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## More on the “W”

Last week we discussed the possibility of a “W”-shaped recovery/recession. In such a scenario the economy rallies for a few quarters (two or three) then falls back into recession lacking sufficient momentum for recovery. Our economy started its growth trajectory surging 2.8% during the third quarter and is expected to continue growing for several months. The Conference Board released its index of leading economic indicators showing steady economic growth continuing into the new year. But the recovery is saddled with issues that will not quickly dissipate.

On Wednesday the Federal Reserve reiterated that they would continue “exceptionally low levels of the federal funds rate for an extended period.” While they noted that the labor market deterioration was slowing, they said they expected the economy to remain weak for “for a time” due to a weak labor market, only modest income growth, lower housing wealth, and tight credit.”

The case for a “W” rather than a “V” is gaining credibility. The ever-so-wise bond market is seems to agree. Yield on the 30-year Treasury which peaked at 4.43% during last week’s somewhat weak demand for a record funding if falling off again despite this week’s jump in the Producer Price Index. Bond investors may be indicating they believe the economic recovery will not be so strong as to spark inflation. Yields have risen from 3.89% in October to 4.43% today as the economy has continued to give signs of recovery.

The stock market is up nearly 65% since its March lows, having never risen so far so fast. The advance has made Americans \$5.4 trillion richer, boosting everything from consumer confidence to banks’ balance sheets. Earnings among S&P 500 companies are forecast to rise 65% in the fourth quarter and 24% next year. As the stock market anticipates roughly six to eight months ahead, one could argue the most optimistic of scenarios is already priced into the markets.

While a V-shaped recovery is certainly possible, the most stubborn component will be unemployment. Levels of 10% and above may prove too high a wall to scale this time. The government has already pledged, guaranteed, and spent more than \$11.6 trillion, before Obama’s trillion yesterday with little or no measureable impact on jobs creation. The good so far has come in the slowing of job destruction. But just how much credit the government can claim for its stimulus efforts slowing the decline or reversing the trend is debatable.

Last year, the press was full of stories about how aggressively and deeply businesses cut their workforces in the face of a crumbling economy. It is likely that a majority of businesses reached their employment targets early in cycle, choosing not to make graduated cuts. More recent job losses are probably the result of businesses that were more optimistic that the recession wouldn’t be as deep or as long as it has been. In other words, the slowing of job losses, doesn’t necessarily suggest job creation in the near future. Economists expect unemployment to remain above 10% until June of next year.

In this busiest shopping season of the year, the consumer remains engaged, but not overly enthusiastic. Redbook reported on Tuesday that same-store sales rose 1.5% over the same period last year. Seasonal goods are doing well and discounters are doing especially well. The report also noted that consumers have been procrastinating more than ever this year.

On the manufacturing side reports were largely mixed this week. The New York Fed reported that manufacturing in that region slowed to a crawl after very strong rates of growth in October and November. The Philadelphia Fed later reported that their headline index rose more than 3-1/2 points to 20.4, indicating strong monthly acceleration in the region's manufacturing sector. And the US reported that industrial production for November was quite healthy up a healthy .8%. Either the NY data was a temporary exception, or the harbinger of worse news in other regions.

Housing reports were also mixed this week. The homebuilder's housing market index fell back 1 point in December to 16, now 3 points below September's 19. While still very weak, 19 was the highest reading so far in the housing recovery. The report said that credit conditions remain very tight and that questions over job security are keeping potential buyers from taking advantage of government credits.

Housing starts in November rebounded 8.9%, following a revised 10.1% plummet in October. The November pace of 0.574 million units annualized was down 12.4% from a year ago. The bounce was led by a 67.3% rebound in multifamily starts, following a sharp 29.5% plunge in October. The single-family component edged up 2.1% after a 7.1% fall the month before. At best, housing remains in a slow recovery.

Bank leaders were chastised by the President earlier this week for trying to gut banking reforms and for, among other things, failing to lend. But pushing banks to lend in this environment is like pushing a rope. Eric Vason sums it up this way, "Just like you can't drink yourself sober, banks are not going to lend in the same manner that got them in to this mess." The loan environment has not turned the corner and may have another leg down as commercial mortgages. Banks have only written off roughly a third of the \$600 billion in problem commercial loans discovered during the stress test earlier this year.

Next year looks like a difficult one for the recovery as many of the primary cogs in the machine are missing. Businesses are not investing in capital or hiring, unemployment is at double digits and not likely to improve soon, banks are not lending and may face new credit problems with adjustable rate mortgages and commercial loan defaults, manufacturing is largely dependent on inventory rebuild at home and exports to a thin global economy, the consumer is facing huge headwinds of tight credit, high unemployment, and decreased home equity, and the housing market remains near its cycle bottom. Government support of autos has already been pulled and will eventually end for housing.

Recently announced stimulus may prove no more beneficial than the latest program in bringing back on line the economy's major components. It's not so much a matter of if as when. This recovery cycle could build enough momentum to push through as implied by the latest strong GDP reports, but it is hard to make the case without the participation of major components just mentioned. Our best advice is to revisit your plan and to make sure you are not taking any more portfolio risk than is absolutely necessary to meet your long-term goals.

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