Economic and Market Update: May 4, 2009

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The Economy:
The Bureau of Economic Analysis estimated that the U.S. economy contracted by an annualized 6.1% in the first quarter, following a 6.3% decline in the fourth quarter, 2008. This is very bad news and accounts for the rapid rise in unemployment. However, some components of the GDP release were somewhat encouraging, indicating that the sharp contraction in GDP will slow considerably in subsequent quarters and moderate growth may occur in the 2nd half of 2009.

First, consumer spending rose by 2.2% and, in contrast to investment, contributed positively to growth. Second, the inventory adjustment subtracted 2.79% from growth. This suggests that businesses are quickly adjusting to the GDP contraction and the fall in industrial production should moderate for the remainder of the year. Third, in perhaps the biggest surprise, state, local and federal government spending collectively subtracted 0.81% from growth. This will be reversed as spending from the stimulus package increasingly kicks in for the remainder of the 2009 quarters.

The most damaging part of the report was the dramatic fall in non-inventory-related investment, 6.04%. This accounted for more than 100% of the entire GDP contraction. The contraction was significant in all three major components of non-inventory-related investment. Despite leading the economy into recession, the drop in residential construction, 1.36%, was the largest quarterly percentage drop to date. The only potential benefit is that the fall in construction will lead to a lower inventory overhang in future quarters. Commercial construction subtracted 2.13% from growth. This component is only now beginning to drop precipitously and will likely continue to drop sharply for several more quarters. Finally, equipment and software investment subtracted 2.55% from growth, the second straight quarter of a greater than 2% drop. Further contraction in this component can be expected, although the stimulus program should slow the drop for the remainder of the year.

Finally, the net export sector is buffering the downturn in the economy as the contraction of imports related to the drop in the demand for consumer goods is disproportionately felt by foreign suppliers to the U.S. In effect, the U.S. is exporting about a portion of the downturn (if this were not the case the annualized decline in the GDP in the past two quarters would have exceeded 7%). Although the drop in both exports and imports is a negative sign for the economy, the net decline in the monthly U.S. trade deficit means that the U.S. must import less foreign capital which, in the long run, will lessen the downward pressure on the dollar.

Looking forward, second quarter GDP is likely to contract by between 1 and 2%. The most positive factor will be the impact of the stimulus on personal income, private investment and public spending. I expect personal consumption will add between 1 and 2% to growth. Inventories may continue to be liquidated but, with the possible exception of autos, at a slower pace. The way GDP is computed, if the rate of inventory disinvestment declines, there will be a positive impact on growth. Further, the decline in both residential construction and in equipment and software should moderate. However, commercial construction will likely continue to decline at a 2% or greater pace. On balance, then, investment should subtract less than 4% from growth, as opposed to the eye-popping 8.83% (combining the 6.04% from non-inventory-related and 2.79% inventory subtraction). Imports are likely to decline less than the 6% in the first quarter as consumption ticks up while exports are likely to continue dropping at near the 4% level of the first quarter. Thus, second quarter net exports could either subtract or add a small amount to growth. Finally, government expenditure, especially at the federal level is likely to rebound and the drop in state and local spending will be mitigated by those components of the stimulus package that are intended to support state and local police and education jobs. On balance, I expect total government spending to add, say, 1/2% to growth.

Second half growth will be bolstered by the full effect of the stimulus package and the declining momentum of the effect of the housing downturn and leverage and subprime-inspired banking collapse. Still, consumer credit and commercial credit default rates are likely to increase. Perhaps more importantly, unemployment will continue to rise, which will negatively impact household income and spending as well as make many households more risk-adverse. Finally, although the decline in residential housing prices will slow, on average, further declines will likely offset much of the positive impact of the wealth-accumulation effect of recently higher equity prices. Thus, it is too early to say that growth will rebound meaningfully in the second half. My best guess is that growth in the second half will be between flat and up 2%. This would leave the year's contraction in the 2-3% range. In this scenario, the unemployment rate is likely to climb to near 10%.

Longer term, I am skeptical that growth can return to the robust levels of the past two decades. U.S. households will not soon recover the loss of wealth from the decline in equities and housing prices. The unemployment rate will stay high for several years to come, probably averaging more than 8% in 2010 and 6% for two years beyond 2010. And, as baby-boomers age into their 60's the U.S. will face on-going and rising public obligations from Social Security and Medicare. Further, we enter this period with budget deficit in 2009 and 2010 that are likely to be the highest as a percent of GDP in any non-war period. On balance, then, U.S. households will be forced to spend less and invest more in order to build the productive base needed to service both our external (trade-deficit-related) and internal (budget-deficit-related) debts.

The Markets – Interest Rates:
Recently, longer-dated treasury rates have been rising even as short-dated rates remain at 0%. The 10-year note rate has risen to 3.2% from a low just over 2%. Meanwhile, the spread between treasuries and more risky securities has narrowed, although most have remained unusually high and well above the "typical" spread of the past couple of decades. This result is natural if one considers the U.S. government has taken on many of the obligations of the private sector.

I am neutral on longer-dated treasuries and I expect short-dated treasuries to remain at 0% well into 2010. As long as the unemployment rate is above 8% and capacity utilization is 10 points below the 80+% that would get the Fed's attention, there is no reason for a change in the target fed-funds rate. With respect to longer-dated maturities, the negative associated with the rising level of federal debt to GDP and fears of longer-term inflation are offset by the willingness of the Fed, given current conditions, to defend Treasuries by buying whatever is needed to "sop up" excess supply. In addition a further contraction in the demand for credit from the private sector will likely make domestic and foreign holders of fixed income, pensions, sovereign funds, banks, hedge funds, etc. hold increasing amounts of Treasuries and other forms of debt guaranteed by the Fed.

Equities: I view the primary reasons for the sharp 30% rally in equity prices as:

- The near-term deeply oversold condition of the market in March,
- Optimism that the economic contraction is subsiding, and
- Liquidity looking for a home as the Fed floods the market at the same time credit demand is declining.

In addition, analysts and corporations lowered their earnings expectations so dramatically that actual earnings came in somewhat better than expected.

Looking forward, I suspect that earnings from non-financial companies will continue to decline in 2009. More write-offs from downsizing will continue for several more quarters and, on balance, profit margins will be negatively impacted as production volumes continue to decline for at least one more quarter. On the other hand, stock prices are forward looking and, once production is brought in line with future sales projections, companies will presumably be lean. Further, they will be reluctant to hire until an upturn in demand is firmly established. Thus, productivity should begin to increase quickly and that will reverse the decline in margins. Based on this reasoning, much of the recent rally in stock prices is justified.

Has the sharp rebound already captured the most optimistic growth and earnings scenario or is there more to come? In my opinion, the news on the economy will continue to be quite mixed through the second quarter although, in comparison with the circumstances last fall and winter, the news will continue to be better. Thus, although several economists and analysts I respect are calling for new market lows, I disagree. This is not the "Great Depression" but rather the "Great Recession".

At the same time, I don't see a lot more upside to the market. The factors that will contribute to an economic recovery are the stimulus and an aggressive Fed. However, the

Administration has been straight forward in acknowledging that it will not be "business as usual" with regard to policies. The recent willingness to let Chrysler declare bankruptcy and their failure to give into the various constituencies that had claims on any remaining equity in Chrysler sends a loud and important signal to investors. Clearly, businesses and jobs will become more important than capital providers. This is a clear reversal from the policies of the past four Administrations, especially the most recent one.
In addition to the effect of policy changes, the "hangover" from the credit crisis will leave banks, private equity and hedge funds less willing to "leverage up" as rapidly once growth returns. Increased and, hopefully, improved regulation will also play a role. Thus, what we monetarists refer to as the "power of money" is not likely to be restored to the heady levels of the early 2000's. Thus, wealth increases are likely to increase more slowly.

The bottom line is that, after rising steadily for two decades, profits as a proportion of GDP is likely to reverse course, leading to gains in the government's share and, to a lesser extent, labour's share. In this climate, equity prices are not likely to move back to the 2007 level for at least several years. My forecast is for the S&P to remain in a range from, say, 750-950 for the remainder of the year.

The dollar:
Several factors have allowed the dollar to remain stable, despite the economic problems and the huge net foreign investment in the U.S., and zero policy rates. First, aside from China, economies outside the U.S. are also contracting. Second, stress in Eastern Europe is giving pause to those who might otherwise convert dollars to euros. Third, many Asian countries, particularly China and Japan, "manage" their currencies, holding them steady by buying huge amounts of Treasuries or Treasury equivalents.

In the present situation, I would steer clear of the euro. The conflicting pressures cited above give me little confidence in a move, up or down. At the same time, the recent stability that has kept the euro trading between 1.25 and 1.45 since last October, could end at any time, should news either in the U.S. or Eastern Europe cause an abrupt move.

Although I see the potential for it to appreciate over the longer term, the yen has recently held in a range near 100-1, as economic weakness in Japan exceeds that in the U.S., and as rates in Japan are also near zero. Given its reliance on exports, Japanese authorities are committed to preventing a rise in the yen that would worsen the competitiveness of its exports.

The Canadian dollar has rallied to the top of its 6-month range of 77 to 85 cents. Although the Canadian economy is, like the U.S., in a deep recession, policy moves over the past decade, the integrity of the banking system, and the availability of basic resources will likely favour the Canadian dollar over the intermediate term. I am raising my near term range on the Canadian dollar to 81 to 87 cents and look for the Canadian dollar to rise back to the 90 cent level over the next 9-12 months.

Finally, although the Chinese yuan has been very stable in the past few months, I consider the currency a "one-way" bet. Over time, the Chinese yuan will appreciate, although on a controlled basis. With China needing to import vast amounts of resources to maintain growth and with China becoming relatively more dependent on domestic growth, I think Chinese policymakers will eventually conclude that a rising yuan is beneficial to their development. The downside is that yuan appreciation depreciates the value of their vast holdings of foreign debt. However, I see the Chinese authorities as relying less on increasing their overseas holdings, given the huge internal growth possibilities and the potential for increasing domestic consumption.

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