WEDGE WATCH Q2

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# What, Me Worry?

*"The problem with learning from experience is that you always get the test before the lesson."*
–Alfred E. Neuman (1954 - )

Second Quarter 2009
Financial Statistics

DJIA: 8447.00

S&P 500: 919.32

90-Day T-Bill: 0.18%

30-Yr. T-Bond: 4.33%

*MAD* magazine's gap-toothed cover boy and resident knucklehead Alfred E. Neuman (of *what, me worry?* fame) may be gloating right now. Rumor has it he threw caution to the wind and loaded up the truck with equities at the early March lows. True or not, and we'd bet not, the fact is that stocks have rebounded sharply in recent months. Since the March 9th low, the S&P 500 soared 36% (through the end of 2Q09) despite the palpable sense of doom and gloom that abruptly reemerged early this year (following the initial post-Lehman Brothers market collapse) and violently drove the index well through its previous November 2008 low. In addition, several key foreign stock indices have recovered even more robustly off their lows, while oil prices have doubled from the trough set late last year. So, *what, us worry?*

It is a long-held axiom on Wall Street that stocks love to climb the proverbial *wall of worry*, and the asset class's abrupt price surge since early March has once again, at least for now, validated that oft-cited phenomenon. Many investors, however, remain wary and far from convinced that happy days (at least economically) are just around the corner. They believe the economy and the financial system have incurred far too much structural damage for a meaningful economic recovery to take hold (despite massive fiscal and monetary stimulus). **This time, they're sure, is different.**

Ammunition supporting the skeptics' cautious posture certainly remains abundant. Case in point, a recent editorial in *Investor's Business Daily* (paraphrased and quoted below) bluntly highlighted some of the principal concerns of those possessing a more pessimistic view of the structural state of the U.S. economy:

*Thanks to soaring federal government spending on retirement programs over the past year, each U.S. household is now implicitly on the hook for an additional $55,000. In fact, all-told, each household owed nearly $550,000 at year-end 2008. That's four times what American households owe for their individual mortgages, car loans, credit cards and other debt - a rather staggering sum. However, it is the long-term picture that should spook investors most.*

*According to estimates, the U.S. is staring at over $100 <u>trillion</u> in retirement and healthcare obligations over the next 75 years. However, **at current tax rates it's estimated we'll have only $50 to $55 trillion to pay for it all**. (Higher taxes anyone?) Throw in a projected $9 trillion addition to our federal deficit over the next ten years from recently approved stimulus plans and bailouts, and a concurrent (estimated) $1 trillion+ outlay to fund a proposed government takeover of our healthcare system – an estimate most healthcare experts believe is laughably low – "and you have the makings of **an epic financial tragedy.**"*

*Adding to the concerns, total federal debt is projected to soar from just over 40% of GDP to over 80% in just the next 10 years alone – more debt than our country rang up in the first 235 years of existence. Over the next half-century, Americans are expected to owe more than $60 trillion – over 4.5 times our current GDP of $14 trillion.*

Not surprisingly, the fiscal concerns just highlighted are likely to have negative long-term implications for the dollar, interest rates and the economy, among other things, if not forcefully addressed (sooner rather than later). Paul Volcker, former Fed Chairman and Chair of the President's Economic Advisory Board, addressed these burdensome encumbrances early last month when he told the graduating class of Brooklyn Law School that the U.S. has been spending beyond its means for a long time and, as a result, faces "an unimaginable budget deficit as far as one can see." He went on to caution that, "Foreign countries have been for a long while willing to finance our excess spending, but that process can't continue indefinitely."

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## ...Worry

Echoing a similar theme, *Berkshire Hathaway's* Warren Buffett recently told *CNBC*, "A country that continually expands its debt as a percentage of GDP and raises much of the money abroad to finance that, at some point, it's going to inflate its way out of the burden of that debt." Coming from two of the world's most respected financial luminaries, such warnings will likely not be lost on the two biggest buyers of U.S. Treasury securities, China and Japan. In fact, in recent months, Chinese officials have begun to voice public trepidation about the size of current and future U.S. fiscal deficits. Reflecting that concern, they have been moving proactively to diversify their country's excess reserves into real assets such as gold (as a hedge against a weaker dollar and its likely byproduct - higher inflation). Apparently the Chinese believe Mr. Volcker's and Mr. Buffett's admonitions will prove prescient in time. At a minimum, they appear to be taking little chance that the two old warriors are wrong.

*"Getting and spending, we lay waste our powers."*
–William Wordsworth, British poet (1770-1850)

Objectivity is a fundamental requirement for long-term success in the money management business (though such a pure state of consciousness is, by nature, quite elusive). That said, despite our lament regarding exploding deficits and overleveraged consumers, **we recently sought to objectively unearth data that might help explain the rekindled optimism now evident across much of the capital markets**. Though we can't be entirely confident of its efficacy or relevance to the current investing environment, *a thoughtful review of post-World War II recessions and recoveries* is instructive. More specifically, those cycles appear to suggest an obvious rationale underpinning investors' renewed belief, justified or not, in economic recovery - despite the enormous structural headwinds just cited.

A recent research paper by Michael Mussa (*World Recession and Recovery: A V or an L?* - April 2009), Senior Fellow at the *Peterson Institute of International Economics* and former Economic Counselor and Director of Research at the *IMF*, reviews the history of business cycle contraction and recovery. Mussa was a former colleague of Victor Zarnowitz (1919-2009), a long-time professor of economics at the University of Chicago, who was generally considered the world's leading authority on business cycle forecasting and well-known in academic circles for the *Zarnowitz rule*.

Mussa's research (which, with permission, we've quoted and paraphrased extensively) highlights, among other things, advice Zarnowitz shared with him years ago: "Forecasters had never been very successful in forecasting business cycle turning points: when an expansion would end and a recession would begin, how long or how deep a recession might be, or when expansion would resume. Long expansions did not appear to die of old age and were not necessarily followed by deep or long recessions." The professor went on to explain the basic premise of the *Zarnowitz rule,* which holds that there is "only one reliable regularity about business cycles and business cycle forecasts: **Deep recessions are almost always followed by steep recoveries,** and forecasts generally fail to take account of this regularity in consistently *underpredicting* the initial strength of many economic expansions."

Notwithstanding the historic data supporting Zarnowitz's assertions, we believe skeptical forecasters would unabashedly challenge the efficacy of his premise, as it relates to the current cycle, by emphatically pointing out that *today's economic downturn is far different and quite unique relative to past recessions*. In particular, unlike most other cyclical downturns, the current economic contraction is being driven by systemic **deleveraging** (a far more formidable obstacle to renewed and sustained economic growth) as opposed to the more common recessionary driver *inventory destocking*. This key distinction, the naysayers would stress, goes a long way toward explaining why this recession will prove to be deeper and more prolonged, with an eventual recovery likely modest and slow to gain traction and upward momentum.

Given this largely predictable debate among economists (and investors) regarding the depth of the so-called Great Recession, and the timing and magnitude of recovery, a review of other postwar recessions and recoveries may prove instructive. **Table 1**, from the Mussa paper, "presents data concerning the behavior of key components of real GDP during the ten previous postwar recessions here in the U.S. The starting and ending dates are based on peaks and troughs in real GDP and do not correspond exactly to the *NBER* business cycle dating, which relies on monthly data." Of particular note, Mussa projects the peak-to-trough decline of real GDP in the (current) recession at 3.2 percent (through 2Q 2009), "which is marginally less than the declines in the 1957-58 and 1973-75 recessions. By other measures, especially the rise in the unemployment rate (which Mussa estimates will rise, trough-to-peak, approximately five percent in the current downturn), **this is the deepest postwar recession on record**." However, despite sharing obvious commonalities with previous recessions, important distinctions appear evident.

In a normal recession, *inventory destocking* typically plays a large role. In fact, during four of the ten postwar recessions, inventory liquidation accounted for more than 100 percent of the fall in real GDP (again see **Table 1**). However, in the current recession, inventory contraction, though certainly evident, has played a relatively minor role. According to Mussa, "there was no undesired build-up of business inventories before real GDP started to fall (inventories of unsold homes do not count in these figures). The flip side," however, is that one "should not expect a huge impetus to recovery from an enormous rebound of inventory investment" as some market observers have forecast.

As is now widely-known, residential investment experienced a significant decline during the current recession. However,

## Table 1

### Comparison of Postwar Recessions, Main Components of Real GDP (RGDP) Using 2000 Chained Dollars

| Period | % Change In RGDP | Contribution (% Change) | | Investment: Equipment & Software (% Change) | Investment: Non-Residential Structures (% Change) | Investment: Residential Structures (% Change) | Consumption (% Change) | | | | Government Spending (% Change) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Net Exports | Inventory Investment | | | | Total | Durables | Non-Durables | Services | |
| 1948*(Q4)* – 49*(Q2)* | -1.8 | +0.5 | -3.5 | -10.9 | -4.2 | -9.1 | +1.7 | +6.8 | +0.7 | +1.2 | +7.5 |
| 1953*(Q2)* – 54*(Q1)* | -2.7 | +0.3 | -1.3 | -5.3 | +3.4 | -3.6 | -0.5 | -6.7 | nil | +1.1 | -2.7 |
| 1957*(Q3)* – 58*(Q1)* | -3.7 | -0.7 | -1.1 | -14.2 | -2.4 | -4.1 | -1.3 | -7.9 | -1.7 | +1.4 | +0.7 |
| 1960*(Q1)* – 60*(Q4)* | -1.6 | +0.5 | -2.9 | -5.8 | +5.3 | -11.1 | +0.9 | -1.2 | +0.6 | +2.0 | +4.0 |
| 1969*(Q3)* – 70*(Q4)* | -0.6 | +0.3 | -1.4 | -5.9 | -3.6 | +0.9 | +2.5 | -2.2 | +1.6 | +2.3 | -2.8 |
| 1973*(Q4)* – 75*(Q1)* | -3.3 | +1.2 | -2.4 | -9.5 | -11.2 | -30.2 | -0.6 | -9.2 | -2.8 | +3.7 | +4.6 |
| 1980*(Q1)* – 80*(Q3)* | -2.2 | +1.0 | -1.5 | -5.9 | -1.7 | -17.1 | -1.2 | -6.7 | -1.5 | +0.6 | -1.1 |
| 1981*(Q1)* – 82*(Q3)* | -2.3 | +0.7 | -1.1 | -5.0 | +1.0 | -27.2 | +1.4 | -4.1 | +1.5 | +2.9 | +2.1 |
| 1990*(Q3)* – 91*(Q1)* | -1.3 | nil | -0.6 | -3.0 | -6.6 | -11.2 | -1.1 | -5.7 | -1.1 | -0.1 | +1.4 |
| 2000*(Q4)* – 01*(Q3)* | -0.2 | -0.4 | -0.7 | -8.0 | -1.7 | +2.4 | +1.1 | +2.3 | +0.7 | +0.7 | +0.4 |
| **2008(Q2) – 09 (Q2) est.** | **-3.2** | **-0.3** | **-0.4** | **-16.3** | **-9.1** | **-17.6** | **-1.7** | **-11.6** | **-3.8** | **+1.2** | **+3.0** |

*Source: Peterson Institute for International Economics*

it has not contracted as much as in some earlier recessions because, according to Mussa, *"residential investment started to decline in early 2006, well before real GDP started falling."* Nonetheless, the order of magnitude of the still-ongoing residential contraction has been mind-numbing. "From the peak at the end of 2005, the decline in real residential investment is expected to reach almost 50 percent – 10 percentage points larger than the previous postwar record."

Another hot topic of debate among investors and economists is the health of the U.S. consumer's balance sheet and its future impact on consumer spending. Mussa addresses this as well. In earlier postwar recessions, "real consumption spending registered declines in only" five of the ten such downturns on record. In the current recession, however, it has experienced a sharp decline, driven by weakness in durable and non-durable spending (with services posting a modest gain). In terms of relative magnitude, **consumption spending this cycle has contracted more than any on record since WWII**. In fact, "the combined decline in the third and fourth quarters of 2008 is a little larger (in percentage terms) than the very sharp one-quarter drop in the spring of 1980 when the Carter administration temporarily imposed controls on consumer credit."

Now, let's change gears and analyze *the prospective economic expansion* by reviewing **Table 2**, also from the Mussa paper, which highlights the magnitude of *cumulative* real GDP growth during the first six quarters of recovery for nine of the ten previous postwar expansions. Excluded from the data set is the expansion following the brief recession of 1980 which, after a sharp two-quarter rebound, "fell back into recession in the spring of 1981 as the Federal Reserve pressed on with determined efforts to defeat inflation (pushing longer-term U.S. Treasury rates to 16 percent in late 1981)." In terms of the numbers from the other nine recoveries highlighted, *they show that since World War II, "the average cumulative real GDP gain over (the first) six quarters" of post-recession expansion "was 7.7 percent." Excluding the somewhat aberrational recoveries from 1948-49 and the 2001 recessions, the average is even higher at a relatively robust 8.8%*. Mussa's rationale for calculating the growth statistics excluding those two other recoveries is that: "The episode in the late 1940's was mainly a huge inventory cycle and not really relevant to today's situation;" and "the 2001 recession was exceptionally mild with real GDP declining only 0.2 percent." As a result, "the recovery was very flat."

Given the backdrop just articulated, it seems apparent that the current "recession is not like the mild recessions of 1990-91 or especially 2001." To the contrary, Mussa surmises, "it is more similar to the deeper recessions earlier in the postwar era" (though this appears debatable per some of the particulars in **Table 1**). Nevertheless, he concludes, **it is reasonable "to expect that the recovery from the present recession would look broadly similar to the recoveries from those earlier recessions – a V-shaped pattern of recession and recovery."** This, needless to say, may strike some as a bold statement, and one decidedly contrary to the much publicized view that structural headwinds are far too deep and entrenched for the next recovery to mimic V-shaped spikes of the past. However, Mussa expresses optimism that, along with expected strong growth from China, the unprecedented monetary and fiscal stimulus implemented and/or announced in recent quarters will prove an important impetus to economic rejuvenation in the not-too-distant future (though this is obviously far from certain).

The so-called L-shaped recovery, which forecasters and pundits have habitually deemed probable in the months following the 4Q08 capital markets train wreck, is also addressed by Mussa. However, his perspective is decidedly different from theirs. According to him, *history shows that such an outcome is actually quite rare*. In fact, since World

## Table 2

### Recoveries From Postwar Recessions, Cumulative Rise of Real GDP in First Six Quarters of Recovery

(% Based on 2000 Chained Dollars)

| Period | | Depth of Preceding Recession | Strength of Recovery |
|---|---|---|---|
| 1949*(Q4)* – 51*(Q2)* | *Truman* | -1.6 | +12.5 |
| 1954*(Q2)* – 55*(Q4)* | *Eisenhower I* | -2.7 | +9.8 |
| 1958*(Q1)* – 59*(Q3)* | *Eisenhower II* | -3.7 | +10.0 |
| 1960*(Q4)* – 62*(Q2)* | *Kennedy* | -1.6 | +9.2 |
| 1970*(Q4)* – 72*(Q2)* | *Nixon* | -0.6 | +8.9 |
| 1975*(Q1)* – 76*(Q3)* | *Ford* | -3.4 | +7.4 |
| 1982*(Q4)* – 84*(Q2)* | *Reagan* | -2.3 and -2.2 | +11.5 |
| 1991*(Q1)* – 92*(Q3)* | *GHW Bush* | -1.3 | +4.6 |
| 2001*(Q3)* – 03*(Q1)* | *GW Bush* | -0.2 | +2.6 |
| Average | | -2.0 | +7.7 |
| Average, Excluding *Truman & GW Bush* | | 2.2 | +8.8 |

*Source: Peterson Institute for International Economics*

War I there has been only one such occurrence in the U.S. and it was not even a "business cycle in any normal sense. From 1945 to 1946, real GDP dropped 13 percent (measured in 1962 dollars) and then was essentially flat for two years. This episode marked the end of World War II, when federal spending dropped suddenly from over 40 percent of GDP to less than 10 percent. Unlike any normal recession, private consumption and private investment soared in this period – but not enough to match the cutback in the war effort. U.S. production was strained to the absolute limit in order to win the war, and when the war ended it was natural and desirable to relax."

The final part of the Mussa paper we'd like to draw attention to provides *a thought-provoking* commentary on economic recoveries and bank credit cycles. As primary backdrop, the author highlights "the deep recessions of the early 1980's when many U.S. banks and most savings and loan associations became insolvent based on market valuation of their assets and liabilities" (though traditional accounting practices did not reveal that at the time). Of particular relevance to the current cycle, Mussa highlights the fact that despite the heavy overhang of bad loans at so many of those institutions then, the gradual recovery of the economy and a decline in interest rates eventually drove up the value of stressed bank assets. As a result, "many banks returned to solvency on a market value basis, although some (including Continental Illinois) did ultimately fail." Despite those early 1980's credit-cycle dislocations, as in a large number of other similar instances in the past, "it was economic recovery," according to Mussa, "that restored health to many financial institutions rather than the other way around." Of particular note he states, "many savings and loan associations were too deeply damaged to recover, and ultimately (in 1989) the government needed to take over many of (them) at considerable cost to the taxpayer." Sound familiar? "But *the fact that many financial institutions remained in trouble in 1983-84 and beyond did not preclude a very vigorous economic recovery;*" an outcome, per the *Zarnowitz rule*, Mussa expects will be repeated again this cycle (despite the obvious and sizable structural impediments that still loom ominously both here and abroad).

Although postwar history appears solidly on his side, Mussa, like all of us, will simply have to wait to see how things play out. That said, as fiduciaries we were quite pleased to see the recent vigorous rally in the financial markets (a mostly logic-driven rebound, in our view, propelled by massive monetary stimulus and cyclically-depressed valuations). In addition, we certainly hope Professor Zarnowitz's central premise regarding economic recovery proves valid once again. However, count us among the somewhat skeptical regarding the inherent capacity for sustainable economic growth (at levels we've been accustomed to in years past) to emerge *over the intermediate-term,* and possibly the longer-term as well. The numbers just don't appear to add up (especially given what's happening to the federal deficit). The elephant in the room simply can't be ignored; in our opinion it's just too large, and growing right before our eyes.

*PIMCO's* Bill Gross summed it up well recently when he stated that, "the U.S. annual deficit of nearly $1.5 trillion is 10 percent of its gross domestic product – a number never approached since the Great Depression." He went on to question (with a tone of obvious skepticism) who is going to buy all this debt, and to further point out that "the Chinese and other surplus nations cannot fund the deficit even if they were fully on board – which they are not." The math, according to Gross, is just too daunting as the cumulative impact of incurring five more years of 10-percent-of-GDP deficits would likely raise America's debt-to-GDP level to over 100 percent; a level both rating agencies and markets recognize as "a point of no return."

*"If you put the federal government in charge of the Sahara Desert, in five years there would be a shortage of sand."*
–Milton Friedman (1912-2006)

Notwithstanding the varied structural overhangs we've enumerated here, equity investors and buyers of corporate debt are *apparently* beginning to like what they see down the road. (Although it is far from certain that the economy will begin to grow on a sustained basis by late this year, as stock prices now seem to be suggesting.) That said, given the unprecedented size of the combined U.S. fiscal and monetary response to the economic crisis, it seems reasonable to assume that, in time, such a prodigious shot of adrenaline will help drive some economic recovery, at least for a while. To put the government's and the Fed's actions in better relative perspective, Jim Grant (of *Grant's Interest Rate Observer* fame) recently sized it up this way: **the one-two stimulus punch is on track to be at least 10 times greater than the average policy response to the 10 preceding post-WWII recessions**. Since the March 9th low, equity investors have certainly taken note.

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In addition to the much hoped for stimulus jolt, investors may also be sniffing out something of even greater import: the proverbial "bridge too far" in terms of the majority political party's aggressive push to expand government via (arguably) excessive and unbridled deficit-spending. Left unchecked, this spending could lead to much higher taxes in the years ahead – a potential "showstopper" for many voters.

Higher taxes or not, one thing is a near-certainty; the innate proclivity of the political party in power to overreach its bounds, especially when that party's power is decidedly dominant (as it is now). If, as we expect, that tendency rears its head again, the 2010 mid-term Congressional elections may offer the first glimpse of *an electorate pushed too far*.

Like the spirited opposition to healthcare reform which emerged in 1994 to stop President Clinton and his party dead in its tracks, the current controlling party's reluctant though seemingly *inevitable* move back toward the political center may prove, when and if it comes, a welcome relief for stocks and, likewise, the economy. Bottom line: **spending must be cut, sooner rather than later** (as the recent spike in Treasury yields seems to imply). No doubt, there is more than enough government excess and redundancy to fuel consequential downsizing as far as the eye can see. What is in doubt is the political will to make such unpopular cuts.

Although a concerted move to dramatically reign in the deficit would certainly be a huge positive, we're not holding our breath. Such fundamental change doesn't happen overnight (and, of course, the trend appears decidedly in the opposite direction now). However, the **law of unintended consequences** is immutable and the **invisible hand** never rests. As a result, it seems only a matter of time before *the chickens come home to roost* and the political winds shift (possibly with a vengeance). That said, the future is certainly never guaranteed and the still tenuous political and fiscal backdrop will likely remain a primary investor worry for some time to come. Nonetheless, like *the eternally dim-witted nature* of Alfred E. Neuman's comic book persona, we believe such a long overdue fiscal and political about-face, driven, in large part, by America's deeply-embedded survival instinct and proud history of self-determination, **is something you can bank on**. *If we're wrong, all bets are off.*

| Index | 06/30/09 Price | 2nd Quarter Price Change* | Year-to-Date Price Change* |
|---|---|---|---|
| Dow Jones Industrials | 8447.00 | 11.01% | -3.75% |
| S&P 500 | 919.32 | 15.22 | 1.78 |
| Value Line Composite | 244.80 | 26.35 | 8.37 |
| American Exchange Comp. | 1582.02 | 16.38 | 13.20 |
| NASDAQ Composite | 1835.04 | 20.05 | 16.36 |

*Does not include dividend income.

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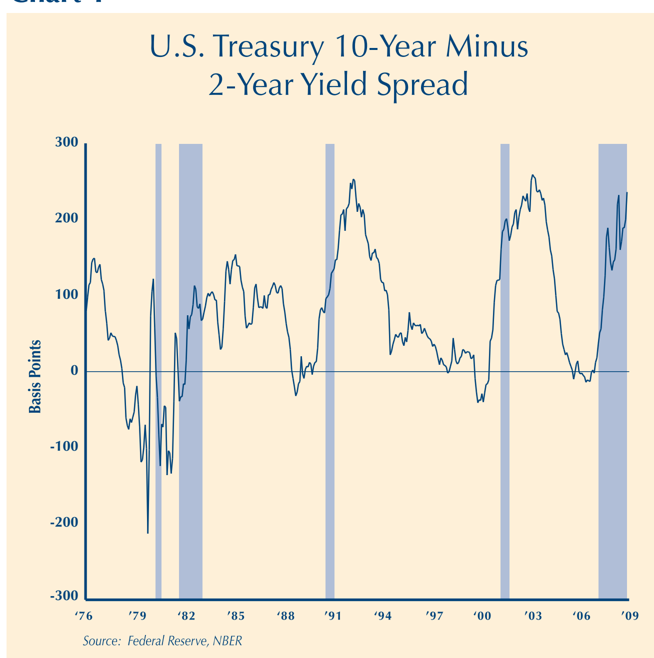
Fixed Income

# Yield Curve Signaling Recovery?

Reflecting on the economic cycles of the past thirty-five years, very few indicators appear to rival the slope of the Treasury yield curve in predictive value. **Chart 1**, which shows the yield difference between the 10-year Treasury and the 2-year Treasury, highlights several important relationships. Note that we have superimposed recessions, as defined by the *National Bureau of Economic Research*, on the yield curve below in the form of shaded vertical columns. Of course, we do not yet know the ultimate duration of the current recession.

**Chart 1**




The first relationship that can be observed is that every time the yield curve has inverted, that is, the 2-year yield exceeds the 10-year yield (resulting in a negative spread), the economy has entered a recession relatively soon thereafter. The *cause and effect* here is that when the Federal Reserve becomes concerned about inflation and an overheating of the economy, it begins raising short-term interest rates (the Fed Funds rate). This tightening of policy drains resources from the credit system, which ultimately slows the economy. The 2-year Treasury yield is highly correlated with these Federal Reserve actions.

Second, the yield curve typically **begins** to re-steepen (10-year yield exceeds the 2-year) before, during and well after the recession. The economy responds to signals from the money markets with a lag of varying time periods. Restrictive Fed policy tends to put stress on the financial system, which sometimes leads to a financial crisis - i.e., the bursting of the "dot-com" bubble in 2000, and the collapse of the housing sector and near collapse of the banking sector during the current cycle. The Fed is then typically forced to **rapidly loosen policy** to lower rates and relieve market stresses. Of course, this process is taking on extreme and unprecedented magnitudes amidst the current downturn.

Third, note that *the point of maximum steepness is not realized until well after the recession has ended*. Time will tell if this relationship persists in the current cycle. Historically, the Fed has been purposefully slow in withdrawing liquidity from the system following recessionary periods to help ensure economic activity has regained solid footing. At the same time, **longer-term interest rates tend to rise in anticipation of economic recovery and the prospects for higher inflation**.

The behavior of the yield curve since the end of the first quarter, particularly the 10-year yield, has certainly borne out this last point. Since the middle of March (through mid-June), the 10-year yield has risen sharply (approximately 125 basis points), while the 2-year yield has increased by approximately 40 basis points. Over the same time period, a number of economic indicators appeared to bottom out, while the stock market and commodity prices rose sharply.

Last year, we began buying TIPS (Treasury Inflation Protected Securities) in client portfolios when **deflation** was a prevailing expectation. With the recent steepening of the yield curve possibly signaling economic recovery, higher inflation expectations are now beginning to be reflected in longer-dated Treasury rates. As a result, TIPS have been strong performers. Going forward, if recovery does take hold, as the yield curve seems to imply, we would expect these securities to continue performing relatively well. **Stay tuned**.

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