Third Quarter 2009

"Any man who is a bear on the future of this country will go broke." -- J.P. Morgan

Is the Great Recession over? The financial news media, economists, and politicians are all abuzz about the possibility that the current economic contraction has hit bottom and progress toward recovery is imminent. Maybe that's true and maybe it isn't. But frankly, we feel that identifying a precise date as soon as possible does not matter (more on that later in this missive). What really matters is how such a recovery unfolds over time, and this holds true whether the bottom is last month or next month or 12 months from now or any other time.

Regardless of when the recovery starts, real GDP for American economy could grow very slowly for a number of years, perhaps on the order of 1% to 3% per year on average compared to the 3% to 4% experienced in the past 50 years (according to data from the U.S. Bureau of Economic Analysis). One major reason for expecting below average growth is that American consumers may be in a prolonged period of deleveraging (cutting back on use of credit and paying back debt) and buying less. This is the natural, necessary, and prudent response required to pay for the sins of past irresponsible behavior. For example, we overtly over-consumed, fueled by borrowing and leveraging far beyond what family incomes could sustain. The new reality for Americans is contained in the old-fashioned words of wisdom from a bygone era: "live within your means", "if you don't have the money for something do without it", and "save for a rainy day". (We know, this is so unfair!)

Many people are quite concerned about future inflation given the massive government stimulus, and rightfully so. However, in the near team the purpose of the stimulus is to combat deflation, as this remains the more immediate threat to the economy. Once the economy is back on its feet with sustainable albeit tepid growth, the federal government will then have to walk a fine line between removing the stimulus too soon, which risks an economic relapse, versus overstaying the stimulus, which risks double-digit inflation. But we expect that will be some time in the future. For now, the goal of policymakers is to keep the patient alive and worry about infection later.

Recall from history that in the first half of the Great Depression the ravages of severe deflation are what led to the worst effects in the economy, which included 25% unemployment in 1933. Deflation was caused in part by the policy mistakes of contractions in money supply, credit, and government spending (they didn't want deficits to get out of control). Eventually these were reversed somewhat to stimulate the economy and by 1937 unemployment was reduced to "only" 14%. But as growth appeared to return, policymakers removed the stimulus too soon so that the economy relapsed in 1937-38 (according to the National Bureau of Economic Research) and thus prolonged the Great Depression.

Data Source: *http://fraser.stlouisfed.org/docs/meltzer/maremp93.pdf*

Federal Reserve Chairman Ben Bernanke is a student of the Great Depression and knows the importance of learning from history, as do other policymakers, in order to respond more appropriately to the economic crisis. This does not mean everything they do will be right (indeed, we disagree with at least a few of their initiatives), but instead suggests they are less likely to repeat the mistakes of the past.

Unemployment could be a noticeable problem for a few years. We expect to hear the phrase "jobless recovery" from the pundits as the official statistics may be consistently in the mid- to high-single digits well after the recession officially ends. High unemployment persisted after the end of the last two recessions in 2001 and 1990-91 (according to data from the U.S. Bureau of Labor Statistics) at least partly because the American economy is now service-based (from being manufacturing-based), where transitions between contraction and expansion are relatively more gradual. Thus, employment lagging for quite some time is actually a normal state following a recession in a service-based economy and is not necessarily indicative of something wrong with the economy.

The National Bureau of Economic Research (NBER, http://www.nber.org) is the independent arbiter that determines the dates of peaks and troughs in American economic activity, which conceptually is measured via domestic production and employment. Such data takes a while to collect and is usually vague because the data sets usually change direction at different points in time. Because of this, the NBER purposely waits before making their announcement identifying the month of the peak or trough in an effort to be very certain that a change in direction of the economy has indeed occurred. By necessity their announcements can be (and have been) easily a year after the fact. For example, they made the announcement of the December 2007 peak in December 2008, and they made the announcement of the November 2001 trough in July 2003 (20 months or more than 1-1/2 years afterward!).

These delays are one reason why identifying a precise date as soon as possible (which certainly can not be done in real time) does not matter and why pundits trying to be the first to guess such dates are engaged in a meaningless exercise. Another reason is that real and financial markets do not act simply based on knowing whether a recession has begun or ended.

How do slow growth and the policy responses affect investments? Quite simply, domestic equity returns for perhaps the next decade or so could be lower on average, perhaps mid- to high-single digits, than the 10% long term average since 1926 (according to Ibbotson) and stock prices could be more volatile. Domestic fixed income investments should do fine as long as inflation remains under control. Housing prices, even if they are currently in the process of bottoming, will likely not return to a new bubble to rescue over-leveraged homeowners.

So is this bad news for investors? We don't think so, for two reasons. First, keep in mind that slow growth is better than no growth or continued decline. For many investors the biggest ramification of slow growth is to keep expectations realistic, which simply means that we expect to see decent returns, but not the spectacular returns that we have experienced in the past. Second, we think investors have good opportunities outside the United States. While the present situation also affects the developed economies around the world to one degree or another, particularly in western Europe, many emerging markets have demographic, political, and economic environments that could prove quite favorable for investors. The growth and demand emanating from emerging markets could provide higher returns for those willing and able to take some additional risk.

All told, we believe there are still opportunities for investors throughout the global economy. As we have cautioned before, the journey will not be smooth and there always remain some risks (geo-political, policy error, etc.). But the end of the financial world is not at hand, so whether the current recession is already over or still has some time left, growth of some sort will come from economies around the world. Inevitably the cycle of expansion to contraction to expansion will continue.

John Kleponis, CFA

Senior Portfolio Manager

Paul Heckler

Managing Director

Past performance is not indicative of future results. The information contained herein is based on internal research derived from various sources and does not purport to be statements of all material facts relating to the issues mentioned. This information contained herein, while not guaranteed as to accuracy or completeness, has been obtained from sources we believe to be reliable. Opinions expressed herein are subject to change without notice.

The S&P500 Index is designed and maintained by Standard & Poor's (a division of The McGraw-Hill Companies), includes 500 leading companies in leading industries of the U.S. economy, and is intended to be an ideal proxy for the total market.