

# U.S. Market Watch

JULY 2010 | Markus Schomer, CFA *Managing Director, Chief Economist*

## Overview

- We are halfway through the year, and it's worth our time to take stock of the state of the US economy and look ahead at the next six months. Until recently, the US recovery seemed firmly on track.
- The three-month period that ended June 30 will likely deliver the fourth consecutive quarter of real GDP growth, labor markets have turned, employment is rising again, surveys of business activity remain in expansionary territory, and the Federal Reserve's policy rates are still at record low levels.
- Financial markets surged last year in anticipation of the recovery, yet in the past few weeks, investor confidence has taken a serious hit, and US stock and bond markets act as if we are heading back into recession.
- In fact, US stock markets had a horrible second quarter, losing more than 10% in value from the end of March, and, in the process, falling to their lowest level since last September. Year-to-date, stocks are down more than 6%.
- On the other end of the spectrum, Treasury yields staged a massive rally in the second quarter, pushing 10-year yields below 3% for the first time since April of last year. Even more astonishingly, 2-year Treasury yields fell to a new record low – lower than we saw during the worst days of the “Great Financial Market Crisis.”
- Credit markets posted strong, positive, returns during the quarter, as a result of the drop in yields, while credit spreads, on average, changed very little. After matching the stock market performance last year, US credit markets are outperforming stocks by more than 10 percentage points so far this year.

## Economy

- What has caused investors to lose so much confidence in the US recovery? The key issue right now is housing, which collapsed (again) following the expiration of the second installment of the government's “First-Time-Home-Buyer Credit.” The program was successful in boosting demand for new and existing homes, but mostly at the expense of future sales.
- The most recent New and Pending Home Sales reports posted stunning declines in excess of 30% during May. Consumer spending also slowed notably from the stronger pace it enjoyed earlier in the year, during which spending was growing faster than incomes, and savings rates were falling again.
- The most critical indicator of the health of the recovery, though, is still job growth, which is lagging well behind the strong growth of recoveries past. Given the “over-firing” that occurred during the crisis, relative to the depth of the recession, we should be seeing job growth exceeding that of the rebounds in the mid-1970s and mid-1980s. Then, job growth averaged about 400,000 a month one year into the recovery; now private-sector job growth is running at about a quarter of that rate at this point in the current cycle.
- With markets and pundits embracing our second-half slowdown call, let's look at the other side of the argument. We have stated before that we don't expect the US to fall into a double-dip recession. Most labor market indicators suggest unemployment will continue to improve, albeit at a frustratingly slow pace. The most recent data also showed that income creation from private sector activities is picking up.
- Businesses may be reluctant to spend and hire, but competitive pressures will force companies to invest in order to sustain productivity growth, and export demand will continue to provide a positive stimulus for US manufacturers.
- Finally, the recent sharp drop in home sales and housing starts reflects past events. Looking forward, record low mortgage rates and increasingly attractive housing valuations suggest we won't see another crash in housing, but rather a slow and gradual expansion. Thus, it's hard to find a catalyst for a double-dip recession. Instead, we expect a period of slow growth in the next six to nine months.
- However, with all GDP components expected to contribute to overall economic growth, and monetary and fiscal policy at best neutral, (but more likely still accommodative), a renewed downturn in growth and employment is extremely unlikely, and the recovery should accelerate again in 2011.

## Policy

- Given the deteriorating economic environment, the current benign inflation backdrop and volatile financial markets, it's not surprising that the Federal Reserve is still nowhere close to ending its Zero Percent Interest Rate Policy. In fact, in their latest policy statement, the central bankers pointed to deteriorating financial conditions driven by “developments abroad” as a new justification to not only to keep rates at all-times lows, but also to leave the current forward-looking low interest rate commitment in place.
- We have pushed back our forecast of the start of policy rate normalization to the first quarter of next year, but, admittedly, have little confidence in that call. Clearly, the Fed is still focused on supporting the administration's efforts to boost economic growth and sees little risk in leaving rates at record lows, which makes it hard to accurately time the change in policy objectives.
- Fiscal policy continues to occupy much of the spotlight. The administration's latest US \$34 billion spending package, which would extend unemployment benefits to 1.5 million Americans

who would otherwise lose that income support, is stuck in the Senate. Supporters claim further government-sourced stimulus is necessary to sustain the recovery, while opponents are focusing on the need to address the unsustainable growth trajectory of government debt.

- The same dissonance was evident at the latest G20 meeting in Toronto, which pitted the policy of fiscal retrenchment in Europe against the more growth-oriented fiscal policy stance of the US administration. The summit essentially left the US isolated as the only major economy without a credible fiscal exit strategy.
- The mid-term elections in November will make it more difficult for the Obama administration to pass legislation, which could jeopardize an agreement on how to reduce the deficit. So far, financial markets are evidently not demanding a higher risk premium on US government bonds, which actually gives the administration more time than most other governments to address the debt issue. However, the inevitable can't be postponed forever.

## Investment Outlook

- The dramatic rally in Treasury yields has further tilted the performance balance so far for the year in favor of bonds. However, it seems that financial markets have adopted an overly pessimistic tone at the end of June. We have been cautious on the prospects of US equities and bullish on US credit for most of the past eight months, but at current levels, we are beginning to see value in the stock market. The US business sector remains in good shape with healthy balance sheets, ample cash on hand, and, due to downsizing during the recession, much more productive and profitable than before.
- The adjustments based on expectations of a weaker growth backdrop should conclude soon, and the risk of a double-dip recession remains low. What is weighing on stocks now is the uncertainty about politics and policy, but investors are likely to look ahead into the next year soon and realize the recovery momentum will re-accelerate in 2011. That change in investor focus should help bring about the next upward trend in equities.
- The reverse argument holds for fixed income asset classes. Treasury bonds are pricing in extremely low inflation (the breakeven inflation rate on 10-year Treasury Inflation Protected Securities (TIPS) has fallen close to 1%), as well as extremely low economic growth – 10-year real yields are at 0.9% at the time of writing. It is extremely unlikely that we will enjoy 1% inflation and 1% real economic growth for the next 10 years. So, if you don't expect a double-dip recession, bonds look extremely rich.

- Potential catalysts for reversing the most recent market moves could be the second-quarter GDP report at the end of July, which is expected to deliver another 3% annualized growth rate, and jobs reports over the summer, which should show steady gains in payrolls and deflect fears of a renewed increase in unemployment.

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