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MACROCOSM

What Recession?

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Things will have to get a lot worse for this to be a recession. And they're likely to get better.

It is now taken as nearly axiomatic that, as the *New York Times* put it last weekend, "the United States is almost certainly now ensnared in a recession." This assertion came in the context of the reported decline of 20,000 payroll jobs in April, which the *Times* took as a sign of "widening distress." But the *Times* failed to note that that was the lowest reported job loss so far this year (job cuts in the first quarter averaged 80,000 per month), and could well be a sign that the economy is emerging from the worst of the present slowdown.

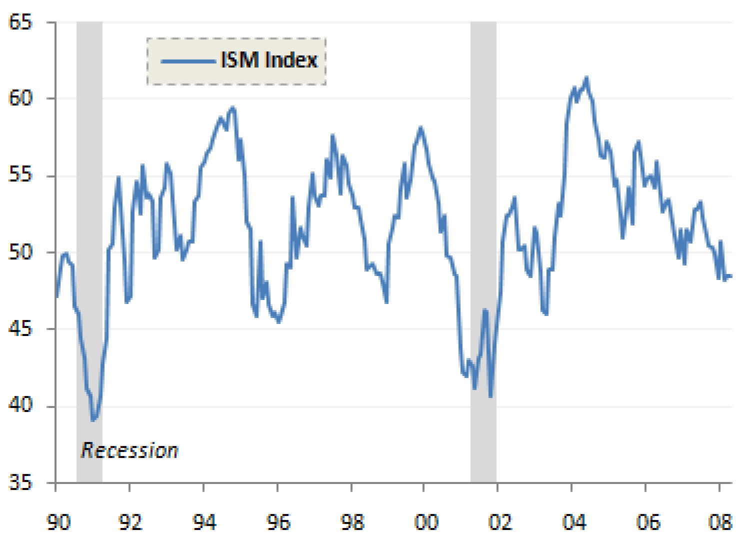
From our perspective, the slowdown has not yet reached a point that would qualify it as a recession. More important, it may never qualify -- various forward-looking indicators are now providing significantly more upbeat signals about the outlook.

Update to strategic view

US MACRO: For all the widely reported near-certainty that the economy is in recession, there remains good reason to doubt it. The most dependable coincident indicators have yet to confirm it. And in the midst of an overwhelming air of pessimism, markets are showing a strong belief that better times are coming.

[see Investment Strategy Dashboard]

If, as many analysts believe, the economy decisively fell into recession around the beginning of this year, we should be seeing coincident data consistent with past experience during the fourth month of contraction. But the more reliable coincident indicators have thus far remained well clear of their levels in the two most recent recessions. For example. in the fourth month of the 2001 recession, the ISM manufacturing index was at 43.5. At the same stage of the 1990-91 recession, it was at 41.3. In the most recent release last week covering April, it registered 48.6 for the second consecutive month. While that's



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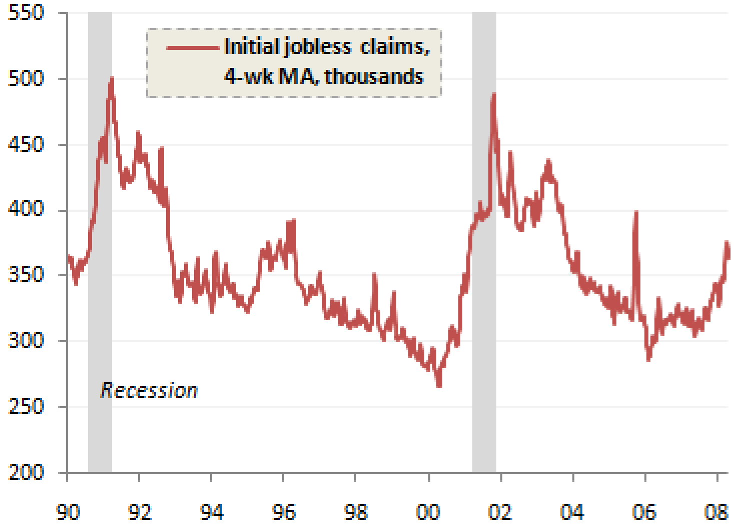
slightly below the breakeven level of 50, it's well above typical recession performance, and still at levels which the ISM itself considers consistent with overall economic expansion.

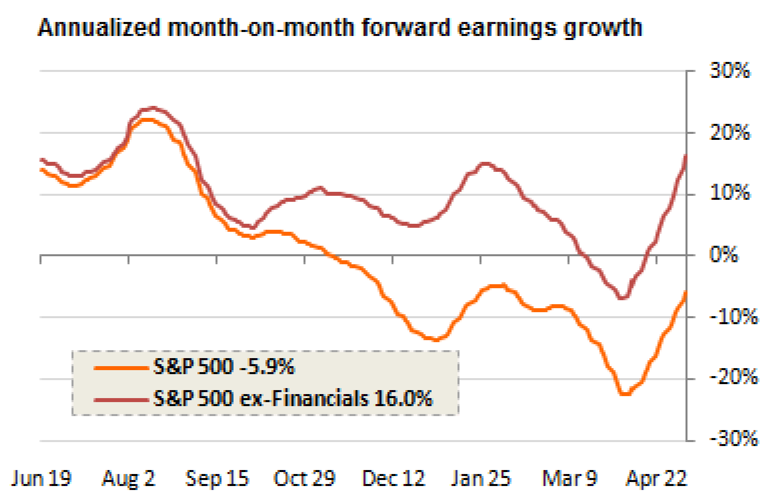


Weekly jobless claims have been trending higher since early this year, and on a four-week moving average now stand slightly above 360,000, having actually declined from above 375,000 in the most recent two weeks. Four months into the 2001 recession, claims were just below 400,000. At the same point in the 1990-91 recession, unemployment claims were running above 480,000.

At the same time, industrial production has declined from a four-month annualized growth rate of 3.5% last September to a slightly negative -0.4% last month. Four months into the 2001 recession, it was contracting at a 6% rate, while in the 1990-91 recession it was declining by 4.4%.

All of this is not to say that a *further* weakening from here wouldn't establish in hindsight that we were, in fact, in a recession right now, or that such weakening is inconceivable. But given the rampant pessimism last week's advance report of a real 0.6% GDP growth rate for the first quarter had to be considered mildly heartening. For what it's worth, following that release, one member of the recession dating committee of the National Bureau of Economic research stated that it would be highly unlikely for the panel to declare a recession in the face of still-positive GDP growth.

Even more encouraging than this data, however, has been the turn seen recently in more sensitive indicators of the market's forward growth expectations. The market's risk preference is a fundamental variable in that regard, as a greater willingness to bear risk comes in anticipation that the risk will be rewarded with higher returns which, in the aggregate, is synonymous with faster growth. Also, restoration of the appetite for risk is essential to the process by which capital is devoted to its most growth-enhancing uses. Since mid-March, we've seen a decisive shift for the better in the market's appetite for risk. On March 17, the first market day following the Bear Stearns implosion which fed fears of a generalized market meltdown, the Merrill Lynch High Yield Index spread peaked at 862 basis points. That spread has since narrowed by nearly 200 bps. We've seen similar contractions in almost all the risk spreads that had been so exaggerated by the credit crisis.



This period has also been marked by an impressive recovery in the corporate earnings outlook. Ex-financials, S&P 500 forward earnings are now growing at annualized rate heading for 20% after falling into negative territory in the two weeks after the worst of the market's travails in the first quarter. A broader shift in sentiment has also become apparent in the prediction markets. The Intrade contract on the probability of recession this year peaked at nearly 80% last month. Today, it's quoted at 21%.

Critical to this restoration of confidence has been the action taken by the Fed in the immediate wake of the Bear Stearns collapse. Opening the discount window to Wall Street investment banks through the Primary Dealer Credit Facility relieved the counterparty risks which were threatening to take down the whole system. This recovery, though, also underscores the peculiar nature of the forces which were bearing down on the economy, penalizing growth. The housing bust and its destructive effect on risky mortgage assets engendered a crisis of confidence which raised the market's risk abhorrence to nearly unprecedented levels. A generalized mood of dread arising from the credit crisis also imposed a drag on consumption and business investment activity.

But through it all, the economy's fundamentals have actually remained remarkably resilient. Ex-housing, four-quarter real GDP growth is running at a 3.5% rate. The negative factors which typically cause economic downturns are absent in this episode. Most of all, earlier recessions were almost always explained by a tight Fed, with a real funds rate exceeding 4%. At a 2% nominal rate, the current funds rate is negative relative to both headline and core inflation. This excessively easy stance of policy is giving rise to a substantial inflationary breakout which the Fed will have to deal with down the road. That's a story for another day. For now, the waning of the credit crisis is restoring the economy's growth impetus, which should become increasingly apparent in the weeks and months to come.

BOTTOM LINE: For all the widely reported near-certainty that the economy is in recession, there remains good reason to doubt it. The most dependable coincident indicators have yet to confirm it. And in the midst of an overwhelming air of pessimism, markets are showing a strong belief that better times are coming.