Investment Perspective

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RUNNING IN PLACE

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Financial markets have been choppy this year, as investors wrestle with many of the same issues they faced a year ago. Once again, the specter of a double dip here in the United States has collided with renewed fears of a European financial crisis. It seems as if we are running in place.

It is a testament to the severity of the last recession that, two years after its official end, the recovery remains grudging and uneven. This is hardly surprising. History tells us that downturns prompted by financial crises linger much longer than garden-variety recessions. Why? Primarily because the crisis severely interrupts and alters the flow of credit.

Credit is not due

The residential mortgage market offers a striking example of this. One-third of people who might have qualified for a "prime" mortgage five years ago could not do so today, as Fed Chairman Bernanke recently pointed out. And that is not likely to change any time soon. Lending standards have been reset.

Small businesses have also had a tougher time accessing credit, although there are signs of an easing. However, the latest National Federation of Independent Business survey indicated that credit availability is not much of an issue for the vast majority of small firms. Most are still hunkered down, in no need of financing to fund new investments. This sector typically accounts for a sizable share of economic activity, particularly job growth. It needs to rebound.

So two years into the "recovery," the housing market is still sputtering, credit growth is sluggish, and high unemployment persists. Why should we have any hope that growth will resume?

Hidden strengths

Well, most metrics *have* shown improvement over the past 12 months, if haphazard. With the media's tendency to focus on the negative, good news is often obscured. One glaring example: As we all lament the demise of the American consumer, few have recognized that total consumer spending has rebounded — and is actually higher than its previous peak.

From where we sit, a double-dip recession cannot be dismissed, but it seems unlikely. The weight of the evidence suggests a return to moderate growth as we move through the back half of the year. Importantly, a number of factors hampering first-half growth should fade away.

First, gasoline prices have fallen by about fifty cents from their peak, after surging this spring in response to unrest in North Africa and the Middle East. Less pain at the pump will clearly aid household budgets and perhaps confidence. Second, supply chains are recovering along with Japan after the earthquake. That natural disaster interrupted, in particular, the production schedules of U.S. auto and electronics manufacturers. Motor vehicle production dropped 9% over April and May, clipping GDP growth by at least 0.5%. Automakers project that output will return to previous levels over the next two months. Third, while we are always wary of using it as a crutch, severe weather did impact construction activity during the first half of the year.

Pent-up demand

Meanwhile, significant pent-up demand will be released at some point. Corporate cash flows have surged, and we suspect a new wave of capital spending is in the offing. Many businesses have delayed investments in recent years because of the uncertain climate. But a temporary provision in the tax law allowing for the 100% write-off of capital equipment purchases expires at the end of this year. Businesses should thus be inclined to step up procurement of computers, software, machinery and vehicles.

A boost in capex could be the stent that helps unclog the job market. Job growth is crucial to a strong and sustainable economic recovery. It has been moving in fits and starts. Some 8.8 million private sector jobs were lost, and only 2.2 million have so far been recovered. Nearly one in six workers is still unemployed or underemployed.

The automobile and housing markets are two other areas where pent-up demand could act as a tailwind. It is only the timing that is in question. Activity in both sectors remains below natural replacement rates. Auto sales have not been keeping up with the pace of population growth and scrappage. And housing starts have been running sharply below the typical household formation rate. Sooner or later these anomalies will correct themselves.

Greece trap

In Europe, the sovereign debt crisis has not yet been contained. This policy failing has contributed to considerable market uncertainty. Greece remains the center of the turmoil, and the fear is that its default could trigger a European banking crisis. Here in the United States, the impact would be mostly indirect, as our banks' exposure to Greek debt is low. However, our institutions do have exposure to Europe's banks themselves.

Fortunately, it appears that the Greeks will be granted some breathing room to roll over their maturing debt although European authorities continue to dither. In return, the government will adopt a series of "austerity measures" and sell some state assets. But like Sisyphus, condemned to push a boulder up a steep hill only to see it roll back down each time, today's Greeks are also caught in a vicious spiral. Spending cuts and tax increases will retard growth, which in turn will make it increasingly difficult to pay down their debt. At some point, Greece's public debt will have to be "restructured" — no one wants to use the D-word.

The more pressing near-term risk is that the debt crisis could move beyond the smaller nations on the periphery of Europe. These so-called PIGs — Portugal, Ireland and Greece — together account for only 6% of the Eurozone's GDP. In contrast, Italy and Spain make up almost 30%. Signaling some concern, the bond market has recently bid up the yields on their sovereign bonds, particularly those of Italy. Ten-year yields are roughly 6%, compared to 2.7% for Germany. (Greece stands at the other end of the spectrum with 17% yields). It will take a while for all this to play out, but most likely Europe is not going to collapse into the Mediterranean.

The debt bet

To some degree, most developed nations face the same challenges to their public finances. Years of deficit spending have led to relatively high levels of debt. With low interest rates and decent economic growth, this model seemed sustainable. But the Great Recession aggravated the imbalances and laid bare the vulnerability of the social welfare state. And with populations aging, the demographics imply onerous expenditures for healthcare and retirement benefits in future decades.

Here in the United States, a consensus seems to have developed, acknowledging the need to address our fiscal imbalances. This is obviously positive. Predictably, however, there is little agreement on the underlying drivers or the most appropriate solutions.

Dancing on the ceiling

The debate about whether to authorize an increase in the federal "debt ceiling" is the latest political sideshow. This drama underscores the notion that our political elites have forsaken substance for style. At its core, the issue is whether the U.S. Treasury will be granted the authority to sell securities to pay for spending *that has already occurred.* Or, put another way, for programs and expenditures that many of these same politicians had previously sanctioned.

Yet the GOP is using the debt ceiling issue to argue broader fiscal priorities. But they are looking at things backward as Democrats did in 2006 when roles were reversed. The amount of debt the government needs to issue is a result of revenue and spending decisions and the path of the economy. Fiscal policies don't flow from the debt ceiling — it's just a number. Instead, the debt limit must be adjusted to reflect previously enacted policies.

The fiery rhetoric is disturbing on a couple of levels. Most immediately, without an increase in the statutory limit, the government will be unable to pay all of its bills by early August. It will begin to shut down. Now some may not view that as a bad outcome, but surely there are some federal functions that are worthwhile. Also, however, failure to reach agreement on the debt ceiling could damage our standing with our creditors. Our $14 trillion of public debt has not overwhelmed us, thanks to low rates on our "risk-free" Treasuries. What happens when bond investors begin requiring a premium to cover default risk?

A long-term fix

The ultimate irony is that the United States may well default on its obligations before Greece does. The shame in all this is that there is still sufficient time to address our nation's sizable fiscal challenges. We are not facing an immediate crisis that requires drastic fiscal austerity today; certainly nothing that warrants the political bickering over the debt ceiling. And with the economy still fragile, policymakers should be careful about tightening too soon anyway. It took years to get into this mess. It will take years to get out — and that's OK. But to paraphrase an ancient Chinese philosopher, if we don't change direction, we may well end up where we're headed.

Fortunately, with politicians already running for cover, the country will most likely avoid a default next month. But we will probably have to wait until after the 2012 elections to see any real progress on the budget deficit. Neither side has an interest in seeing the other succeed ahead of that date.

A long way from the bottom

So there is lots of noise that could potentially impact the investment landscape. But let's not lose sight of the fact that we have come a long way from a deep-seated financial crisis and recession. Households are rebuilding their balance sheets and slowly increasing their spending; manufacturing productivity has surged; corporate profitability has rebounded; core inflation remains low. We may be running in place for now, but we are running.

— Christopher J. Singleton, CFA, Managing Director
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