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Will the Economy Muddle, 'W,' or Surge?

With only a small bobble yesterday, the market as measured by the S&P 500 roared another 2.5% higher this week. It is some 7% higher this month, but still 32% below its peak on October 9, 2007. Good news from various economic indicators and positive comments from Central bankers and economists have boosted the confidence of investors. On Tuesday, Mr. Bernanke confidently declared that from a technical perspective, the "recession is very likely over at this point." But he added that tight credit conditions and unemployment will keep the recovery muted. The consensus view is that the economy is in recovery, but views diverge on the whether it is sustainable. The threat of government stimulus being removed prematurely and the notion that consumer spending will remain weak through next year weigh heavily on the prospects of strong recovery.

The week's economic reports continued their positive direction, climbing from historically low levels. Warren Buffet said yesterday that we've "hit a plateau at bottom. We have not bounced but we've quit going down." He also said "we're through the worst of it in residential real estate in all probability," adding that he doesn't expect a "double-dip" recession.

The homebuilders' housing market index rose for the third straight month adding credibility to the argument that housing is in recovery. It is also apparent that it will be uneven. September's index rose one point to 19 with strength centered in current single-family purchases. But single-family starts took a step back. Housing starts in August rose 1.5%, following a revised 0.2% drop the previous month. The August pace of 598,000 units annualized was down 29.6% year-on-year. The rebound in August was led by the multifamily component which jumped 25.3% after plunging 15.2% the month before. Housing permits rose 2.7%, following a 1.1% dip in July. The four-week average for new mortgages shows that purchase mortgages were down 0.4% while refinances increased 5.2%. Loan rates were mixed in the week with 30-year mortgages up 6 basis points to 5.08% and 15-year and one-year adjustable rate mortgages down slightly.

Unemployment looms as one of the largest threats to the fragile recovery. While the official unemployment rate stands at 9.7%, shadowstats.com calculates it to be closer to 21%. They believe unemployment is not going to improve any time soon. Their process is to add to the government numbers those discouraged workers, part-time workers that can't find full-time work, unemployed workers that have fallen off the unemployment roll, and others.

Data show that US companies are still reducing the ranks of temporary workers, showing that any rebound in overall employment won't happen soon. Manpower Inc. said last week that its index of U.S. companies' hiring plans set a record low for the third straight quarter. The latest reading was based on the outlook for fourth-quarter jobs. The staffing firm, began compiling the gauge in 1962. On a note of good news however, the government reported yesterday that the trend of firings is slowing. The number of workers filing new claims for jobless benefits fell 12,000 last week to 545,000. Economists had expected an increase.

Unemployment concerns are but one of the concerns that will impact consumer confidence and spending. A massive tax increase is coming in 2011 after the Bush tax cuts expire next year. Consumers may cut back their spending in 2010 in anticipation of higher taxes.

Consumers are also saving more and paying down debt rather than spending. According to Ian Shepherdson, chief U.S. economist of High Frequency Economics, households' financial balance -- the widest measure of savings, adding housing equity, rose to 3.3% of gross domestic product in the second quarter, the highest level in 17 years. But as reported by Randall Forsyth of the WSJ the pay-down is of little effect. Shepherdson says they brought their total debt-to-income level down to 129% from 131% in the first quarter and 135.9% at its peak in the first quarter of 2008. Shepherdson sees that ratio coming down markedly, consistent with the "new norm" of frugality discussed widely. He also noted that the dramatic tightening of credit conditions is working in the opposite direction. The latest data show that the rate of consumer debt pay-down is accelerating. While deleveraging is healthy for the individual consumer, it does not bode well for the idea that the consumer will bail us out this time.

Looking forward, the view of many is that we will experience a 'W-shaped' economic pattern, or a double dip. Dr. Ed Yardeni points out that as investors look beyond 2010, there are mounting concerns about the likelihood of the second recovery in this scenario, especially during 2011, if the Bush tax cuts are allowed to expire. He adds that the government stimulus will eventually have to expire, but they may be pulled too soon. There is also the threat that China, the current global engine, might stall if authorities reduce bank lending too abruptly.

Others, including Dr. Yardeni believe that that real GDP growth won't fall next year, but it will likely be lackluster; around 2%. He says "we've managed to muddle along before, and we will probably do it again. Besides, we always fret about the sustainability of recoveries, yet they usually do become self-sustaining and don't require any additional government stimulus programs." Fed Chairman Ben Bernanke seems to be in this camp as well.

Finally, there are those who believe the economy will be surprisingly strong in 2010. A weaker dollar might revive manufacturing in the US. Higher stock prices might provide a positive wealth effect on consumption and congress might extend the Bush tax cuts.

While each of the three scenarios has its own likelihood of occurrence, the truth is no one really knows what will unfold in the coming quarters. It took a financial meltdown of Depression-like strength to slow the mighty US economy and it will take untold energy and time, to rebuild its potential once again.

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