EYE ON THE MARKETS

Monthly Commentary—May 2009

The Non-Recession Recession

By Dr. Jerry Webman, Ph.D., CFA, Senior Investment Officer, Chief Economist, OppenheimerFunds, Inc.

The second half of 2009 will mark the official end of the recession, the trough in the economy following more than 20 months of damage. Although the economy is no longer in free-fall, we might want to hold off just yet on breaking out the champagne bottles. For many Americans, conditions are likely to feel quite recessionary heading into 2010. This was not a normal recession, nor will there be the sharp cyclical recovery we've come to expect.

A Lulled Sense of Security

Remember the Great Moderation? Recessions in the post-World War II era were supposed to last on average approximately six months, not almost two years. The five-year recession of the 1870s following the post-Civil War boom, the panic of 1907, the Great Depression…these were of a different landscape, a different era, with little relevance to the modern world. Sure, even the bible talks of seven years of plenty followed by seven years of lean, but over time hadn't we become smarter, more efficient, and better able to massage the amplitude of the business cycle? Companies were more robust, using technologies to streamline businesses and just-in-time controls to prevent inventory investment from outpacing demand. Globalization opened new markets in economies that were supposedly de-coupled from the U.S. economic cycles. Financial innovation freed up available capital to consumers and businesses, plugging gaps in spending power and freeing consumption and investment from pesky cash-flow expectations.

Long economic expansions lifted standards of living worldwide, but they also created great imbalances and unsustainable excesses. Lulled into a sense of security and seeking higher returns, investors accepted weak lending standards, and everyone from households to businesses to the federal government lost inhibitions about borrowing. By 2008, household debt reached a peak of 133% of disposable personal income, the median home sold for four times median family income, investment banks levered their balance sheets at ratios of 50:1, and the federal deficit exceeded 3% of GDP—fueling rather than moderating the boom. All was well

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For over 25 years, Dr. Webman has been involved in the investment and economic markets—as a researcher, a financial advisor and a portfolio manager. Prior to joining OppenheimerFunds in 1996, Dr. Webman was managing director and chief investment strategist at Prudential Mutual Funds, where he had been since 1986. Before Prudential, he specialized in municipal housing finance with a public finance advisory firm. Dr. Webman began his municipal finance career at Merrill Lynch Capital Markets in the municipal research department. Previously, he was an assistant professor of politics and public affairs at the Woodrow Wilson School of International Affairs at Princeton University. Dr. Webman is frequently quoted discussing his views on the economy and markets in leading media outlets including *The Wall Street Journal, The New York Times, The Washington Post* and *CNBC*.

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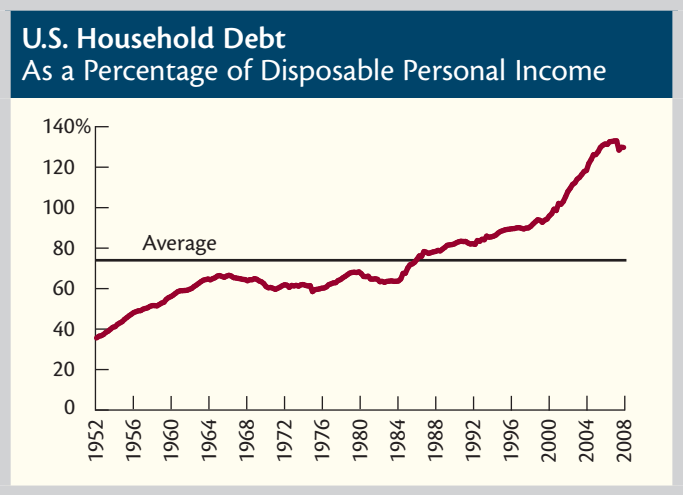
as long as the good times rolled, but once the party ended the excesses needed to be worked off. This does not happen overnight.



Source of chart data: Federal Reserve Board as of December 31, 2008.

When the Great Moderation did occasionally confront a financial crisis—the Crash of 1987, the Asian/LTCM/Russian collapse of the late 80s, the tech wreck—or the occasional recession, the Federal Reserve Board would quickly ease credit and after about nine months to a year the economy's health was restored. Once interest rates fell far enough, we'd all borrow to refinance or purchase a house, buy a car, or expand our business, and the overall economy would leap forward. Economist Paul Samuelson's famous quip that "Recessions come stamped 'Made in Washington'" now read that recoveries were made in Washington as well. Even the equity bubble, terror attacks, and accounting scandals earlier this decade were no match for the ability of low interest rates to jumpstart economic activity.

Now recall that the Fed began aggressively easing monetary policy in August of 2007, some 21 months ago, and yet the economic downturn has just begun to moderate. This time really is different.

Why the Recovery?

I'm getting tired of hearing about "green shoots," as yet another cliché, but the composition of the economic contraction really is improving. Compare the GDP reports for the first quarter of this year with the fourth quarter of 2008, two successive quarters suffering economic declines of over 6%. In Q408 the consumer was falling off of a cliff, accounting for almost 50% of the economic contraction.

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All the while, business inventories were essentially flat. That is the antithesis of a recovery: full shelves, no buyers. Fast forward to Q109. Fully 2.79% of the first-quarter's 6.1% drop came from inventory destocking, indicating that companies are finally becoming significantly leaner. As inventories contracted, however, consumers, particularly in January and February, were generally spending more—albeit off of very low levels. This is how recoveries happen. Eventually demand—even if it's weak—outstrips inventories to the point where companies must produce more. In doing so, they create jobs and growth.

On another particularly telling note, government spending also contracted in Q109, primarily from cuts in defense spending. Please raise your hand if you think federal spending will continue to decline.

But it is spring, and signs of life, the so-called "green shoots," are turning up all over the place. Key consumer, housing, and manufacturing indicators have all bounced off of extreme lows. Even the employment picture is less bad with jobless claims, though still over 600,000 a week, trending lower. Stock markets have surged ahead, and there are encouraging signs of improvements in the credit markets, particularly for lower quality corporations and municipalities. Interest rates are low, commodities have stabilized and government policies have brought the financial system back from the abyss. The old adage says that the deeper the recession (this was the most catastrophic decline in GDP in the post-World War II era), the faster the recovery.

So why can't I share in all of the euphoria?

No V-Shaped Recovery

The Banks

The results of the stress tests are promising—in both senses of the word. If the reports are to be believed, the threat of financial system collapse has past. According to the Treasury Department, even an unemployment rate above 10% or a further home price decline of 22% renders none of the 19 largest U.S. banks insolvent. The tests determined, however, that nine of the banks collectively need to raise over $65 billion in capital (a staggering figure) and will have six months to do so. The best way to raise capital, of course, is to make money, and although revenue growth is likely to be weak, the banks do benefit from government funded debt guarantees, a steep yield curve and ample credit spreads. Earnings build slowly, however, and require that loan and securities losses don't mount.

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To speed up the capital-raising process, banks have begun issuing new stock and selling assets. Expect more of the same, but if these measures fall short, expect the government to convert preferred shares into common equity and to foist more assistance on the taxpayer's banking partners. "Hi. I'm from the government, and I'm here to help."

The result is the end of the beginning for a differently shaped economy that will not be rebuilt on leverage. Banks that do not disappear will be smaller, more conservative, and more tightly regulated, and the shadow-finance system, which securitized trillions worth of debt, likely remains moribund. Gone are the days of 50:1 leverage with the financial sector accounting for 30% of total S&P.

I expect tangible innovation and value creation, not leverage, to drive the next cycle. And that process will be slower than we're used to as many of the viable small- and mid-sized businesses that will grow industries and create jobs will face even higher obstacles than usual in accessing capital.

Monetary Policy

As I said at the beginning, bargain-basement interest rates do not have their usual effect following periods of great excesses as households and businesses look to save, not borrow. Consequently, the Federal Reserve and many of the world's other central banks have supplemented extraordinarily low interest rates with other policy innovations such as "quantitative easing"—an attempt to improve the supply, not just the price, of credit.

Although such a massive, unprecedented extension of government makes me queasy, the Fed's quantitative easing policy, by backstopping the residential mortgage, interbank lending and commercial paper markets has, in my opinion, been a vital step not only in shoring up the financial system but also in preventing greater carnage on Main Street. This year's decline in home mortgage rates—in the face of a 110 basis point rise in 10-year treasury yields—can be attributed to the Fed's acquisition under the quantitative easing program of $366 billion in residential mortgage-backed securities, none of which it owned a year ago. Fed intervention late last year in private commercial paper financing revived that market and may have averted spreading disaster among money market mutual funds. On a side note, for all of those concerned that the U.S. is turning into Japan, note that the Bank of Japan did not pursue an aggressive quantitative easing policy until a full decade after their real estate and equity bubbles burst.

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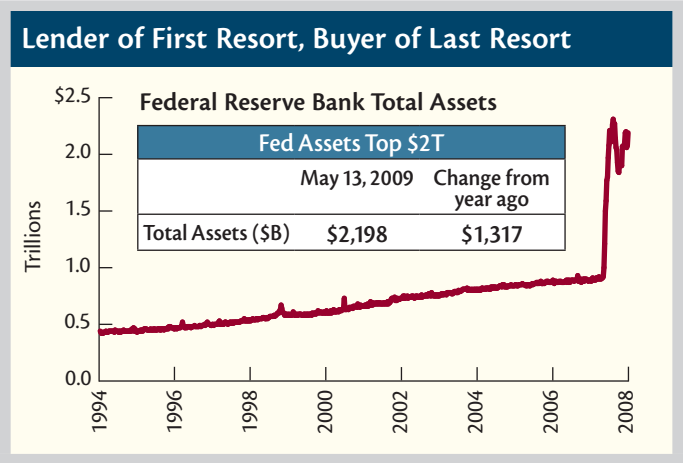

Source of chart data: Federal Reserve Board as of May 13, 2009.

There are of course no free lunches. Quantitative easing implies printing money[1] to buy government and corporate debt and mortgage- and asset-backed securities, and we have been warned that "inflation is always and everywhere a monetary phenomenon." Are we headed back to 1970s-style inflation?

Since quantitative easing explicitly intends to reflate the broad economy,[2] there's a substantial basis for eventual inflation concerns. Today, however, deflation remains the bigger risk. If consumers and businesses expect prices to continue declining, they are likely to postpone consumption or investment plans, further weakening the economy. Ironically any whiff of near-term inflation would carry a scent of returning prosperity. Nonetheless, the Fed will have to "stick the landing" on the swelling money supply by raising short-term interest rates or selling securities back into the market as soon as inflation expectations rise above the Fed's comfort zone. This is easier said than done. Just ask former Fed Chairman Marriner S. Eccles. Eccles began contracting the money supply in 1936 as demand began to percolate, one of many policy mistakes that extended the Great Depression. We hope that our policy makers have learned a thing or two over the past eight decades, but a look back to the ongoing policy debates during the 1930s indicates that these were some pretty sophisticated thinkers. The recovery could be derailed if the Fed tightens prematurely, and inflation will threaten if they lag. It's a lot easier to criticize monetary policy than to make it.

1. "Printing money" is somewhat a figure of speech. Actual currency in circulation has increased by about 11% or $90 billion over the past 12 months. Excess commercial bank reserves and borrowing through the Treasury make up most of the Fed's increased funding, but like all bank borrowing and relending, this process "creates" money.
2. Source of data: Allan H. Meltzer, "Origins of the Great Inflation." *Federal Reserve Bank of St Louis Review Part 2,* March/April 2005, pp.145-176.

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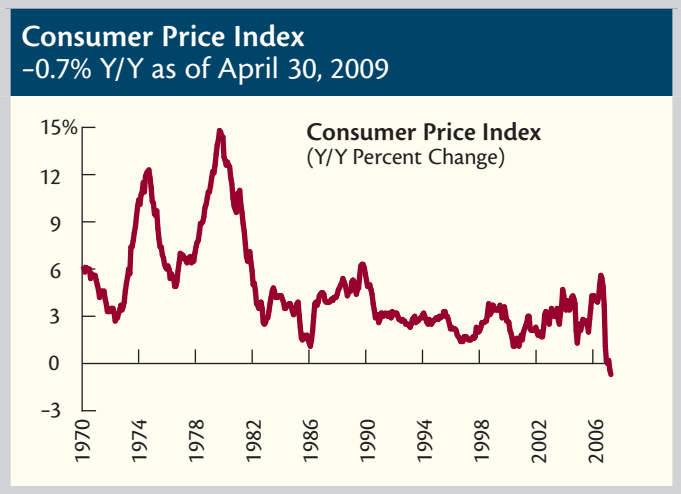
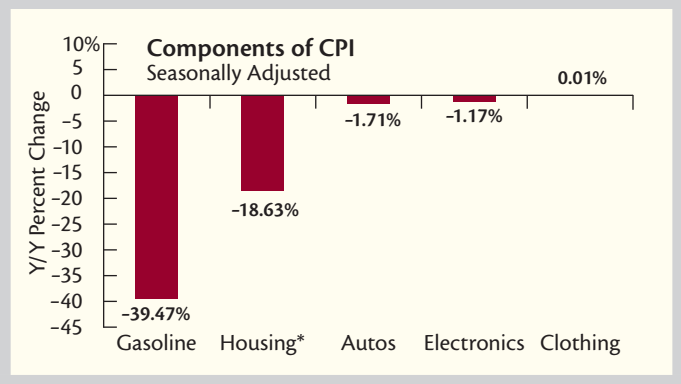




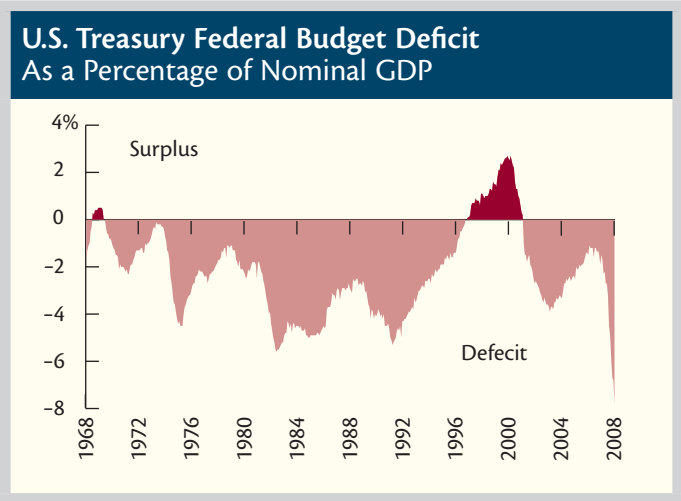
Source of chart data: Bureau of Labor Statistics as of April 30, 2009.
* S&P Case Shiller 20 City Home Price Index as of February 28, 2009.

Fiscal Policy

Congress is likely to have a harder time "sticking the landing" on spending than does the Fed on monetary policy. For all the talk about excesses in the private sector, the federal government is no innocent bystander. Despite the great expansion over the past two decades, our lawmakers failed to save for a rainy day. Now it's pouring. The spending response intended to replace and then stimulate private demand was designed as a "time-release pill" for the economy with its effects extending into 2010 and beyond. The federal deficit has now reached an astounding 7.8% of GDP and is still growing.[3] This is not sustainable, and I always suspect that announced budget expectations assume rosier scenarios than are likely to materialize. Over time, the government's options are limited. They can either raise taxes, cut services (i.e., government jobs), or borrow more money and potentially

3. Note that some of these bloated expenditures are actually investments such as TARP, which the Treasury might eventually recoup.

crowd out private investors. These are not exactly pro-growth policies. But before we panic, please remember that the federal deficit spiked after the recession of the early 1990s only to see dynamic growth generate a surplus by the decade's end. We'll now face the same challenge; only solid private sector growth can pull us through.



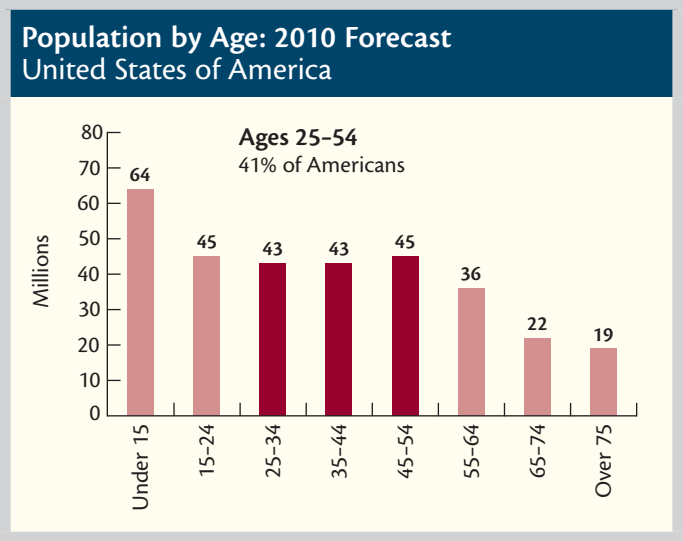
Source of chart data: U.S. Treasury as of March 31, 2009.

U.S. Consumer

U.S. household nominal net worth has taken a big hit over the past two years. Rebuilding wealth will not be an easy task particularly with a slack building job market and the slowest wage growth since the Department of Commerce started keeping records in 1960. Without an improvement in wages, households are left waiting for home prices or equity valuations to recover. Home prices continue to trend lower as inventories remain well above historical averages. A 30% spike in stocks since the beginning of March is only a small start, and I would advise against spending the gains.

The nascent good news is that the consumer has moved from panic mode to just-recession mode and any rebound in consumption off of these levels will feel quite large. The big question is whether we have permanently changed our spending habits, and this remains to be seen. Household debt is still high at 129% of disposable personal income, but our personal savings rate has reversed almost 25 years of decline and has risen from nothing to about 4.5% of disposable income. While this behavioral shift may be a good thing for the economy's long-term viability, it is hardly a harbinger of near-term robust growth. The consumer, however, does

not disappear and over time pent-up demand will build. The demographics in this country are not as bad as you think. This is not Japan with a declining population. In fact there are large numbers of Americans in the peak income and spending age range of 25–54. Life cycle purchases may be delayed, but they will not be ignored.



Source of chart data: United Nations.

What It Means for Investors

Confucius says, "The cautious seldom err." Perhaps not, but the cautious have surely underperformed since the March 9 cyclical equity market low. For those investors that finally capitulated in early March, the opportunity cost has been quite high. Perceived safe havens have not been the place to be as cash rates have paled in comparison to the returns on riskier assets while the treasury market has sold off.

Admittedly, the recent rally in the broad equity and high yield markets has rendered me more guarded with each passing day. These markets have now rightfully taken Armageddon off the table, but we should be vigilant should they start to be priced for a vigorous economic expansion. Sluggish growth and restrictive lending do not bode well for the highly levered companies that need to roll their debt or for the many S&P 500 companies that require a rising tide to prop-up earnings.

Rather, in a deleveraged world, growth is likely to come from companies we've never heard of and some whose names we cannot pronounce. Small-cap innovators in niche markets and companies with a competitive advantage in serving

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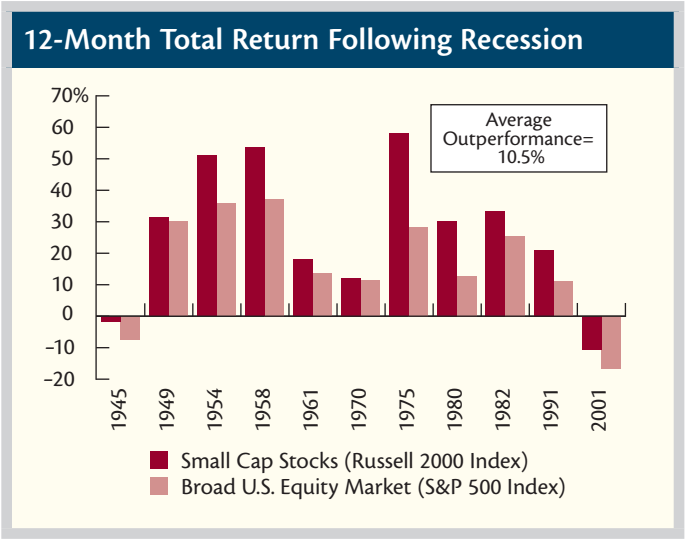
emerging economies should lead in generating the generic organic growth that will drive returns in the next cycle of prosperity. These markets will remain volatile and we should be building positions over time. As I said last month, we don't have to be heroes. My approach continues to be a barbell: focusing on the dislocations and cash flow in fixed income markets while adding risk in select small-cap and emerging market companies.



Source of chart data: Ned Davis Research as of 12/31/08. Historical performance of indices is shown for illustrative purposes only and is not intended to predict or depict the performance of any particular investment. Indices are unmanaged, include reinvested income (but not transaction costs or taxes) and cannot be purchased directly by investors. The above chart shows 12-month performance after recessions ending October 1945, October 1949, May 1954, April 1958, February 1961, April 1970, March 1975, July 1980, November 1982, May 1991 and November 2001. **Past performance does not guarantee future results.**

For investors, there is no shortage of risks on the horizon. As investors, rather than worry about these risks, we can try to identify assets that can help to offset the pain some of these risks might inflict.

Taxes? American taxpayers will ultimately have to pay for the massive expansion of the federal budget. Among the tax increases already proposed in President Barack Obama's budget are the cap-and-trade system for carbon dioxide emission permits and higher marginal income tax rates on Americans earning more than $250,000. For investors worried about their future tax burden, I continue to highlight municipal bonds. Despite recent spread narrowing, the yields on municipal

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bonds are still north of treasury rates and that's before the tax advantage. As property values decline and sales-tax revenues lag, the muni bond market will quiver from time to time. States and municipalities have already cut programs, laid off workers, and raised taxes to close budgetary shortfalls, but defaults, particularly on debt backed by taxes or revenue for essential services, have been miniscule. More federal stimulus dollars will be allocated to state and local municipalities in the months ahead to further address budgetary gaps.

Inflation? As I said above, I do not believe that troubling inflation is right around the corner. Pricing pressures are not typically associated with growing slack in the job market or with the nation's factories operating well below their output capabilities. Longer term, as a more sustainable economic recovery takes hold and money begins to change hands at a faster clip, we have to be mindful about the amount of dollars that have been pumped into the system. Again, the Fed will face a delicate balancing act and the proverbial punchbowl will be hard to take away after a long recession. In case policy goes wrong, investors should consider building or maintaining hedges like commodities and international bonds denominated in local currencies to offset those threats. Again, we might even get paid to protect ourselves. Take Brazil for example, a country blessed with natural resources, strong demographics, a thriving democracy, an independent and effective central banking system, and a strong budgetary position. Real yields on Brazilian sovereign debt are still over 7%, double today's real yield on U.S. Treasuries.

Investors can make money in this environment; they just have to be more selective. We've come a long way since the beginning of the year. If I had told most investors on January 1 where we would be in the middle of May, they would have taken it. Maybe we don't go from years of plenty to years of lean, but let's make sure we remain realistic on this pending recovery.

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