SISR Strategic International Securities Research Inc.
An Independent Research Firm

United States Sector Rotation Report*

Economics & Financial Markets

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United States Equity Markets

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Part IV: The Recovery Portfolio: Will Construction, Manufacturing, and/or Retail Lead the Recovery?

I. Introduction

If we begin with the assumption: that all recessions must come to an end, the obvious follow up question must become: where should one positioned their portfolio to maximize the benefit of that eventual occurrence, irrespective of when that event actually occurs?

Figure I: Traditional Sector Cycle Theory as Reported by Fidelity Investments

Source: Fidelity Investments, Products Division

If our assumption is correct that all recessions must end, and that the economy is in the late recession phase, then according to conventional wisdom Financials and Consumer Cyclicals both durables and nondurables are the traditional location for the next wave the bottom and into the early recovery. In the table above the early recovery similarly would encourage looking at Transportation as well as Technology stocks for the early recovery.

This recession however, has not been the traditional recession and the traditional recovery may not be the norm in this recovery either. There are two factors that have thrown the traditional recovery pattern into chaos and that is the extent of damage to the financial sector, and secondly the impact of gasoline on the consumer and transportation. We will argue that this recovery will be lead by basic materials and primarily construction materials given the conditions on the ground of this recession. This recession has been the most severe and housing has experienced the most severe downturn in modern history. The consumer is struggling with high unemployment, nearly 10%, and still relatively high gasoline prices, which will affect the technology space, which ultimately needs a strong consumer to participate. Transports similarly are still reeling from high gasoline prices.

If the consumer, technology, transportation, and the financials are not the recovery areas where could it come from? In this recession it must come from Construction and Professional Technological Services because there is no other place for job growth except from that space. Construction is a space that has lost the most jobs, and is also the area where the most jobs can be created in the shortest order. Professional and Technological Services is the area where growth had been the fastest. No other sector can produce jobs as quickly as the construction and the Professional Technology sectors. It is this hypothesis that we will pursue in this report.

II. Evidence from Nonfarm Payrolls

On **April 6, 2008** we wrote:

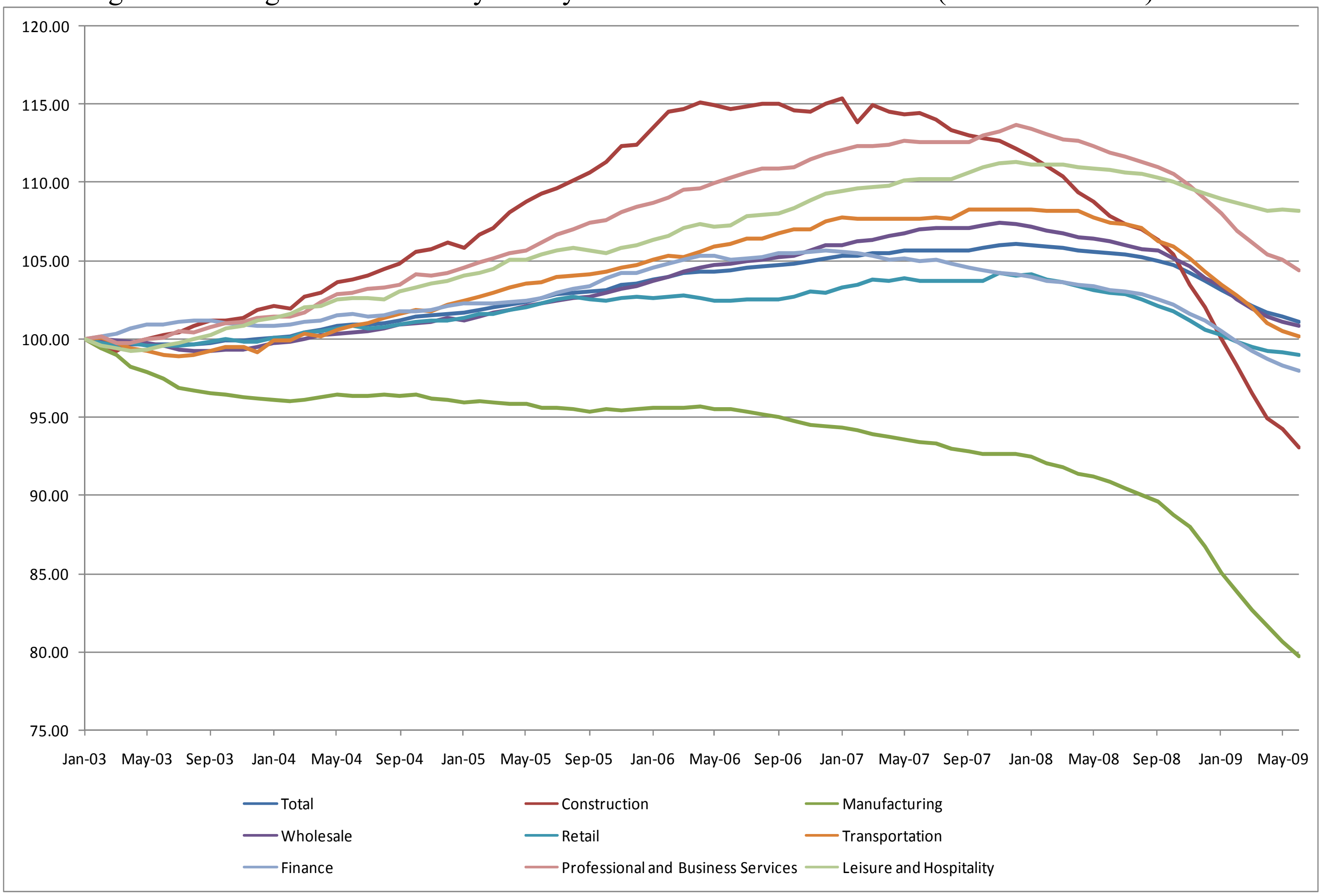
> On Friday April 4, 2008 the Department of Labor reported that the economy lost 80,000 jobs last month, after having lost 76,000 the month before. This is the third month in a row where the economy has lost jobs. Since World War II there have been 11 rece3ssions, and there has never been an instance where the economy has NOT been in a recession when the economy has lost jobs for three months in a row.

In that report we argued on April 6th that the economy was already in a recession, well before the NBER had declared the economy to be in a recession.

The value in this data which often is considered the most important single economic report of the month may be used in a slightly different manner. It can help us figure out where jobs can be created, and as a consequence where jobs need to be created to begin to regain back the more than 6 million jobs that had been lost. If one adds the 100K jobs per month that are required for the economy to grow we are looking at a required 8 million new jobs just to get back to where we were prior to this recession, given the population growth from both legal immigration of working age, about 500K per year, and new entrants into the labor force.

Figure II show the percentage change in the number of jobs lost by sector. We have included the Sectors of Construction, Manufacturing, Wholesale, Retail, Transformation, Professional Services, Leisure and Hospitality and Finance as well as the total loss of jobs. The table is indexed to base 100 from January 2003 indicating that a score of 100 would mean zero growth from 2003 to June 2009, and a score of 130 would indicate job growth of 30% in that sector. Similarly a score of 80 as we have with manufacturing would indicate a 20% loss of jobs from 2003.

Figure II: Change in Nonfarm Payrolls by Sector Jan 2003 to June 2009 (2003 = Base 100)



Source: Department of Labor, SISR

The figure shows that construction from 2003 to mid 2006 and professional and Technical Services until early 2008 had created the largest number of jobs. It also indicates that 20% of all construction jobs had been lost have been lost since then. We also can observe a decline in manufacturing jobs with a decline closer to 12% since 2007. Manufacturing job losses have been occurring throughout the decade of 2000 and as a consequence it is unlikely that this is where we can expect massive growth recovery. Business and professional services which includes legal and accounting services as well as computer and technical consulting lost approximately 7% as did all other areas except for leisure and hospitality which is down only about 3% from its high.

Of the sectors reported Professional and Business Services accounts for 13% of the economies jobs, followed by retail at 11%, Leisure and Hospitality at 10% manufacturing at 9%, finance and construction both at 6% wholesale at 4 and Transportation at 3%. This accounts for 61% of all jobs in the economy. The two excluded sectors: education and Health, and the Government makes up most of the remainder. We excluded Government because there is no way to invest in the government and Health and Education because those sectors have been adding jobs throughout the recession, and we do not see massive job gains in Health and Education.

From this table it is clear that in order to begin to recapture some of the jobs lost we must look to construction and professional services and consulting. Construction was the first area to roll over, Manufacturing has been losing jobs all decade, and the other areas which all rolled over at about the same time will begin to show some growth, but most likely only once there is some job creation. Professional and consulting services has been the stop gap for much of the lost jobs in manufacturing over the decade, with more individuals moving to the service sector where there have been the greatest growth in jobs.

There is no other area besides Construction that has the total upside potential for jumpstarting the economy. In addition the expected stimulus bill has a great deal of infrastructure in the bill that will be spent in the next 6 to 12 months. Housing appears to have stabilized, and as a consequence the construction area is the most likely and necessary area for recovery.

III. **Conclusion**

If the jobs report is going to help us in any way going forward it is likely that job creation must come back from those areas most affected. It is for this reason that we at SISR have been arguing that construction must become a viable area for growth. We also like the high tech area of consulting simply because that had been the second fastest growth area prior to the recession and we expect that this area will continue to grow as manufacturing continues to lose jobs well into the next decade. It is for this reason that we have Accenture (ACN) and Infosys Technology (INFY) in our portfolio on the consulting side, and caterpillar (CAT), Granite Construction (GRA), Jacobs Engineering Group (JEC), Texas Industries (TXI), Vulcan Materials (VMC) on the construction side.

We believe that much of the Stimulus which has not been spent will be proceeding much faster on the infrastructure side, and with the health records bill and the new regulations for the financial system these programs should help the technological consulting firms.

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