Double Dip

Ice cream or the economy?

"Double dip." It wasn't long ago when these two words would invoke pleasant thoughts. The only dilemma the phrase posed was which of the two flavors of one's double dip ice cream cone should go on top. Unfortunately, when we hear "double dip" today, it generally refers to the fear that the all-too-recent recession will return.

Are we headed back into a recession? Or, are we just in for a period of slower growth?

The breakdown in confidence in our economy has been triggered by a variety of factors, including disappointing economic news, disruptions in manufacturing and supply as a result of the tragedy in Japan and fiscal problems in Europe. The list would not be complete without adding the frustration related to the political antics in Washington D.C. and most recently, the credit-rating downgrade of U.S. government securities by Standard & Poor's.

This lack of confidence can turn into a self-fulfilling prophecy: another recession. However, recessions require a large drop in many segments of the economy. Yet many segments - housing, automobiles, and small business - never really exited recession to begin with. Therefore, the likelihood of major drops from these levels is low. Let's take a look at some of the major factors affecting the economy and the markets right now.

GDP Growth

First quarter 2011 GDP growth was revised down to a paltry .4 percent and second quarter GDP was reported at 1.3 percent. The textbook definition of a recession is that GDP must be negative for at least two consecutive quarters.
The first half of 2011 was plagued by uncharacteristically bad weather, unrest in the Middle East, and a devastating earthquake in Japan. Unfortunately, GDP movements tend to be persistent. Good news tends to be followed by good news and bad news by bad news.

The economy may still be hurting from a series of temporary hiccups, but unless the labor market improves that weakness will persist. This leaves the economy more susceptible to shocks and keeps global financial markets on edge.

Manufacturing

The closely followed Purchasing Manager's Index (PMI) published by the Institute for Supply Management (ISM) was reported at 50.6 for August. The consensus expectation had been for the PMI to fall to 48.5. Levels above 50 are considered to be in expansion territory and below 50 to be contracting.
We should note that the PMI is a survey and not a gauge of actual manufacturing activity. It is a measure of how managers view current business prospects versus the prior month. We should also look at indicators of actual manufacturing activity.

While the ISM report suggests we could see slowing of the manufacturing sector, August's report on capacity utilization should help reduce fears that a severe recession is on the immediate horizon. Capacity utilization in the manufacturing sector ticked up to 77.4 percent in August from 75.0 percent in July and 74.6 percent in June. This is still 3 percentage points below its average from 1972 to 2010 but trending up is always a positive sign.

The Consumer

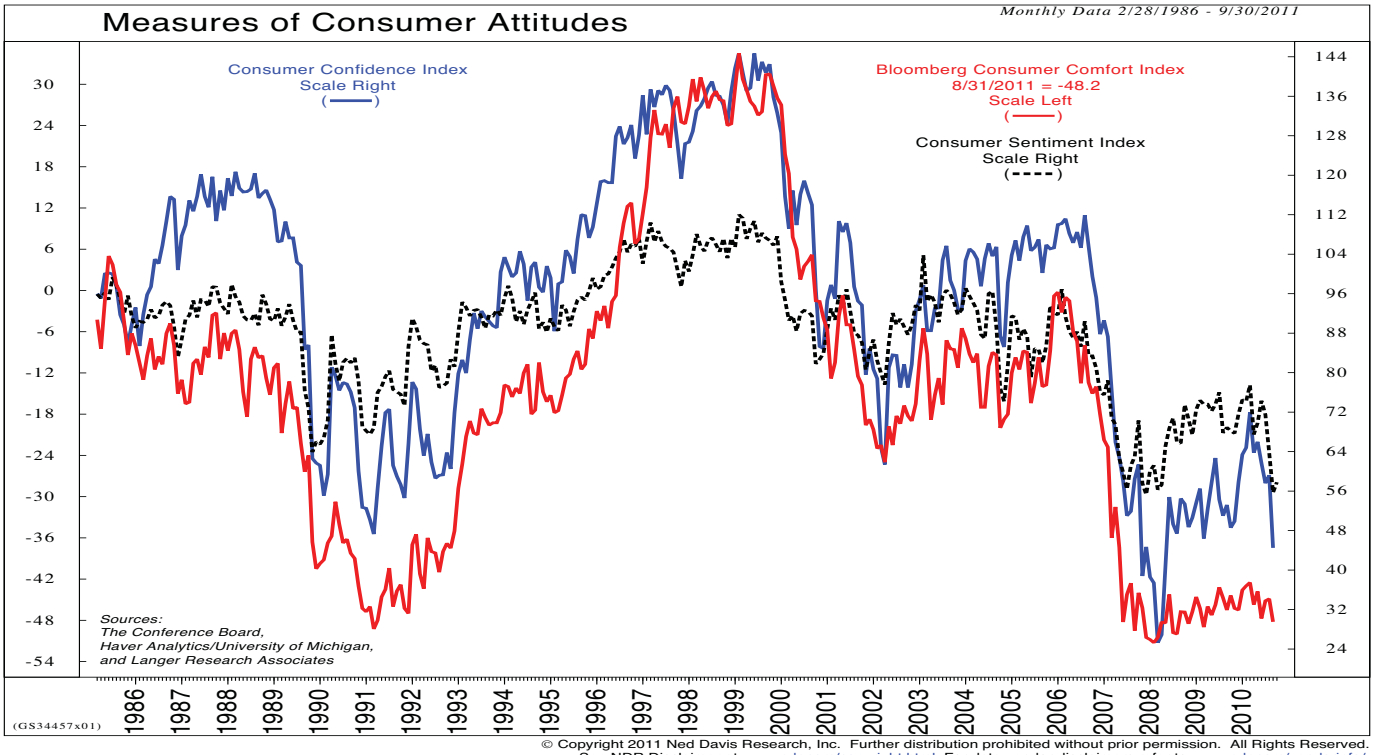
As evident in the chart below, any measure of consumer sentiment or attitude is incredibly low right now. In fact, it has dropped to its lowest level since the recession ended in June 2009.

It is not hard to see why. GDP reports and the lack of meaningful job growth have been some of the original culprits of concern. In addition, the political gridlock in Washington D.C. over the debt ceiling culminated in a credit downgrade by the rating agency Standard & Poor's. During this time, volatility began to increase in the stock markets. With the childish games being played in Washington D.C. combined with less-than-stellar economic reports, the markets moved up and down with very large swings. As if all of our domestic issues weren't enough, sovereign debt crises in Greece, Portugal, Ireland, Italy, and Spain continue to spook the markets.

The Bloomberg Consumer Comfort Index (red line on chart) fell to -48.2 through the end of August and mid-September's numbers show a further drop to -52.1. The Consumer Confidence Index (blue line) and the Consumer Sentiment Index (black line) have seen significant drops during this recent quarter after bouncing back significantly from the March 2009 lows.

An interesting note, the Consumer Confidence and Consumer Sentiment Index are composed of monthly surveys and incorporate a measure of future expectations. The Bloomberg Comfort Index is not forward looking but surveys consumer's present situation. The Bloomberg surveys ask consumers to describe the state of the nation's economy and their personal finances "these days" and whether now is a good time to buy the things they need.

Even though consumer sentiment has been low throughout the entire quarter, retail sales have held up fairly well. Although it would seem that consumers would stop spending given their outlook on the economy, this is not always the case. Retail sales climbed .3 percent in July after a .2 percent gain in June. However, August retail sales were unchanged. Given the economic headwinds, it appears the consumer is now being a little more cautious.



Operation Twist

In September, the Federal Reserve acted as expected and announced what is known as "Operation Twist". The goal of this program is to lengthen the average maturity of the Fed's balance sheet. The Fed has indicated it will buy $400 billion of Treasury securities that mature in more than six years and sell an equal amount of its existing holdings that mature between three months and three years from now. The result, ostensibly, will be to lower longer-term borrowing rates, including mortgage rates.

The thesis behind the lowering of long-term borrowing rates is that money will find its way into the economy and create jobs. Unfortunately, the problem is not that interest rates are too high, but that we're in a debt de-leveraging cycle that started three years ago in the private sector. Corporations already have plenty of cash on the sidelines that could be used without the need for borrowing. Until the political landscape and economic picture improves, it is highly unlikely we will see an increase in borrowing. We applaud the efforts by the Fed, but it is unlikely these efforts will have much of an impact. Hope is not a plan.

Proceed With Caution

As mentioned in the opening paragraph, a lot of talk recently has focused on the likelihood of a double-dip recession. The risk of another recession is certainly elevated, but it's not yet conclusive. Keep in mind a few segments, housing and small business, never really came out of the prior recession. Therefore, it will be hard to drop back into a "formal" recession.

A troubling relationship we are currently facing is between stocks and the economy. Historically, the stock market is a discounting mechanism because it takes in all available information, both present and potential future events. Is the stock market signaling a weakness in the future economic growth (possible recession) or has the stock market become a catalyst, or "self-fulfilling" prophecy, actually triggering another recession? It is impossible to discount the fear currently baked into the market. It is also difficult to feel too good about the economy and the market when home prices are still depressed, unemployment is still high, Europe is still a mess, and the politicians are still quarrelling like the Hatfields and McCoys. However, we believe it is critical to not overreact to these severe market conditions. Over the long term, history has shown that a significant portion of stock market gains have been generated when markets stabilize and rebound right after a severe down movement. Selling into these down markets could deny participation in the eventual stabilization and rebound.

In the U.S. corporate sector, earnings have been reasonably strong and balance sheets have continued to show healthy fundamentals. As a group, the companies within the S&P 500 have the largest net cash positions in more than three decades. Valuations of U.S. stocks remain quite reasonable, especially in comparison to the alternatives in fixed income. The current dividend yield on Wal-Mart (2.8 percent), Pepsi (3.3 percent) and IBM (1.7 percent) compares to the 10-year Treasury yield of 1.9 percent and the 30-year Treasury yield of 2.9 percent.

Would you rather lock in these Treasury yields or take a chance that these three U.S. behemoths would appreciate just one dollar over the 10-year or 30-year time horizon? I think I know what my answer would be.

One important thing to remember is an investment in U.S. stocks is very different than an investment in U.S. gross domestic product (GDP) growth or the U.S. government. We believe many corporations today are in better shape than either components of GDP or the U.S. government. We will continue to monitor events and movements around the world and how they affect the markets on a macro basis, but more importantly, how these will affect our clients' portfolios on a micro basis.

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