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THE WORLD CUP OF CONFIDENCE

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A double dip of rocky road?

How capriciously the prevailing view seems to change. After the 2009 lows came a sharp run-up, mostly uninterrupted. Then, in the just-ended second quarter, the stock market began walking down a path of fear. The sovereign debt crisis in Europe brings back memories of the credit meltdown in the U.S. financial sector back in 2008. Add in sluggish job growth and low consumer confidence, and many pundits have now determined that the nation is on course for a "double-dip" recession.

There is indeed a wall of worry for the market to surmount — yet again. In fact, at times it feels not like a wall but a series of walls, or even a maze. But after an 80% rebound, it is hardly surprising that stocks retrace a portion of their gains and take a breather. While painful, such action is typical and arguably healthy.

No quick fixes

We do not mean to paper over the risks here. The global financial system was previously shaken to its core. As the tide from the tsunami has receded, a number of longstanding imbalances have become evident, the most significant relating to debt levels of both the public and private sectors. There are no quick fixes. These are still fragile times, and another shock could certainly threaten the global economic recovery.

Capricious, indeed. Not long ago, commentators were warning about inflation accelerating out of control. The money supply has increased dramatically over the last two years, but its rate of circulation — its velocity — is still very low. Too much is still sitting idle on bank balance sheets, as banks remain cautious about extending credit. An overheating economy generally carries the threat of inflation, but there has been scant evidence of that. Rather, the greater near-term risks in the developed world have been and continue to be deflationary. Deflation could coincide with an environment of excess capacity, elevated unemployment, and anemic economic activity.

We have argued all along that the economy's recovery from this Great Recession is likely to be muted and uneven. That would mark a break from history, as the scale of a recovery typically mirrors the depth of the preceding contraction. But this time there are many schisms that have to be filled before things return to normal — assuming *normal* can even be defined any more.

Uncertain terms

The choppy recovery has produced lots of background noise and conflicting signals. So we are clearly in a period characterized by much uncertainty. The old cliché that the market

hates uncertainty has been underscored by the volatile price action of the past few months. At the moment, the forces influencing the stock market are all deflationary in nature, and that drives the speculation about slipping into another recession.

One such force relates to the turmoil across the pond in the Euro area. The continent's credit markets, and by extension its banking system, are not functioning smoothly. A handful of southern European nations are burdened with wide budget deficits and high levels of public debt. The vast majority of this debt is owned by the European banks themselves. The possibility of one or more sovereign defaults has caused bond spreads to widen and made banks wary of lending to each other, even on a short-term basis. The danger is that a liquidity crisis will ensue, whereby entities cannot roll over maturing debt or access additional capital.

This backdrop stands in sharp contrast to that of the United States, where credit markets are no longer under significant stress. This, thanks to a long series of aggressive policy actions to add liquidity and restore confidence. Also, larger U.S. banks underwent stress tests and have been prodded to write down or dispose of the toxic assets on their books.

The Europeans do have a bit of a mess on their hands. Greece has garnered much of the headlines but, in and of itself, is marginal in the scheme of things. Indeed, in terms of its economic heft, Greece is to the European Union what Atlanta is to the United States. Greece is more significant as an embodiment of what ails much of the developed world. Simply put, the sustainability of the social welfare model has been called into question by the global downturn. Public finances are stretched and will continue to be under attack by the demands of aging populations.

The U.S. is not Greece

However, we do need to be careful about blindly extrapolating the Greek experience. Some of the uber-bears have even raised the possibility of a U.S. default, which is simply absurd. First, since gaining its independence from the Ottoman Empire in the early 19th century, Greece has been in default about half the time. The default records of some of its Club Med neighbors are similarly abysmal. Second, the Greeks, like all adopters of the euro, have ceded control of their monetary policy. They cannot devalue their currency to boost export growth nor inflate their way out of their debt crisis. The United States, on the other hand, issues debt in its own currency and has its own central bank and thus dictates its own monetary and foreign exchange policies.

If a double-dip recession does occur anywhere, Europe is the most likely candidate. The stock market fears that austerity programs will hamper economic growth, which in turn could make it even harder for governments to close their budget gaps and pay down their debt. It's a potentially vicious spiral. To counter the rising stress in the euro-area credit markets, the European Central Bank (ECB) and International Monetary Fund (IMF), after much dithering, joined to establish a 750 billion euro ($1 trillion) stabilization fund. While a Greek default may be manageable, a Spanish or Italian default would have much more dire consequences.

Chances are, the ECB will have to take further steps to restore confidence. These may include stepping up its direct purchases of sovereign bonds, while allowing the money supply to increase. Whether

the Bank will actually pursue this remains to be seen. It is fairly dogmatic in its charge to forestall inflation, which it still seems to view as the greater threat. A weak Europe and, by association, weak euro will hamper U.S. exports. However, exports to Europe account for only about 2% of our Gross Domestic Product, so we should be able to muddle through a slowdown.

Jobs are Job One

The other major source of concern for the stock market lately relates to the all-important U.S. consumer. What's different today? Doubts about continued job growth. After filling nearly 500,000 jobs during the first four months of this year, private employers slowed their additions markedly in May and June. Yet it is simply too early to call this change a new trend. Two leading indicators of overall job growth — the average workweek and the number of new jobs at temp agencies — continue to suggest a rebound. Initial claims for unemployment insurance remain high, but they are down significantly from peak levels and have dropped faster than for the previous two recoveries.

The real estate market is another factor weighing on the consumer. In many localities, home prices appear to have stabilized. However, residential real estate continues to face a variety of headwinds that threaten to derail a housing recovery. Credit remains tight after being freely available to just about anyone with a pulse — never mind a job. Meanwhile, the supply of homes for sale, although down from its peak, is still elevated. And this does not include a huge "shadow inventory" of bank-owned properties and homes in various states of foreclosure. Compared to median incomes or rents, home prices remain above long-term averages. So in light of tepid demand and potentially rising supply, home prices will stay under pressure.

After a recent survey to gauge the recession's impact on households, the Pew Research Center used the term *new frugality* to characterize the more reticent consumer. As one would expect, more than half of adults polled have cut back on their spending, boosted savings, and pared their debt. But the survey further indicates that a sizable minority expect their frugality to persist beyond the recession. Nevertheless, overall consumer spending has begun to pick back up and should generally continue to contribute to economic growth — albeit to a lesser degree than in past recoveries.

Back in business

In contrast, the corporate sector appears to be in reasonably good shape, particularly for having endured such a sharp contraction. Staring at the abyss, businesses cut costs significantly, which helped mitigate some of the drop in profit margins. With revenues starting to rise again, more is flowing to the bottom line. Profit growth has been strong. Total corporate cash flows have actually returned to their pre-recession levels, a remarkable feat. Meanwhile, balance sheets are healthy, with sizable amounts of cash in reserve.

Historically, rising corporate profits have led to increased investment spending and hiring after several quarters. This serves to unleash a virtuous cycle of more consumption, higher profits and thus more capital investment and hiring. There are still impediments to this self-reinforcing cycle. The first is simply uncertainty that the recent pickup is more than temporary. Businesses do not want to build their field of dreams and have no one come. A second barrier relates to uncertainty about government policy. From healthcare to energy, from financial regulation to tax policy, Washington is shifting the landscape. Businesses have

to factor in the impact before aggressively expanding. Lastly, among smaller businesses, tighter access to credit also represents a key headwind. This is a critical issue, since small companies account for more than half of the economy's new jobs.

Concrete confidence

In light of the tenuous global recovery, the first role of policymakers should be to restore confidence. If there is a crisis today, it is a crisis of confidence. This generates caution: for businesses in their investments, consumers in their spending, and financial firms in their extension of credit. When uncertainly reigns, entities defer major decisions until they have more clarity.

There is a vigorous debate about the appropriate policy actions within each region. For U.S. monetary policy, there is not much more the Federal Reserve can do. Short-term rates are already close to zero; the money supply has expanded sharply. Bernanke and company have been encouraging banks to step up their lending. Within the European Union, the central bank has not been nearly as accommodative, which partially explains why Europe's recovery has lagged that of the U.S. Influenced by the German hyperinflation that set the stage for World War II, the ECB has been slow to acknowledge any deflationary pressures.

The more heated arguments relate to potential moves in fiscal policy. The issue involves whether governments should cut spending and raise taxes to address widening budget deficits, or ignore fiscal imbalances and step up spending to stabilize their economies. Some nations, such as Greece, Portugal, and Spain, do not have much choice. They must adopt austerity programs to restore market confidence. Others, including the United States and Germany, have the capacity to adopt more stimulative policies. While acknowledging the looming long-term budget challenges, we should point out that the U.S. experience during the 1930s and Japan in the 1980s underscore the potential downside of overly restrictive policies.

Fragile but fertile

While it cannot be dismissed outright, the double-dip recession scenario is not a likely outcome at this point. The yield curve has been a reliable indicator of business cycle turns, and it still points to expansion. Meanwhile, there has been an unprecedented global stimulus in force with plenty of "free" money that will eventually find a home. Policy rates, particularly in the United States, should remain low for an extended period of time. The economy has regained some traction, but we are still in a fragile stage of the recovery. This fragility will lead to mixed signals over the next few quarters; therefore, we expect stock prices will continue their erratic pattern. That said, valuations are fairly attractive after the recent sell-off.

— Christopher J. Singleton, CFA, Managing Director

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