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THE ECONOMIC OUTLOOK -- RECESSION RISK LOW

It has now been almost three years since the onset of the most intense phase of the financial crisis, in late summer and fall of 2008, and slightly over two years since the official beginning of the economic recovery in June 2009. Recall that the freezing of credit, the sharp drops in asset prices, dysfunctional financial markets, and the resulting impacts to confidence had sent global production and trade into freefall. Economic policy makers around the world correctly saw the monetary risks of a global financial meltdown in the fall of 2008 and understood the dire economic consequences of such an event. Governments and central banks moved to forcefully and in close coordination to avoid the looming collapse. Their actions to stabilize the financial system were accompanied, both in the US and abroad, by substantial monetary and fiscal stimulus. While the combination of these initiatives helped avert a much-dreaded global financial debacle, severe damage to the global economy was unavoidable. To an important extent, we continue to experience the after-shocks of the 2008 financial crisis in the form of a loss of confidence in both financial institutions and the ability of our political leaders to find solutions to the problems which stem from that period.

Where do we stand today? There have been a number of positive developments over the past few years. In the financial sphere, our banking system and financial markets are significantly stronger. Credit availability for many borrowers has improved, though it remains tight in some categories (i.e. small business lending) where the balance sheets and income prospects of potential borrowers remain impaired. Given the source of the crisis, structural reforms have been enacted to enhance financial regulation and supervision, especially for the largest and most systemically important financial institutions. Unfortunately, the sheer volume of these new regulations with which those institutions must comply, and the unintended adverse consequences of some of these, have themselves caused new uncertainties and have created impediments to a smooth working of the financial markets.

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Nevertheless, it is clear the recovery from the crisis has been subpar. Recent comprehensive revisions of government economic data we have reviewed show the recession was even deeper and the recovery weaker than previously thought; for example, following two years of recovery, aggregate output in the US still has not returned to pre-crisis levels. US stock prices are 25.0% below their prior highs despite record corporate profits. And, most visibly, economic growth over the past two years has, for the most part, been at rates insufficient to achieve sustained reductions in the unemployment rate which remains above 9.0%.

The pattern of sluggish growth was particularly evident in the first half of this year, with real GDP estimated to have grown at an annual rate of only 0.8%, on average. It is true that some of this weakness can be attributed to temporary factors including the pressures placed on consumers and business by the run-ups earlier this year in energy prices and other commodities, the effects of the disaster in Japan on global supply chains and production, and disruptive storms in the US. Now, with commodity prices coming off their highs, manufacturers' problems with the supply chains well along to resolution and more normal weather here at home, GDP growth in the second half, is likely to pick up to about 2.0% -- better, but still well below-trend.

PERSISTENT HEADWINDS

However, new data suggest other, more persistent factors have been retarding the recovery. A striking aspect in the weak recovery is the unusual weakness in household spending which amounts to about 70% of GDP. After contracting sharply during the recession, consumer outlays expanded moderately through 2010, only to decelerate in the first half of this year. The aforementioned temporary factors -- the rise in commodity prices, which has hurt households' purchasing power, and the disruption in manufacturing following the Japanese disaster, which reduced the supply of autos and hence sales -- are only partial explanations for this slowdown. Households are struggling with other important headwinds as well, including the persistently high level of unemployment, slow gains in wages for those who are working, falling house prices, and debt burdens that remain high for many, despite the fact households, in aggregate, have been saving more and borrowing less. Consumers seem exceptionally cautious. Indeed, readings on consumer confidence have fallen substantially in recent months as people have become more pessimistic about economic conditions and the seeming inability of government to agree on solutions to our economic problems.

Compared with the household sector, the business sector is performing well. Manufacturing has risen nearly 15.0% since its trough, driven importantly by growth in exports. Indeed, the US trade deficit has narrowed substantially when compared to where it was prior to the crisis, reflecting in part the improved competitiveness of US goods and services. Business investment in equipment and software is also continuing to expand rapidly. Corporate balance sheets are flush with cash and companies with access to public financing have generally had little difficulty in obtaining credit on favorable terms. But, problems are also evident in the business sector: Business investment in non-residential structures such as office buildings, factories and shopping malls, has remained at a depressed level, held back by elevated vacancy rates at existing properties and difficulties, in some cases, in obtaining construction loans.

VIRTUOUS CYCLE?

Historically, recessions have tended to create the preconditions upon which subsequent recoveries are built as reduced spending on investment, housing and consumer durables generates pent-up demand. As the business cycle bottoms out and as confidence returns, this pent-up demand, usually augmented by the effects of stimulative monetary and fiscal policies, is met through increased production and hiring. Increased production in turn boosts business revenues and increased hiring raises household incomes -- providing further impetus to business and household spending. Improving income prospects and balance sheets also make households and businesses more credit worthy, and financial institutions more willing to lend. These developments normally create a "virtuous cycle" of rising incomes and profits, more supportive financial and credit conditions and lower uncertainty, allowing the process to build upon itself. While these restorative forces are at work today, and they will continue to promote our business recovery over time, the depth and scope of the past recession was extraordinary and unusual in being associated with both a financial crisis and a deep housing market slump. These two features of the downturn, individually and in combination, have acted to slow the natural recovery process.

HOUSING OVERHANG

Notably, the housing sector has been a significant driver of recovery from most recessions in the US since WWII. This has not been the case in this instance. The overhang of distressed and foreclosed properties, tight credit conditions for builders and potential homebuyers, and ongoing concerns by both borrowers and lenders about potential future house price declines has depressed new construction to a rate of less than one-third of its pre-crisis peak. Depressed construction has hurt providers of a wide range of goods and services related to homebuilding. The weak housing market has also adversely affected financial markets and the flow of credit as the sharp declines in house prices in many areas have left homeowners "underwater" on their mortgages creating financial hardship for households and, through their effects on rates of mortgage delinquency and default, stress on lenders as well.

Clearly, the financial crisis of 2008-2009 played a central role in sparking the global recession while banking and financial conditions in the US have improved significantly since the depths of the crisis, financial stress continues to be a significant drag on the recovery both here and abroad. This drag has become particularly evident in recent months, as bouts of sharp volatility and risk aversion in markets have reemerged in reaction to concerns about European sovereign debts and related strains, as well as developments associated with the US fiscal situation, including the downgrade of the US long-term credit rating by S&P and, the acrimony surrounding the raising of the US debt ceiling. How much these events and the associated financial volatility have affected economic activity thus far is anyone's guess. We have little doubt they have damaged household and business confidence and they pose ongoing risks to future growth. Moreover, they have made clearly visible the inability of governments globally to come to grips policy-wise with their most pressing fiscal problems.

GOVERNMENT RETRENCHING

While the weakness in housing and continued financial volatility are two key reasons underlying the frustratingly slow pace of recovery, other factors are also likely to be at play. For example, state and local governments continue to retrench cutting spending and reducing payrolls in the face of ongoing budgetary pressures, while federal fiscal stimulus is being withdrawn. In the absence of adequate demand from the private sector, a substantial fiscal consolidation in the short-term could add to the headwinds facing economic growth and hiring. Acting now to put in place a credible plan for reducing future deficits over the longer-term while being attentive to the implications of fiscal choices for the recovery in the near term can help serve both objectives and help to restore confidence.

FORECAST

With last week's employment report showing the US failed to generate any net new jobs last month and flat retail sales for the month of August, the outlook for a resumption of more vigorous growth remains uncertain. Particularly disappointing in Friday's jobs report was the 0.1% decline in hourly wages during August. Growth in pay is an important underpinning for consumption. While consumption has held up well so far, there are fears that with consumer confidence falling to a multi-year low, households, already inclined to delever, will retrench. Elsewhere, housing remains in the doldrums, manufacturing continues to expand, albeit at a more moderate pace than earlier this year, as does the service sector. Recent readings of the Institute for Supply Management Manufacturing and Non-Manufacturing indices, high-frequency economic indicators, continue to signal expansion. Government spending at all levels continues to shrink as thousands of government workers have been laid off in order to bring spending under control. More of this should be expected.

On balance, then, we see the economy continuing to expand at a modest pace during the balance of this year, with GDP growth of 2.0% and unemployment remaining close to the current 9.1% rate. Recent research checks with industry sources provides little, if any, evidence of a material slowdown in business and, in fact, our Economic Model and the Leading Economic Indicators continue to signal expansion. While our current forecast represents a moderate downgrade to our mid-year expectations, we believe the odds of a new recession (i.e. two consecutive quarters of no real GDP growth) are low. Inflation will remain below the Federal Reserve's target of 2.0%, allowing the central bank to continue its accommodative monetary policy for the foreseeable future. Fed measures to lower long-term US Treasury rates and to encourage bank lending through unconventional steps should be expected this fall. While additional fiscal stimulus measures have now been proposed by the White House, their passage by Congress is problematic.

CORPORATE PROFITS

Corporate profits have been on a tear, propelling the stock market's 70% advance from its March 2009 lows. S&P 500 companies have been successful in cutting costs, keeping payrolls lean and expanding their overseas sales, particularly those to emerging markets. In general, since the expansion took hold in the winter of 2009, profits have exceeded expectations. Now, analysts have begun to trim their earnings forecasts for the third and fourth quarters as the slowdown continues.

Nevertheless, we forecast S&P 500 profits to reach $95.00 per share this year, a record, and $104.00 per share in 2012.

THE POLITICAL FACTOR

With governments playing a critical role in financial markets, signs in the US that the rancor between Democrats and Republicans has not dissipated could become a key overhang in the weeks ahead. In Europe, debates between Germany and France and the rest of the Euro zone are also providing worries that Europe is far from reaching any resolution to its crisis.

THE MARKETS

As for the US stock market, we believe the recent sell-off is attributable, in part, to a sense of policy paralysis in the US and Europe as well as the recent marking-down of profit expectations. Given the political and economic uncertainties, we expect market volatility to remain high until there is greater clarity regarding deficit reduction efforts here and progress in achieving fiscal unity in Europe. Nevertheless, with stocks selling at roughly 12.6 times this year's expected earnings and only 11.5 times 2012 forecast earnings, we believe market valuations are incorporating a deeper slowdown than is now generally expected and that share prices are compelling. Compare the 2.0% dividend yield on the S&P 500 with the 2.08% yield on 10-year US Treasury bonds which provide no inflation protection. Corporate balance sheets are strong. And, the consensus of investors remains negative. Any meaningful progress toward resolving the aforementioned political issues could ignite a substantial upward revaluation of stock prices given their statistical cheapness. Periodic corrections should be expected.

Meanwhile, bonds remain unattractive. We are, therefore, limiting purchases to issues with maturities of 3 years or shorter in the expectation we will find opportunities later on to extend maturities at higher yields. We recently eliminated TIPS holdings from clients' bond portfolios as TIPS prices have significantly exceeded our expectations and they appear to be richly valued.

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