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Build Knowledge/Valuation & Analysis

## Expect Real—Though Weak—Q4 Recovery

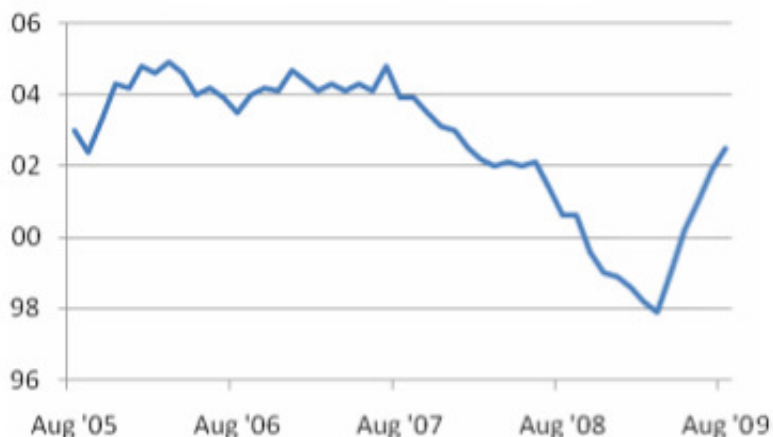
By Barry Mendelson, CIMA  
 Oct. 15, 2009

**A review of third-quarter economic indicators—including stock and bond performance—reveals equal parts guarded good news and cautionary tales. Reasonable expectations are that the fourth quarter will turn in positive performance despite lagging indicators in labor, consumer spending, and real estate.**

What a difference a year makes! In September 2008, the global financial system came under extreme distress in the wake of the collapse of Lehman Brothers and the bailout of AIG. Fear dominated financial markets, individuals, and businesses.

Over the following months, the transmission of news between the financial system and real economy proved almost instantaneous, bringing deep economic contractions in late 2008 and early 2009. The extreme interconnectivity of the global economy became evident.

### Leading Economic Indicators



Source: Conference Board

Policy makers responded with deep interest rate cuts, massive coordinated fiscal stimulus, and creative actions to help stabilize the global financial system. Although it was a rocky road, these actions paid off.

Signs materialized that the worst of the contraction had passed. Second-quarter data showed that Asia had rebounded strongly and that the tide was turning in other regions. The terribly synchronous global downturn was rapidly changing to a synchronous global recovery.

The focus is now on the shape of the recovery. We believe that the U.S. recovery is for real, summed up by three broad conclusions:

- First, the U.S. and global recessions are in the process of ending, but the recovery will be [much weaker](#) than would normally be the case after such a steep downturn. Restrained credit conditions and the need for companies and individuals to rebuild their balance sheets will be a major headwind to growth over the next several years.
- Second (and a related point), [inflation risks](#) should remain low over the next couple of years. At some point, it is possible that excessively easy monetary policy could lead to higher inflation, but it is too soon to consider inflation a significant current risk factor.
- Third, from an equity markets perspective, the combination of stimulative policy and a modest economic revival has pushed and should continue to push stocks higher.

## Economy

A summary of how the economy fared and developing trends in Q3:

### Income and spending

The U.S. economic recovery is easier to understand as an exhaustion of sources of weakness than as the sum of sources of strength. [Consumer spending](#) growth will likely be positive but modest as personal income will be slow to rise.

Incomes will recover somewhat when the aggregate hours worked in the economy start to rise, but with wage inflation falling, interest rates low, dividends cut sharply, and increases in government transfers likely to slow, there are a number of factors that will be a drag on rebounding personal income.

### Labor market

September employment data indicate that while job losses are [moderating](#), they are still very large. The unemployment rate rose to 9.8% in September.

### Third-Quarter Analysis

- Rising unemployment, but fewer job losses
- Housing tests bottom
- Credit spreads narrow; Treasury yields fall slightly
- Global recovery begins
- Markets on the mend, signaling recovery

### Jobs



Source: Bureau of Labor Statistics

The details of the September employment report, moreover, indicate that conditions in labor markets remain very tough. The length of the workweek edged down slightly to 33 hours. We expect conditions to improve in the months ahead, but a return to job growth is some months away.

## Inventories

Another area where weakness is showing signs of exhaustion is in the change in non-auto inventories. As the initial phase of severe liquidation gives way to slower liquidation and eventually to modest accumulation, the contribution to real GDP growth will swing from negative to positive.

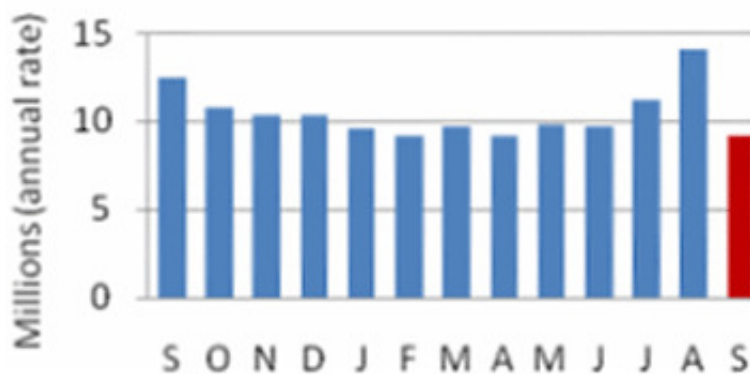
The downtrend in capital equipment spending is also starting to show early signs of exhaustion. Other sectors are likely to remain weak, including the private structures component of capital spending, given the serious problems in commercial real estate.

Also, the [state and local sector](#) is usually a laggard behind cyclical developments in the rest of the economy. The recent recession was so severe that state and local spending is likely to stay sluggish for an extended period of time.

## Autos

A bottoming in auto sales from extremely depressed levels was emerging even before the "Cash for Clunkers" program was adopted. Cash for Clunkers merely borrowed demand from future months. Auto sales had been so severely depressed for so long that there had finally been a buildup of pent-up demand.

### Auto Sales Fall in September



Source: Bureau of Economic Analysis

While the program was certainly successful at stimulating auto sales in the short term, its longer-run impact is open to question. Sales fell 23% in September. A larger issue is whether the program may have cannibalized other forms of consumer spending. Only time and additional data on consumer buying will tell.

## Housing

Another sector where the downtrend is showing signs of exhaustion is residential construction. Declining residential construction has been reducing GDP growth by about 1% per quarter for several years.

The good news: the second quarter of 2009 should mark the last quarter of decline. Like the auto sector, residential construction dropped to extreme levels. Evidence is mounting that a tentative uptrend is beginning.

With respect to house prices, the U.S. has entered a bottoming phase. We expect an L-shaped pattern for house prices and are now near the inflection point from "down" to "flat." Modest recent monthly increases in home prices are encouraging, but some concerns remain.

In the same manner as the Cash for Clunkers program, the expiration of first-timer home-buyer tax credits may stunt price gains in early 2010. Additionally, stubbornly high unemployment and mortgage-rate resets will keep foreclosure rates elevated.

### **Commercial real estate**

Commercial real estate is under [stress](#). There are serious difficulties in refinancing these properties. However, commercial real estate needs a broad macroeconomic fix even more than it needs refinancing.

In contrast with residential real estate, there was not much physical overbuilding of commercial real estate during the boom. Commercial real estate suffered more from a negative demand shock due to the recession than from legacy overbuilding. Prices of commercial real estate properties were elevated by easy credit during the boom on the assumption that demand for space would remain strong. Many commercial properties were financed or refinanced against that peak valuation.

One result of the financial crisis was to lower demand for commercial space and drive up vacancies, thus weakening the clearing price of commercial rents. As bankruptcies of tenants continue and leases roll over, cash flows are likely to drop. Unlike residential real estate, however, commercial real estate is not the core of consumer net worth, limiting the spillover impact on consumption.

### **Inflation and interest rates**

With excess productive capacity and a high unemployment rate, we expect the Federal Reserve to retain a zero federal funds rate until the second half of 2010. The excess capacity in the goods and labor market is likely to sustain a downward shift in core inflation.

Moderating inflation may temper the decline in real wage incomes, since inflation often comes down in the early stages of a recovery, when a good deal of slack remains in the economy. While oil prices may increase a bit with the pickup under way in the global economy, core inflation is expected to decline further.

Productivity is continuing to increase at a solid pace, while all the principal measures of wage rates or total compensation show signs of a marked slowdown. In the non-farm business sector, for example, the year-over-year increase in compensation per hour in the second quarter was 1.3%, down from 4.3% two years earlier. Unit labor costs in the second quarter were 0.6% below their

levels year earlier.

A [drop in prices](#) does not guarantee further moderation in core inflation, but it makes it probable, since unit labor costs play a key role in price determination. The most likely case is that the long-term trend of consumer price inflation should be about 2.5% over the next decade. We understand the widespread concern expressed by many that the Fed may cause higher inflation by staying too easy for too long, but we are confident that this risk lies a few years away.

Inflation pressures should remain dormant as long as there is so much slack in the labor and goods market. As a result, there is no reason for the Fed to adjust its policy stance anytime soon.

## Financial markets

A summary of how the markets performed and developing trends in Q3:

### Equities

From an equity markets perspective, the question has become one of [valuation](#). On the one hand, it is reasonable to expect valuations to be below average, given the severity of the downturn and the high degree of uncertainty. On the other hand, extremely low levels of interest rates and inflation provide support in the other direction. Furthermore, year-over-year earnings comparisons should be favorable.

### S&P 500: 10 Years



Source: Standard & Poor's

On balance, we believe that equities are fairly valued and that earnings are likely to be the driver of market gains going forward. Productivity has been dramatically improved, and we believe that future earnings growth must be delivered by top-line revenue growth, not continued cost cutting.

The rally off March 9 lows was driven by increased optimism about the economy following the massive coordinated government intervention and highly accommodative monetary policy. Given that backdrop, and our belief that the recession is ending, it appears the path of least resistance for stocks should continue to be up.

Nevertheless, investors should be at least prepared for near-term corrections. The market has

advanced 56% from the March 9 lows. Stocks are no longer as cheap as they were several months ago, and a great deal of outlook uncertainty remains.

On the upside, there is still a great deal of cash on the sidelines looking to enter the markets, which could provide another positive jolt to returns. On balance, investors should expect high levels of uncertainty and volatility to continue.

## Fixed income

In the bond market, lower quality continued to outperform. The Barclays Capital High Yield Bond Index returned 14%, while the Aggregate Bond Index returned 3.7%. Yields fell and spreads narrowed in the corporate bond market as the 10-year Treasury yield (currently 3.2%) declined only slightly. Concerns over inflation have subsided, at least for now.

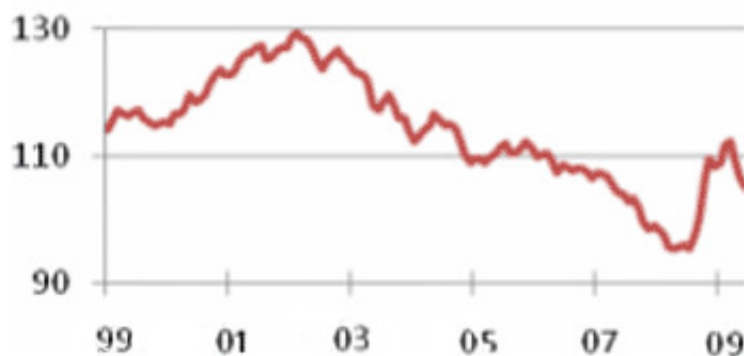
Within the Aggregate Bond Index, BBB-rated securities returned 9.2%. Longer-term bonds also outperformed in Q3 but trail intermediate- and shorter-term bonds YTD.

## Currency

Easy U.S. monetary policy is one explanation for the [weakness in the dollar](#) recently. Another is the interest expressed by major dollar holders in "reserve diversification."

The Chinese yuan is undervalued against the U.S. dollar, as are many other currencies. The dollar is blocked from falling against what it should fall against—the yuan—so it has fallen against what it can (other major currencies).

### Dollar vs. Trade-Weighted Index



Source: Federal Reserve

In what is still a deflation-risk environment, we do not expect the Fed to resist dollar weakness by tightening. As a result, any dollar weakness is unlikely to significantly reduce financial liquidity in the U.S. economy.

In the current context, there are stronger odds of movement toward a negotiated reshuffling of influence within international monetary institutions than of disorder in the foreign exchange market. The simultaneous worldwide economic expansion means that risks are dropping in most countries. Financial stress is falling rather than rising, so dramatic moves appear unlikely.

Performance through 9/30/2009		1 mo	3 mo	YTD	1 yr	5 yr
<b>S&amp;P 500</b>		3.7	15.6	19.3	-6.9	1.0
	Consumer staples	3.7	11.4	9.4	-4.6	6.2
	Consumer discretionary	5.3	19.3	29.6	-0.1	-1.2
	Health care	1.1	9.5	9.7	-3.6	1.8
	Materials	5.0	21.5	38.4	-4.2	4.4
	Information technology	4.5	17.0	46.1	8.5	3.7
	Energy	4.7	10.1	7.8	-14.4	10.0
	Industrials	6.8	22.0	14.8	-12.7	-0.3
	Telecom services	3.0	5.6	1.4	0.0	2.0
	Utilities	1.4	6.2	4.3	-7.1	7.0
	Financials	2.0	25.5	21.2	-23.5	-9.6
<b>Russell</b>						
	3000 Value	4.0	18.6	15.0	-10.8	1.0
	3000	4.2	16.3	21.2	-6.4	1.6
	3000 Growth	4.4	14.1	27.3	-2.2	2.0
	1000 Value	3.9	18.2	14.9	-10.6	0.9
	1000	4.1	16.1	21.1	-6.1	1.5
	1000 Growth	4.3	14.0	27.1	-1.9	1.9
	MidCap Value	5.6	23.6	27.6	-7.1	3.5
	MidCap	5.7	20.6	32.6	-3.6	3.9
	MidCap Growth	5.8	17.6	37.1	-0.4	3.8
	2000 Value	5.0	22.7	16.4	-12.6	1.8
	2000	5.8	19.3	22.4	-9.6	2.4
	2000 Growth	6.6	16.0	29.1	-6.3	2.9
<b>Dow Jones Industrial Avg</b>						
	MSCI EAFE	2.4	15.8	13.5	-7.4	1.9
	MSCI Emerging Markets	3.9	19.5	29.6	3.8	6.6
	NAREIT Equity REIT	9.1	21.0	64.9	19.4	17.7
	Dow Jones-UBS US Commodity	6.4	33.3	17.0	-28.4	1.4
		1.6	4.2	9.1	-23.7	-0.7
<b>Barclays Capital (BC) Aggregate</b>						
	BC Government	1.1	3.7	5.7	10.6	5.1
	BC Credit	0.8	2.0	-1.2	6.7	5.2
	BC High Yield Corporate	1.7	7.5	14.9	19.5	4.7
	BC Municipal	5.7	14.2	49.0	22.3	6.1
	BC TIPS	3.6	7.1	14.0	14.9	4.8
	Merrill Lynch 3-month T-Bill	2.1	3.1	9.5	5.7	4.8
	BC Global Aggregate Bond (ex. US)	0.0	0.1	0.2	0.4	3.1
		2.8	7.9	9.2	15.4	6.7

- All major asset classes had positive returns in the third quarter. [REITs](#) were strongest, up 33%. Outside of cash, government bonds were the slowest, up 2%.
- After bouncing from mid-March lows in the second quarter, U.S. stock markets were positive in all three months of the third quarter, marking seven consecutive up months.
- Small-cap stocks outperformed in both Q2 and Q3, and have a small YTD lead.
- Value outperformed growth in the quarter, predominantly attributable to financials, which are a larger component (and had a higher return) in value indexes.
- As in Q2, the rally in financials led the broad market. Technology, still strong, leads YTD.

Defensive sectors underperformed.

- Internationally, Q3 performance was similar to the U.S. Europe led in both developed- and emerging-market indexes. The MSCI EAFE returned 20% in Q3 and is up 30% YTD.
- Emerging markets are up 65% YTD. Emerging-market growth will likely remain strong, but valuation is a concern. High volatility will persist.
- Investors preferred riskier fixed-income sectors. High-yield bonds continued their rally from late-2008 lows and record-high spreads. Longer-term and lower-quality bonds outperformed in Q3.

## Outlook

A decisive upturn in the Conference Board's Leading Economic Index series since March has been reflected by better financial market performance. This backdrop is consistent with an economic recovery, which we believe is in the process of beginning and will be reflected by the third-quarter GDP report. While we expect some positive news to continue, *this recovery will not be robust*. Challenges will continue, and it will be quite some time before the economy is back on a solid foundation.

The key question now is what type of economic recovery will take shape. The recession was deep, erasing 3.9% of real U.S. GDP. Swift policy responses prevented the recession from spiraling into a worst-case scenario, but the impact of the financial crisis will continue to be felt for years to come.

The economic recovery may be delineated into two stages. The first stage reflects the depth of the decline and the breadth of the policy response to counter it. During the financial crisis, households held off on purchases, and in response, businesses cut production in order to draw down inventories. The actions of the Fed to boost liquidity have been successful in causing a fairly broad-based improvement in financial conditions.

### Fourth-Quarter Expectations

- Unemployment ticks upward
- Fed maintains low rates and easy policy
- Positive GDP in second half
- Consumer will be slow to spend
- Equity advance will be more selective

As confidence has returned to the markets and equities have begun to rebound, pent-up demand—especially for consumer durables and aided by fiscal stimulus and Cash for Clunkers legislation—will lead to a rebound in consumer spending in the year's second half. The reemergence of the automakers from recession will help business inventory investment further boost economic growth. Finally, a trough in the housing market is also central to returning growth to positive territory.

As a result of these developments, third-quarter real gross domestic product (GDP) is now expected to increase at a little better than 2.0% at an annual rate, with inventory investment and residential construction playing critical roles. Together, these two sectors contributed -2.0 percentage points to the annual rate of change of real GDP in the second quarter. In the third quarter, their contribution will probably add about one percentage point, thus accounting for the bulk of the expected turnaround in economic growth from the second to the third quarters.

After the initial boost to household spending and rebound in production, the second stage of the recovery in 2010 is likely to be characterized by a more contained pace of expansion. This slower pace of recovery implies a longer period of time before economic activity returns to pre-crisis levels.

We do not anticipate the level of real GDP to return to its pre-recession level until the fourth quarter of 2010 at the earliest. The U.S. economy in 2010 will still be influenced by households' continued need to increase savings in order to repair lost net worth. U.S. home prices—which to date are down over 30%—will likely bottom in the second half of 2009. Nonetheless, the idea that households can count on their homes as a source of savings has been soundly squashed by the events of the last three years.

Positive job growth will begin in the early quarters of 2010, but by then the unemployment rate will likely have reached a peak of 10.5% or so, and will be slow to move down. The hangover from the credit boom makes the outlook for income growth much more important to the pace of consumer spending growth. Limited wage gains will leave households struggling to continue to rebuild their nest eggs as well as finance current consumption.

We expect an elevated personal savings rate to continue. Non-residential construction is expected to lag the economic recovery and will subtract from economic growth. Credit conditions in this sector remain tight, and high vacancy rates and low capacity utilization will limit the need for increased commercial and industrial space.

The recovery will gain greater traction in 2011. Consumer spending can strengthen as conditions in the housing market begin to improve and job growth picks up. As excess capacity is reduced and corporate profits continue to improve, the pace of business investment should accelerate, improved investment should accelerate, and improved global growth prospects will support export growth.

The markets should reflect this new dynamic. Nonetheless, lingering economic slack will limit inflationary pressures. Core CPI is likely to remain below 2.0%, giving the Fed the time it needs to unwind its expansive monetary stimulus.

*Barry K. Mendelson, CIMA, is the managing partner of [Capital Market Consultants, LLC \(CMC\)](#), a specialized RIA that provides customized investment manager, mutual fund, and economic research as well as portfolio modeling advice to financial organizations and RIAs. [CMC Unified Management Account portfolios](#), based on CMC manager research, are available to RIAs on all major independent custodial platforms.*

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