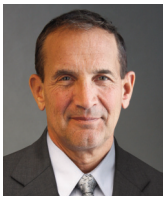

Strategist's Corner | June 20, 2011
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Is the US losing "Escape Velocity" and falling back toward "Planet Recession"?

One should, as a long-term investor, fear the return of recession. Business cycles have finite lives, and the last cycle, with the end of the last recession, is now two years in the rearview mirror. Recessions, on average, create job havoc and cause earnings and stock prices to decline, often more than 25%. So, are we going down again?

Recession talk vs. the facts

To address the concerns that we're heading into recession again, let's review the current "recession talk" and balance that with useful facts:

1. "Job growth is 'dismal,' and the United States can't grow without job growth."

   False, on both counts. First, new jobs, particularly in the private sector, are rising in number, with month-on-month and year-on-year increases. Second, the economy, even without new job creation, can grow. How? Just take the number of hours worked in the United States (they're higher than they were a year ago) and multiply that by average hourly wages (also higher than a year ago). That number is equivalent to hundreds of thousands of new jobs.

2. "The US consumer is too strapped to spend. A recession will soon follow."

   The numbers tell a different tale. Spending by consumers on goods is rising and can be seen in sales at big mid- to high-end retail department stores. Consumer spending on services (47% of gross domestic product) is rising. Air travel and revenue per seat are rising, as are hotel occupancy rates and restaurant visits. The American consumer has less debt than a year ago and is saving more and spending at the same time. All consumer debt service, when stacked up against disposable income, is better now than in the past 12 years.

3. "Emerging market economies are sinking, and the United States will be hurt."

   Emerging market economies have slowed from a high pace of recovery growth to a more moderate pace. They are also shifting to more consumption within their borders. The average interest rate increase in the EM countries over the past six months is less than 60 basis points and does not qualify as a major tightening. Containerized shipping out of the Port of Long Beach, California, to Asia keeps rising. Further, last month showed US exports rising at an annualized pace of 20%. Last year's slow patch occurred in the second quarter, and at that time the annualized rate of export growth was only 6%.

4. "The US government debt ceiling problems and deficit spending will crash the economy."

   Excess government debt, when compared to GDP, is a problem for future growth over long periods but does NOT cause recession or the end of growth in itself, as suggested by several studies, including the 2010 Reinhart/Rogoff study.

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5. "The end of QE2 (quantitative easing) by the US Federal Reserve Board will cause runaway rate increases, collapse bond prices, and kill the business cycle."

   This is possible, since we have never seen QE2 (or an attempt to rein in long-term rates) before, but the market tends to move ahead of the news. This news is out there, and the assets purchased during QE2 will roll off starting at the end of June. Everyone, including market participants, knows this. If this event were to trigger a "bond catastrophe," then would we not be seeing signs of it already? Wouldn't smart hedge fund managers and central banks be dumping bonds like crazy now so they won't get hurt when the Fed steps away?

   This is just not happening. Instead, bids in US Treasury auctions proceed very well these days, with broad buying and yields close to all-time lows.

6. "The US housing market is in double dip, and now a new crisis is forming."

   Yes, the Standard & Poor's/Case-Shiller Home Price Indices show further house price erosion, and new home construction is at rock bottom, but everyone forgets a crucial point. In 2006 and 2007, when house prices were still king and new home construction got to 2.7 million new homes on an annualized basis, the building of primary residences for American families was 6% of our entire economy (GDP). Today, the entire enterprise of making, selling, and financing new homes is down to 2% of the economy, and the economy is now bigger than it was in either 2006 or 2007. So, this shows that we have somehow found a way to do business in America without building new spec homes that no one needs, and it also shows that housing may already be at rock bottom. We now build only 400,000 new main residences per year — that's barely at replacement levels.

7. "Oil prices and inflation are killing the US consumer."

   Yes, oil prices and inflation can be killers of the business cycle, but they have not acted as such yet. Inflation is apparent in clothing, food at the grocery store, and, of course, gas at the neighborhood pumping station. But these items amount to about 18% of the consumer inflation index. The other 82% is made up of housing and wages, which right now are not moving rapidly higher. Oil came knocking on recession's door this spring when crude reached $126 per barrel and gas prices at the pump reached $3.87 per gallon. After that, demand response (a softening of the demand and need for energy) dropped, and prices began to fall. This trend is helping the consumer.

Taking stock and reviewing the current situation

Yes, we are now seeing global slowing in the pace of growth. Global slowing occurs regularly in the path of business cycle expansions, and market stutter-steps and retreats followed by strong advances are normal occurrences. This pattern is normal, but the causes of the uneven pace of growth often vary. This time the causes of temporary slowness are oil prices and supply stoppages for key machine parts coming out of a shaken Japanese economy.

Yes, global government debt is a mess. Indeed it is, but country after country is acknowledging the problem, which is always the first step toward fixing it, and the United States, curiously, is the least "bad" of these borrowing offenders.

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Yes, the markets have turned sour. The recent decline in stock prices was orderly, not dramatic, over a six-week period; again, this fits with normal patterns of rise, retreat, readjust, and advance.

The US stock market did not exhibit signs of "bubble-ness" or historic overpricing before this selloff, and rates and profits are where they were in April when all of this nervousness began.

Conclusions that can be drawn

This cycle could end tomorrow, less than two years after it began. That would be very unusual because since World War II history has shown that recessions last under two years and expansions often last four years or more, and they seem to be getting longer as time passes. This particular business cycle follows an extreme business and credit collapse. It was not easy picking up the pieces of a credit crisis on the scale of disaster that occurred in 2008 to 2009, especially when the major banks, that we count on every day to conduct our lives, were on the brink of collapse.

Still, there have been two years of growth since then, uneven yes, but still real, and the capital base of the banks is much better than it was two or three years ago. The banks are making money. The wild party that was the housing market has ended, and the inventory of unsold homes is shrinking as the population grows.

The policymakers have set the cost of money at a very low rate. Through history, cheap money has worked time and again to encourage growth. It also affects the shape of the yield curve, which now, being very steep, is still one of the best forward indicators, using history as a guide, of future growth and of the willingness of the markets to take on risk.

The situation with companies, especially publicly traded companies, is impressive. They are sitting on record cash levels. These companies continue to break new records with incoming cash flow. They are tending toward more conservative balance sheets. Margins are coming close to exceeding previous historic highs. Revenues are rising, and unspent money on big-ticket capital items is slowly being untethered and released into the system, bringing with it new orders for trucks, containers, roads, computer servers, and software. And, new orders for workers, average American citizens, are geared to match up with the capital now being deployed and those workers will show up in better labor numbers and as newly engaged employees willing to spend a good part of their wages.

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