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MACROCOSM

Muted Celebration

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The data is already showing a sub-par recovery from recession.

While the economy is showing increasingly consistent signs that the recession has come to an end, we also see evidence mounting to support our view that the recovery is likely to be fairly sluggish, at least in its early stages (see "The Square Root of Recovery" July 2, 2009).

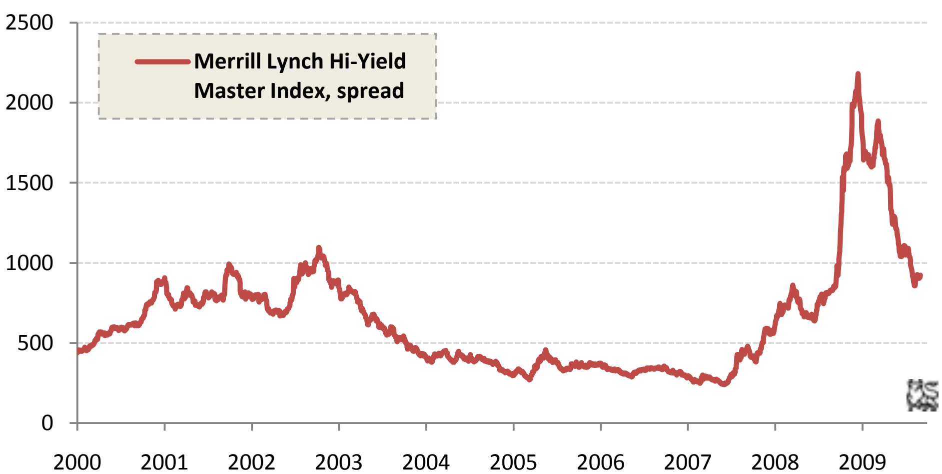
The spasm of severe risk aversion that afflicted the markets in the depths of the panic late last year has been substantially relieved. At its height, the extremely bearish economic sentiment sent the Merrill Lynch High Yield Index spread soaring to nearly 2,200 bp, nearly double its previous peak (see "It's A Recession -- Not the End of the World" November 21, 2008). As markets stabilized and the worst-case economic fears proved to be unfounded, high yield bonds rallied, pulling the spread below 860 bp at its best last month. Since then, the rally has stalled and the spread has backed up by nearly 70 bp. At this point, the spread remains above the levels seen prior to the intensification of the credit market crisis last September.

Update to strategic view

US MACRO: While the trough of the recession has been passed, evidence indicates that growth is likely to be sub-par. Abstracting from noise such as inventory correction, we'd be surprised to see real GDP growth above 2% for the next several quarters.

[see Investment Strategy Dashboard]

This suggests that while the worst of the pessimism has been overcome, a significant element of risk aversion continues to linger. This reflects a certain wariness about the outlook, but the effect is self-fulfilling. A healthy degree of risk tolerance would indicate investor willingness to put capital to work, which is what produces strong growth. The current situation is not unlike that coming out of the



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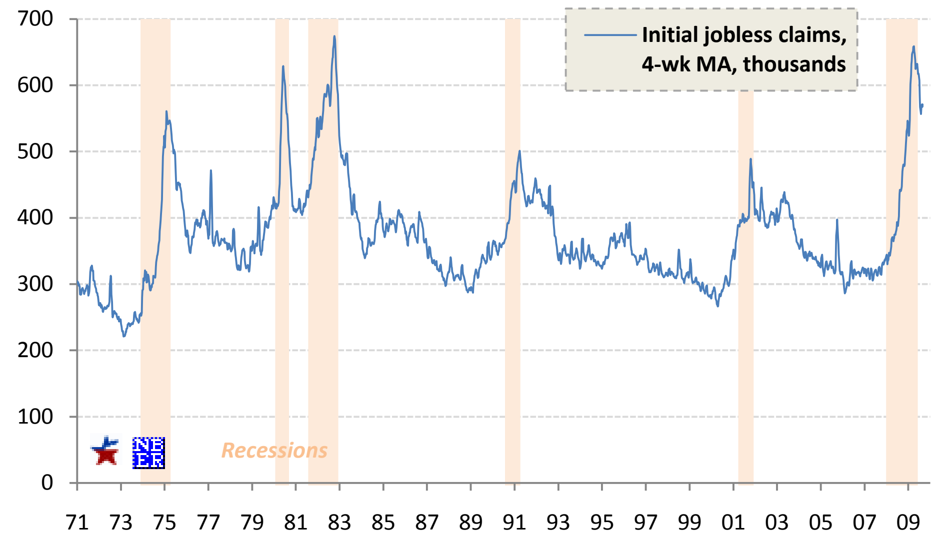
last recession in late 2001, when the high yield spread leveled out at around 800 bp, having narrowed from about 1000 bp. In the first six quarters of that recovery, GDP growth averaged less than 2%, and the high yield spread again widened out to nearly 1100 bp. The precursor for the strong expansion which took hold in the second half of 2003 was the high yield rally starting in late 2002, which took the spread down to near 600 bp through the first four months of 2003.

One of the key indicators in our call that the economy probably bottomed in the second quarter (see "Stress Test for T-Bonds" May 8, 2009) was the decline in initial jobless claims, which on a four-week moving average peaked at nearly 660,000 in early April and fell to below 560,000 last month. The past several weeks have not witnessed further improvement and, in fact, the four-week average has widened out slightly to about 570,000. If the economy were poised for *strong* expansion, it's unlikely jobless claims would plateau for any significant period at such a high level. The last time jobless claims peaked at such high levels was in the 1982 recession, when claims topped 670,000 (the level of claims then could be seen as even higher in relative terms, given the much larger size of the workforce today) . In the recovery through early 1984, claims fell by nearly 200,000 before pausing, and then proceeded to fall by another 160,000.



The ISM manufacturing index for August rose into positive territory for the first time in 18 months, with a reading of 52.9. This is another coincident indicator consistent with the proposition that the recession is over. But it does not necessarily imply that growth will be particularly robust. In the first two quarters of 2002, the ISM was above 52 four out of six months, but GDP growth averaged only 1.55%. And one factor cited by ISM for the improvement, according to its survey respondents, was the "Cash for Clunkers" program -- which has been discontinued. Furthermore, manufacturing is now a relatively small portion of the US economy. The ISM non-manufacturing report, covering the larger services sector, came in for August at 48.4, below the hurdle at the 50-level required to indicate expansion.

The continuing frailties of the financial system figure to be a weight on growth. While the Fed and Treasury's ministrations have allowed the "systemically critical" banks to avoid failure and begin a process of recovery, smaller regional banks are still showing signs of significant distress. The Federal Deposit Insurance Corporation has just added more than 100 banks to its "problem list," bringing the total to more than 400, about 5% of all banks. Banks on the list are at high risk of insolvency. In such a fragile environment, banks are limiting their exposure to risk. According to the FDIC, small business lending has fallen nearly 2% in the past year. FDIC chairman Sheila Bair last week said she expected "credit problems will outlast the recession by at least a couple of quarters." If small businesses -- the engine of job creation and capital formation -- are credit constrained, it doesn't bode well for the strength of the broader economy.

Looking ahead, the economy, to an extent, can be expected to respond to the axiom that "time heals all wounds." The current subdued outlook is in important ways a product of the trauma that was absorbed in the near collapse of the economy and financial system. Getting over such a harrowing experience takes time, so it's only natural that economic actors are exercising a greater degree of caution than would ordinarily be the case. However, that doesn't explain all of it. With the installation of the Obama administration, this has also been a time of great political risk and uncertainty. The markets nearly ceased functioning in the first several weeks of the new presidency when it seemed that Obama was poised to enact the entirety of his interventionist, heavy-handed agenda at the flick of his wrist (see "Quantum of No Solace" March 10, 2009). Thankfully, that runaway train has been slowed significantly, but it would be a mistake to breathe too heavy a sigh of relief (see "Wolf in the Fold" May 18, 2009). His health care crusade appears hobbled, but it's not dead yet. The cap and trade climate change boondoggle is stalled for now in the Senate, but the EPA has regulations in the works that would have much the same effect without the need for new legislation. Also, the administration's unbound ambitions for deficit spending and debt buildup imply the price will eventually be paid with significantly higher taxes. And as it is, the 2003 tax cuts on dividends, capital gains and upper-end incomes are already scheduled to expire after next year. The passage of time should offer some brightening in the outlook as confidence continues to be restored. But political uncertainty will like remain a factor that restrains the economy from realizing its full potential.

BOTTOM LINE: While the trough of the recession has been passed, evidence indicates that growth is likely to be sub-par. Abstracting from noise such as inventory correction, we'd be surprised to see real GDP growth above 2% for the next several quarters.