Mr. Kostin says.

But clean corporate balance sheets and healthy economic growth outside the U.S. could cushion the blow.

"The popular view is that the system is swimming around in huge amounts of debt, and while that may be true for consumers, U.S. companies aren't carrying an excessive amount of leverage," says Larry Puglia, manager of T. Rowe Price Group Inc.'s Blue Chip Growth Fund. "The fact that corporations are in good shape could help stabilize the market."

U.S. companies used 11.7% of their cash flow to service debt in the third quarter, the lowest level in decades, according to Moody's Economy.com. That interest-coverage ratio has been trending down since the last recession, in 2001.

By contrast, more than 14% of consumers' after-tax income went to pay interest and principal on their debts in that period, a record high. The number has been trending up since the mid-1990s.

**Home Trend**

Exacerbating the problem for households, most families' biggest asset, their homes, is falling in value in many places. The median price on a single-family home fell 6.5% last year, according to the National Association of Realtors. Many analysts expect the decline to continue this year. That is bad news for consumers who have been tapping their home equity as a source of spending and, often, to pay off other debts.

The result has been rising credit-card delinquencies, mortgage defaults and write-offs of bad consumer debt at companies such as **American Express** Co. and **General Electric** Co.'s finance group.

Consumers are showing signs of pulling back. Sales at chain stores open at least a year rose a weaker-than-expected 0.3% last month, according to Thomson Financial.

For investors, this is likely to play out much differently from how it did in 2001. "In the last recession, it was the collapse of the corporate side and the equity market," says Mark Zandi of Moody's Economy.com. "This time around, it's the consumer and the credit markets."

Some analysts say the situation looks more like the recession of 1990-91, which followed the savings-and-loan crisis and a real-estate-market slowdown.

During the course of that six-month downturn, the Standard & Poor's 500-stock index rose 5.35%. Consumer-staples stocks rose 20%, health care rose 18% and only small declines were registered in a handful of sectors. By contrast, in the last recession, which began with stocks trading at much higher price-to-earnings valuations than have been seen recently, the S&P 500 fell 8%, with losses in every sector except materials.

James W. Paulsen

This time around, companies that sell outside of the U.S. could enjoy some insulation. That would mark something of a vindication for those advocating the so-called decoupling scenarios, in which overseas economies will weather this economic cycle better than the U.S. economy does.

Many foreign markets are down this year, but only after a stellar 2007. That is especially the case in emerging markets.

"You can downshift consumption and housing and offset it with trade improvement," says James Paulsen, chief investment strategist at Wells Capital Management. "So in some respects, the corporate sector can go on looking good even if consumers are somewhat weaker." Mr. Paulsen, a longtime bull, says further weakening of the dollar will add to the benefits of parking money overseas.

**Soft on the Softs**

T. Rowe's Mr. Puglia likes "soft cyclicals," which are stocks somewhat insulated from the U.S. economy's ups and downs. One example is **Praxair** Inc., which produces industrial gases used in hospitals, oil refining and other industries. He also is favoring defense-related aerospace names such as **General Dynamics** Corp.

Many investors had thought technology stocks, like foreign stocks, would be a haven. But the sector is down 17% since the start of the year, after a strong 2007. Nevertheless, Inigo Fraser-Jenkins, an equity strategist for Lehman Brothers, thinks global technology stocks will stand out in 2008.

He says technology stocks are likely to beat other sectors in earnings growth. Moreover, valuations, at about 16 times expected 2008 earnings, are reasonable, he says. In addition, Mr. Fraser-Jenkins says corporate spending on technology in the U.S. has been below trend in recent years but should be on an uptrend "even before the economic recovery starts."

Mr. Fraser-Jenkins likes financials because of their low valuations. He acknowledges that consumer-debt problems present a hurdle for banks, "but for us, the issue is what is priced in, and what's priced in is something horrific," he says.

Mr. Puglia says that to steer clear of the consumer risk at banks, he would favor nonlenders such as Bank of New York Mellon Corp. or **State Street** Corp.

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### Good News, Bad News

Corporations have pared back their debt burden, but consumers owe more than ever. Percentage of household income needed to keep debt payments current compared with percentage of corporate cash flow needed to repay debt.

Sources: Federal Reserve Board, Bureau of Economic Analysis, Moody's Economy.com