Capital INVESTMENT SERVICES of America, Inc.

Market Commentary

June, 2013

Economic Recovery Still Young

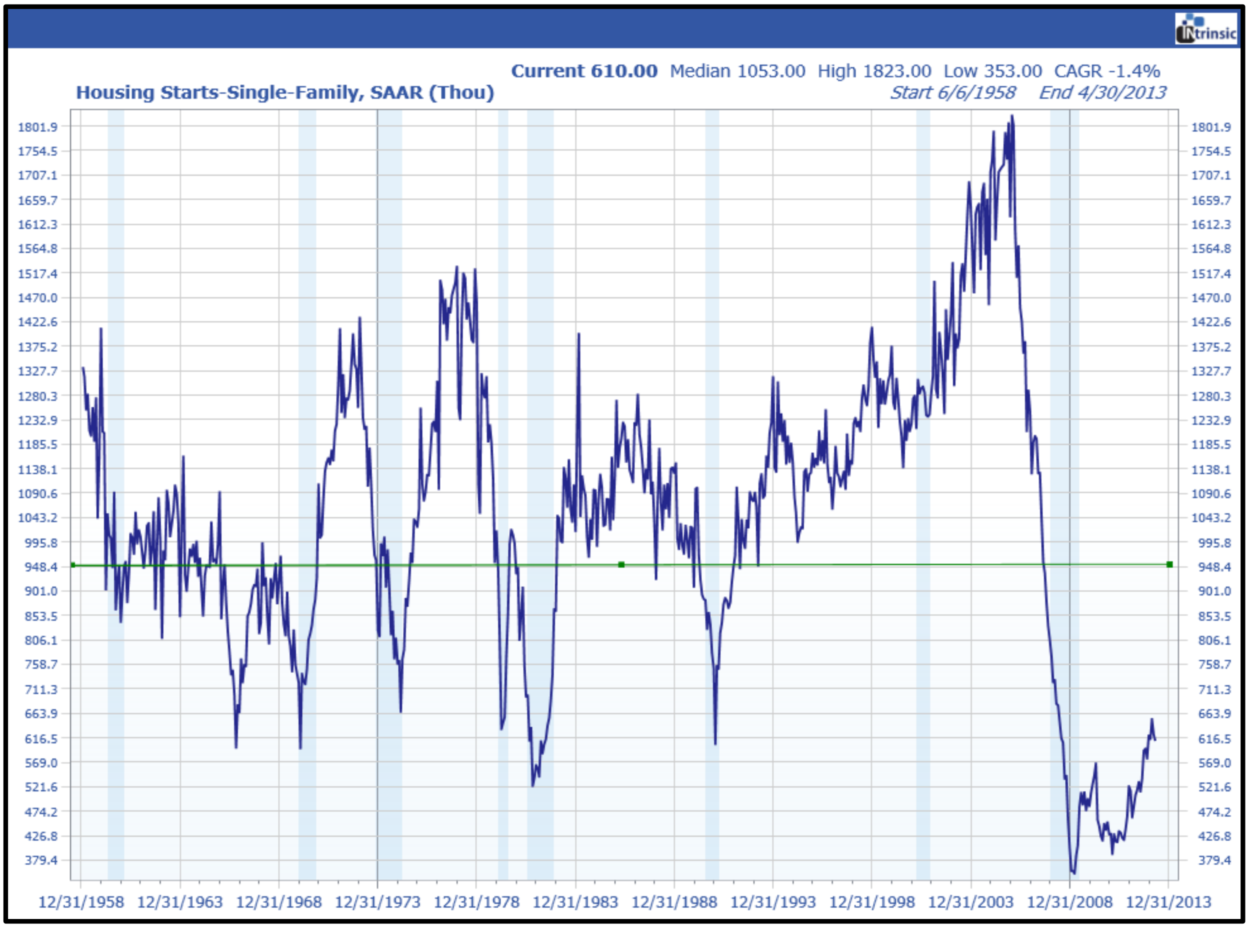
This month marks the fourth year since the 2008-2009 economic recession officially ended and the subsequent recovery started. Looking at the last two recoveries (following the 1990-1991 recession and the 2001 recession) the Federal Reserve was already pursuing a tightening policy by the fourth year of recovery (raising interest rates).

The chart above presents the federal funds rate for the last 25 years. Following the 1990-1991 recession, the Federal Reserve pushed and held the fed funds rate down for the first three years of the recovery. Finally, in early 1994, the Fed Funds rate was increased in response to economic conditions (circled above). Following the 2001 recession, the Federal Reserve moved the fed funds rate lower until mid-2004 (about 3.5 years into the recovery) at which time they reversed course and began tightening.

Capital Investment Services of America, Inc.
700 North Water Street, Suite 325 Milwaukee, Wisconsin 53202-4206
414/278-7744 800/345-6462
info@capinv.com www.capinv.com

Currently the central debate about Fed policy is when will they begin to taper (in other words slow the rate) of bond purchases. There is no discussion about Fed tightening any time soon.

One important difference between the current recovery and the prior two has been the lack of contribution from housing. Housing starts have historically been a more meaningful contributor to economic recoveries than during the current cycle.



The chart above presents single-family housing starts over the last 55 years including the last eight recessions (shaded bars). During the current recovery, housing starts bottomed in the Fall of 2011. This was two years following the end of the recession. Looking back at the prior eight recessions, housing starts always bottomed and were up significantly in the first year of recovery, except for the current period.

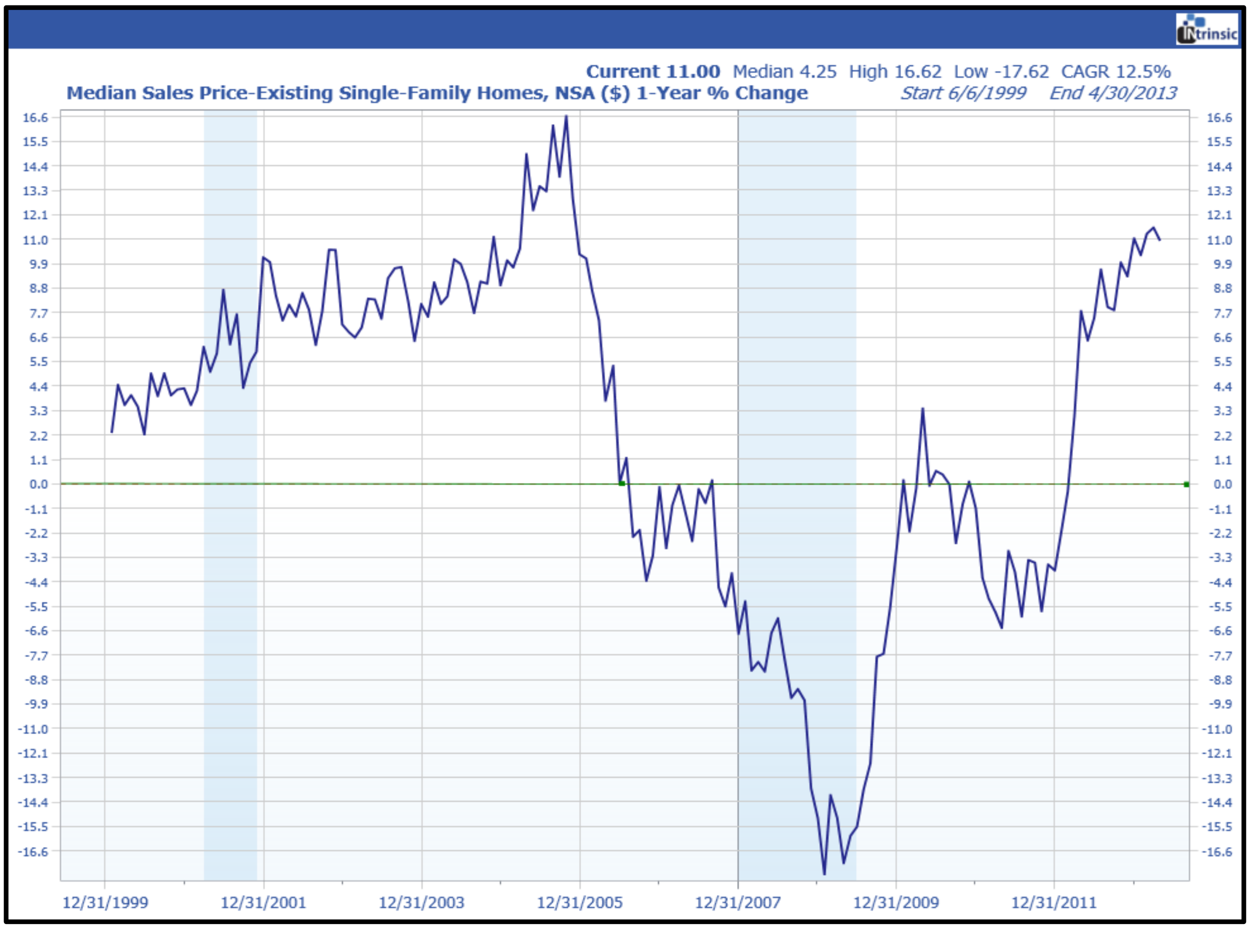
It is suggested that in any typical year, between 900,000 and 1,000,000 single-family homes are eliminated from the housing population due to fires, tornados, floods, storms, age, and other reasons. This would imply that unless a similar number are built (or started) the housing stock available is reduced. The green line on the above chart represents this typical annual elimination rate. Prior to the current recovery, housing starts were expanding the housing population very soon into the recovery.

This point is significant because construction related activities tend to have a high employment related effect. The building of new homes and other construction involve numerous trades and professions and therefore can be a material contributor to a recovery.

Currently, housing starts are at only about 600,000, well below the estimated elimination level. It is worth noting that housing starts never dropped below the estimated elimination rate during the 2001 recession and, in fact, reached an unprecedented level of 1,800,000 in early 2006.

Housing starts should continue to build at least back towards the estimated elimination rate of 900,000 to 1,000,000. If so, this should serve as another tailwind to the overall employment situation.

Supporting the case for continued improvement in housing is that existing home prices have finally rebounded. In early 2012, the price of existing homes (presented in the chart below) started to go up on a year-over-year basis.



The increase in existing home prices are now up 11% on a year-over-year basis. This is encouraging because it suggests that the supply of existing homes have been largely absorbed and overall housing conditions are improved.

Higher existing home prices also have an important positive psychological impact on consumers. Their homes are commonly a meaningful part of their net worth, and when they are rising in value it encourages more optimism.

In our *Perspective*, we have written extensively about psychological challenges facing investors. Although in most cases economic fundamentals have been better than feared; it's the lack of commitment and confidence that continues to be a significant investment hurdle. A sustainable rebound in the housing industry should be another positive element in restoring confidence.

We remain focused on understanding the current trends in fundamentals because it gives us the best probability for success.

For more information on this or any other topic of interest, feel free to contact us.