MARKET INSIGHTS

# Market Bulletin

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## Chapter 2 of the economic recovery:
### A look at the economic recovery and the U.S. consumer

We are now 12 months into a slow but clear economic recovery. In this bulletin, we will review what has driven the recovery to this point, as well as what (if anything) is likely to sustain the recovery in the months and years ahead. With a solid chunk of the inventory cycle behind us, we believe that the consumer will need to assume a bigger role in order for the economy to continue to grow. While a double dip is certainly possible, we do not regard it as the likely path.

### The recovery has begun

Any good action movie relies on a climactic moment of suspense, where the audience strains to foresee exactly how the protagonist, faced with a seemingly impossible situation, will come out alive (think of Harrison Ford in The Fugitive). The more difficult it is for the audience to see that light at the end of the tunnel, the more effective the moment of resolution is.

For our economy, that moment of extreme suspense - where many felt that an end to the downward spiral would never come - happened in early 2009. Fear and uncertainty were deep-rooted. Markets touched decade lows, credit ceased to flow, confidence evaporated and the economy was hemorrhaging jobs. Many wondered, "How are we ever going to recover from this?"

But then, just as in the movies, where the hero slips free of bonds and makes an escape, much to the audience's relief, the economy began to recover.

Data released in late July 2010 by the BEA (Bureau of Economic Analysis) show that the economy has grown by 3.2% over the past year, largely driven by key cyclical parts of the economy - namely, inventories and business spending. And while this growth represents a dramatic contrast to the economy of a year ago, the truth is that this is a sub-par recovery.

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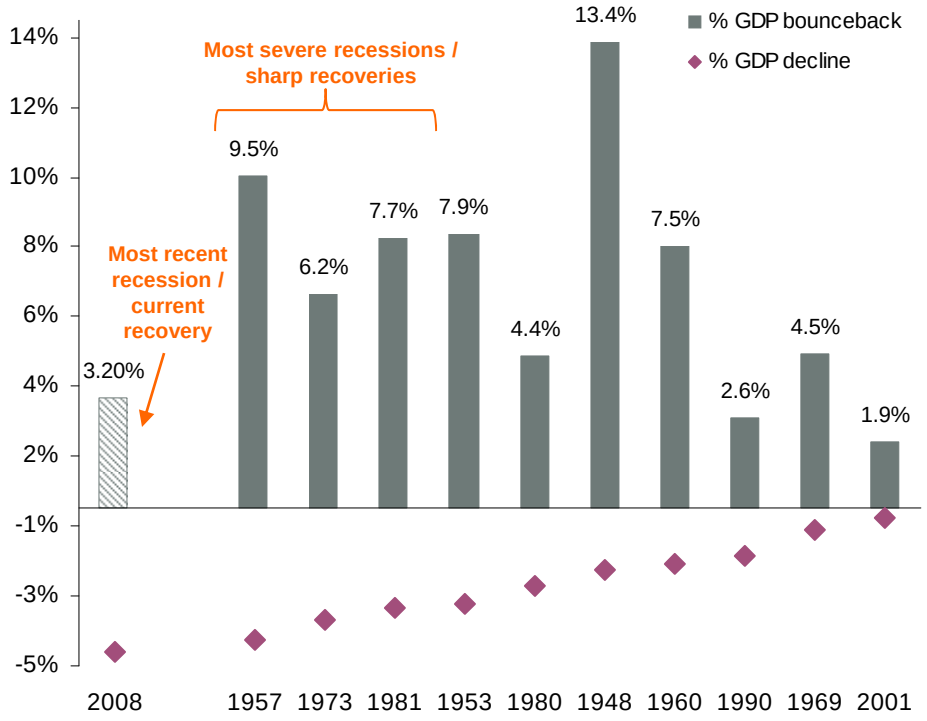
The *Guide to the Markets* chart below shows economic growth in the first year of recovery after each recession since World War II. The most severe recessions saw the biggest rebounds, with average growth of roughly 7% in the first year of recovery. Put differently, the various headwinds and areas of uncertainty in the current economic environment are costing about 4% in GDP (gross domestic product) growth.

**GDP Declines and Recoveries**
Sorted from deepest to mildest recession




Source: NBER, BEA, J.P. Morgan Asset Management
*Guide to the Markets, On the Bench* slide located at www.jpmorganfunds.com/bench

So what has driven this recovery so far, and can it continue?

## Chapter 1 of the economic recovery: *A cyclical thing*

We've often suggested to our clients that the definition of a recession is when everyone decides to **wait and see**. During recessions, a household with two solid incomes may become concerned about the prospect of losing one or both jobs and, as a result, pull back on consumption. The household may postpone certain purchases as they **wait and see** what happens to the economy. The same phenomenon can be observed in business behavior as well.

The trouble with this is obvious: a wait and see mentality can create a negative feedback loop, further exacerbating an already precarious economic situation.

**The Wait and See Mentality**
A negative feedback loop


Source: J.P. Morgan Asset Management

This wait and see mentality was on full display during the recession of 2008 and 2009. As such, understanding *where* consumers and businesses tend to make cutbacks can be instructive.

Historically, consumers and businesses don't cut spending across the board. Even in tough times, consumers generally continue to buy staples like food, deodorant and gasoline. Instead, the cutbacks tend to be concentrated in "big ticket" items - purchases that they can more comfortably postpone until a later time when they feel more confident about their own future. For households, these big ticket items often include automobiles and homes. For businesses, the same behavior is observed when it comes to spending on expensive equipment and machinery or inventory to stock the shelves.

This is exactly why housing, autos, business equipment spending and inventories are the four most cyclical areas in the U.S. economy. They decline the most in recessions because they're the first areas where people and businesses pull back, and they rebound the most in recoveries, as pent-up demand is eventually fulfilled.

As shown in the *Guide to the Markets* chart below, these four areas of the U.S. economy together only accounted for 18.8% of economic growth over the last 50 years - not a particularly impressive number. However, they were responsible for 139.9% of the decline in GDP during recessions and 59.9% of the growth in GDP during the first year of recovery. So far in *this* recovery, 97.4% of the growth has come from these areas with inventories and business equipment spending contributing the most.

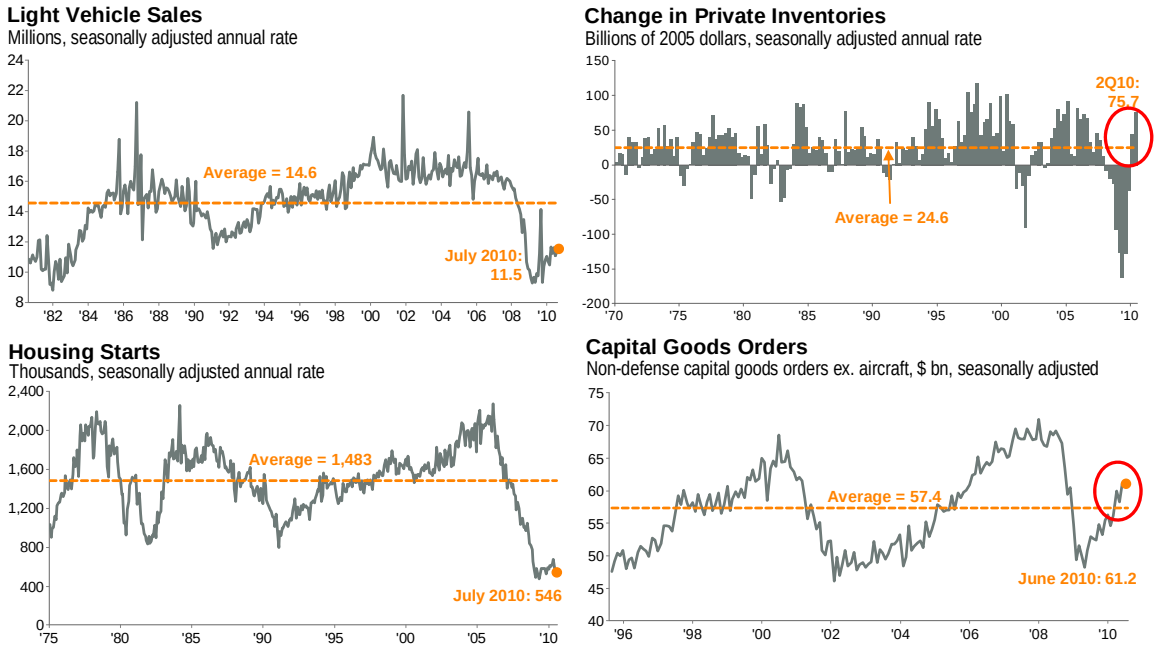
### Contributors to GDP Growth

| | Last 50 Years | | Last 7 Recessions | | Last 7 Recoveries (1st Yr) | | Most Recent Recession | | Current Recovery (1st Yr) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Percent | Share | Percent | Share | Percent | Share | Percent | Share | Percent | Share |
| **Overall GDP Growth** | **3.2** | **100.0%** | **-1.8** | **100.0%** | **5.0** | **100.0%** | **-4.1** | **100.0%** | **3.2** | **100.0%** |
| **Less Cyclical Components** | **2.6** | **81.2%** | **0.7** | **-39.9%** | **2.0** | **40.1%** | **0.6** | **-15.5%** | **0.1** | **2.6%** |
| **Consumption Ex-Autos** | 2.1 | 66.5% | 0.1 | -4.0% | 2.4 | 47.9% | -1.0 | 23.4% | 1.0 | 31.4% |
| **Commercial Construction** | 0.1 | 1.9% | -0.1 | 3.8% | -0.1 | -2.3% | -0.6 | 14.6% | -0.4 | -13.1% |
| **Net Exports** | -0.1 | -2.4% | 0.4 | -23.8% | -0.6 | -12.7% | 1.5 | -37.4% | -0.6 | -20.1% |
| **Government** | 0.5 | 15.2% | 0.3 | -15.9% | 0.4 | 7.2% | 0.7 | -16.1% | 0.1 | 4.4% |
| **More Cyclical Components** | **0.6** | **18.8%** | **-2.5** | **139.9%** | **3.0** | **59.9%** | **-4.8** | **115.5%** | **3.1** | **97.4%** |
| **Auto Consumption** | 0.1 | 3.1% | -0.2 | 11.4% | 0.4 | 7.7% | -0.6 | 15.2% | 0.1 | 3.5% |
| **Residential Construction** | 0.1 | 2.2% | -0.5 | 27.3% | 0.7 | 14.5% | -1.3 | 32.4% | 0.1 | 4.2% |
| **Equipment** | 0.4 | 12.9% | -0.3 | 15.7% | 0.5 | 9.1% | -1.6 | 38.0% | 1.0 | 32.7% |
| **Change in Inventories** | 0.0 | 0.6% | -1.5 | 85.5% | 1.4 | 28.6% | -1.2 | 29.9% | 1.8 | 57.0% |

Source: BEA, NBER, J.P. Morgan Asset Management.
*Guide to the Markets*, page 12

The *Guide to the Markets* chart on the following page represents a snapshot of where each of these cyclical indicators are today relative to historical levels. Autos and housing (charts on the left) remain depressed, while inventories and business equipment spending (on the right) have both shown significant improvement.

## Cyclical Indicators




Source: (Top left chart) BEA, J.P. Morgan Asset Management. (Top right chart) BEA. (Bottom left chart) Census Bureau. (Bottom right chart) Census Bureau.

*Guide to the Markets*, page 13

## Summary

The economy is recovering, having been driven by a cyclical bounce in the business sector. But with a return to inventory accumulation and a significant rise in business equipment spending behind us, it may be time to turn the page on Chapter 1 of the economic recovery and look at what lies ahead.

### Chapter 2 of the economic recovery: *Will the consumer show us the money?*

If Chapter 1 of the economic recovery was called *A cyclical thing*, Chapter 2 will probably need to be called *Now it's the consumer's turn*. The trouble is, of course, that consumer attitudes remain depressed because unemployment is high, credit is tight and there is a general level of uncertainty around a variety of issues that are causing consumers to remain cautious.

## The consumer's role

The consumer is the largest driver of U.S. economic success in the long run, having represented roughly 68% of average nominal GDP since 1960. In considering what to expect from the consumer in the quarters ahead, we think it makes sense to look at two important issues:

1. The **ability** of the consumer to spend
2. The **willingness** of the consumer to spend

### 1. The consumer's **ability** to spend

*Jobs and income*

Principally, consumer spending is a function of income. The more money people earn, the more they can (and usually do) spend. With a 9.5% unemployment rate and 7.7 million jobs lost since 2007, the biggest challenge to spending is unemployment. Moreover, we estimate that it is likely to take more than five years for unemployment to reach 5% again. But despite the obvious headwinds, there have been several positive trends developing, including:

- ↑ Temporary employment ***increased in eight of the last nine months***
- ↑ ISM Manufacturing Employment Index saw ***gains for eight consecutive months***
- ↑ Private sector nonfarm payrolls ***increased for seven consecutive months***
- ↑ Monster Employment Index is at its ***highest level since October 2008***
- ↑ Average hourly earnings for private sector employees have been ***flat or up for seven consecutive months***
- ↑ The length of the average work week ***increased in four of the last five months***
- ↑ Bureau of Labor Statistics (BLS) Mass Layoffs is ***at a three-year low***
- ↑ Conference Board shows ***4.3 million online job postings***
- ↑ Compensation costs for private sector workers are ***up 1.9% in the last 12 months***

While the labor market recovery has been slow, the overall trajectory thus far has been positive. As such, investors should be careful not to ask the wrong question. For example, rather than asking, *"How can the consumer spend with such a weak labor market,"* perhaps the better question is, *"While we know the labor market is weak, is it improving? And if so, will that improvement give consumers the ability to spend incrementally more from a very depressed base?"*

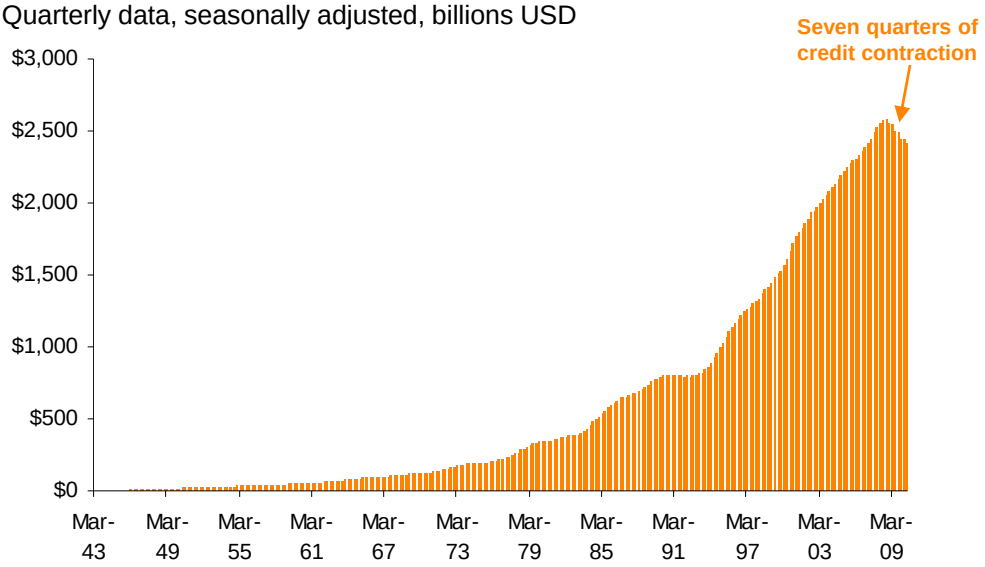
Overall, we believe that a combination of factors, including strong profits, overly aggressive cutbacks during the recession and a generally supportive fiscal and monetary environment have helped to create circumstances that will allow for a continued, albeit gradual, recovery in the jobs market. However, weakness in recent data, such as initial unemployment claims, is concerning and will warrant close monitoring in the coming months and quarters.

*Debt service and credit availability*

Widely recognized as a key driver of the last economic boom (and bust) was the reliance on credit by both individuals and businesses. Consumers used credit cards to fuel their spending habits, while falling over one another to borrow cheap money from banks to buy homes. The aftermath of this credit-fueled feeding frenzy is a temporarily more frugal "de-leveraging" American consumer. As shown in the chart below, for the seventh consecutive quarter (and only the second annual decline on record), consumer credit outstanding has contracted as consumers look to shore up their personal financial situations and fortify their household balance sheets. Bears have asserted that this poses one of the greatest threats to the economic outlook. In the near-term, it most certainly represents a drag on growth.

**Consumer Credit Outstanding**

Quarterly data, seasonally adjusted, billions USD




Source: BEA, FactSet, J.P. Morgan Asset Management.

There are, however, some positives to the de-leveraging cycle. For instance, as the chart on the next page shows, the household debt service ratio - the amount of disposable income that consumers are dedicating to service their debt - has fallen from a peak of 14% in 2007 to 12.5% most recently. While this 1.5% decline may not sound like much, it represents billions of dollars that are no longer devoted to servicing debt, and therefore can be allocated to either savings or spending. The result of “lower-than-normal" debt accumulation, lower interest rates on the existing stock of debt (refinancing) and the decision by some to pay down existing debt is a very healthy long-term development for the consumer.

**Household Debt Service Ratio**
Debt payments as % of disposable personal income, seasonally adjusted


Source: FRB, J.P. Morgan Asset Management
*Guide to the Markets*, page 14

*Household wealth*
Another potential factor in the ability of consumers to spend is their overall level of wealth. The Federal Reserve tracks information related to household wealth, and some selected components of this data are reflected in the chart below.

**Household Wealth: Not at the Top, But Far From the Bottom**

| *Trillions, USD* | *2007 Peak* | *2009 Low* | *Now* | *Chg. From Peak* |
|---|---|---|---|---|
| Total assets | $ 79.90 | $ 62.40 | $ 68.50 | -14.2% |
| Real estate | 24.6 | 17.6 | 18.1 | -26.4% |
| Total financial assets | 51.3 | 40.0 | 45.5 | -11.2% |
| Corporate directly held equities | 10.3 | 5.2 | 7.8 | -24.7% |
| Mutual fund share holdings | 4.7 | 3.1 | 4.3 | -8.2% |
| Pension find reserves | 13.6 | 9.9 | 12.3 | -9.1% |

Source: Federal Reserve, J.P. Morgan Asset Management.

The first and most obvious takeaway in studying the data is that total assets are a long way from peak levels, having fallen from $79.9 trillion in 2007 to $68.5 trillion today[1]. The good news is, however, wealth has recovered from a low of $62.4 trillion, giving the consumer at least a bit of relief.

[1] Data are as of 1Q 2010.

The primary drivers of this, the largest post-War destruction of household wealth, were home values and financial asset values. But it is important to distinguish between the two. For example, while lower home values probably have some lingering "wealth affect," consumers generally don't put off buying a new TV or dinner at Applebee's because their home values are down, especially if they don't have plans to move. We suggest that financial assets, like pension fund reserves or mutual fund share holdings, matter more to such spending decisions in the near term. A look at mutual fund assets shows that, on average, households are only 8.2% shy of 2007 highs[2].

Though consumers are likely to remain cautious, we believe that the recovery, so far, in financial asset values and an eventual recovery in home prices will both aid the consumer's ability to spend.

*Tax policy and consumption*

Economists use the word "average" too much. The fact is, there is no "average" American consumer. Instead, there is a wide income gap in the U.S., and we should consider the impact that this reality may have on overall economic growth with the wealthiest households earning an outsized share of all after-tax income. While there are many angles to consider, perhaps the most important one is the ongoing debate around tax policy and the impact future tax policy will have on wealthy consumers.

While it can conceivably be argued that *tax cuts* for the wealthy do not necessarily translate into immediate spending (the wealthy don't depend on "the next dollar" coming in for putting food on the table; as such, an extra dollar may be more likely to be saved or invested), it seems less of a stretch that an *increase in taxes* on this group could potentially exacerbate an already stressed discretionary consumer. We will be watching this issue closely.

*Summary: The consumer's ability to spend*

In summary, a muted but continued labor market recovery, lower debt burdens and recovering asset values will likely provide ongoing support for consumers. However, while it seems that consumers may have the ability to spend incrementally more over the next several quarters, perhaps the more important question may be, *"Will they?"*

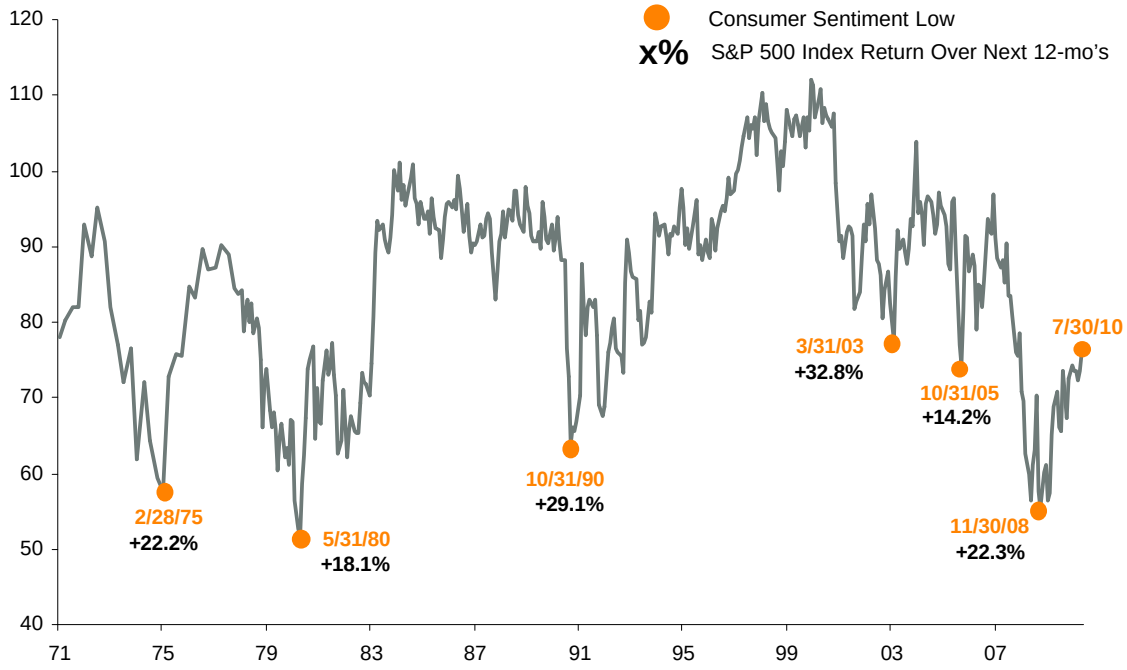
## 2. The consumer's **willingness** to spend

*Sentiment and confidence*

We all know that the markets hate uncertainty. At present, the reality is that the word "uncertainty" is virtually synonymous with the current economic environment. Overall, the current low levels of consumer sentiment and consumer confidence remain as headwinds, despite a sizeable bounce from the lows of 2009.

[2] More details are available in the Federal Reserve's Flow of Funds Z.1 tables in the b.100 report. Next release 9/17/10. http://www.federalreserve.gov/releases/z1/Current/z1r-5.pdf

**Consumer Sentiment Index – University of Michigan**
Including subsequent S&P 500 Index 12-month return




Source: University of Michigan, Standard & Poor's, J.P. Morgan Asset Management
*Guide to the Markets*, page 23

What "turnaround" indicators can investors watch for? Most pertinent to American consumers' view of the world is the job market. While the job market recovery will most likely be slow and arduous, over time, the unemployment rate should gradually drift lower while the private sector should continue to add jobs. In time, this could boost sentiment and encourage spending.

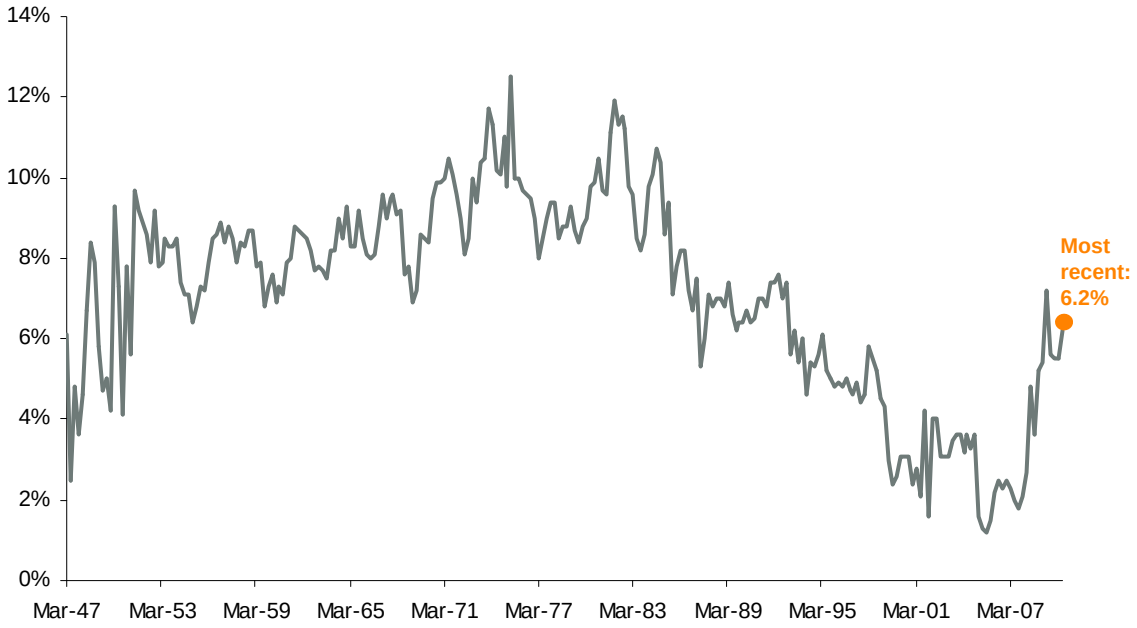
Finally, a quick comment on investing in a period of low confidence: Too often, investors make decisions about investing based on how they feel, rather than analysis of the facts. In fact, we often hear from investors that they would rather wait "until the market settles down a bit." The problem is that markets don't settle down… they settle UP.

This is why Warren Buffet once famously stated, *"Be fearful when others are greedy, and greedy when others are fearful."* Put differently, it can be unsettling for an investor to discuss opportunities when consumer sentiment is depressed and the outlook is murky. However, the chart above demonstrates that markets have rewarded investors for taking advantage of fear and anxiety by "buying low." Though certainly not intended as a way of timing the market, we believe that it makes sense to consider both *risks* and *opportunities* in a market environment like this one.

*Savings rate*

The savings rate recently leapt above 6%, a 17-year high. This likely represents a near-term drag on growth, and perhaps an outright unwillingness to spend. However, a higher savings rate, coupled with a decreased debt burden, could result in a significantly healthier and more balanced consumer in the years ahead - cold comfort at a time when the economic recovery seems perilously close to flat-lining.

**Personal Saving as a Percent of Disposable Personal Income**
Billions USD, SAAR




Source: BEA, J.P. Morgan Asset Management.

*Summary: The consumer's willingness to spend*

In summary, the consumer remains under pressure as the economy slowly improves. As of yet, consumers remain very "bargain-oriented," and only somewhat willing to open their wallets for non-essentials. However, given the recent signs of tepid improvement in labor markets, a more meaningful sense of optimism may be in the offing. Again, time will tell.

## Risks to the Recovery and a Word to Investors

Of course, there are a number of possible risks to the economy, many of which are paraded before us on television each day: Oil prices could spike resulting from rising Middle East tensions, labor markets could begin to relapse, tight credit conditions might stay that way, a change in tax rates may discourage investment, there could be spillover from the European debt crisis and the list of possible threats goes on.

In our view, it is important that investors recognize that these are, in fact, *possibilities*. The *probability*, we believe, is for continued economic recovery.

Consequently, investors have two weapons in their investment war chest: a shield and a sword. The shield may be viewed as the fixed income or non-correlated asset portion of a portfolio that can help to protect against a relapse in the economy. The sword might be equities or high-yield bonds that should be used in the offensive to take advantage of opportunities. This analogy only applies so long as investors do not allow emotions to overcome sound investment logic, resulting in oversized shields that become too cumbersome to lift or swords so stunted that the portfolio fails to grow in a rising stock market.

## Conclusion

On a hot summer day, you can never rule out the possibility of a passing thundershower. But the possibility of a quick shower doesn't thwart golf outings, cancel ball games or prevent beach goers from braving traffic jams to find the shore. When it comes to the economy, far too much time is dedicated to discussing what could possibly go wrong, and not enough time is allocated to analyzing what is likely, or probable. While it is possible that the economy double dips, we believe that the probability is that the economy will continue to recover, even if at a very modest pace.

With the cyclical bound in the corporate sector largely behind us, the consumer's role in this recovery will become even more important. Data show a slowly improving job market, higher asset values, improved sentiment and healthier household and corporate balance sheets. However, the rate of improvement in these areas has moderated. In lieu of a crystal ball, we believe investors would be well-advised to remain diversified and balanced in their approach to investing.