It's Not Over Until It's Over

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Highlights

- While it is premature to conclude that the worst has passed, the outlook for the US economy should gradually improve as we head into 2009.
- The impact of the fiscal stimulus is already fading and there is a risk that economic growth could turn negative by year-end.
- "Whether it's a technical recession or not is not all that relevant. It's clearly the case that for a variety of reasons families are facing hardship." – Fed Chairman Ben Bernanke

A surge in US economic growth during the second quarter of 2008 has led some analysts to proclaim that the worst has passed. It is our view that it is premature to draw such conclusions at this stage, but there are several reasons to believe that the outlook for the US economy will gradually improve as we head into next year. Even so, financial market volatility is likely to persist especially during the summer months when light volume can exaggerate moves. Although fears about inflation have led the futures market to price in interest rate hikes by the Federal Reserve before year end, we expect the central bank to remain sidelined until the dust settles sometime in the middle of 2009.

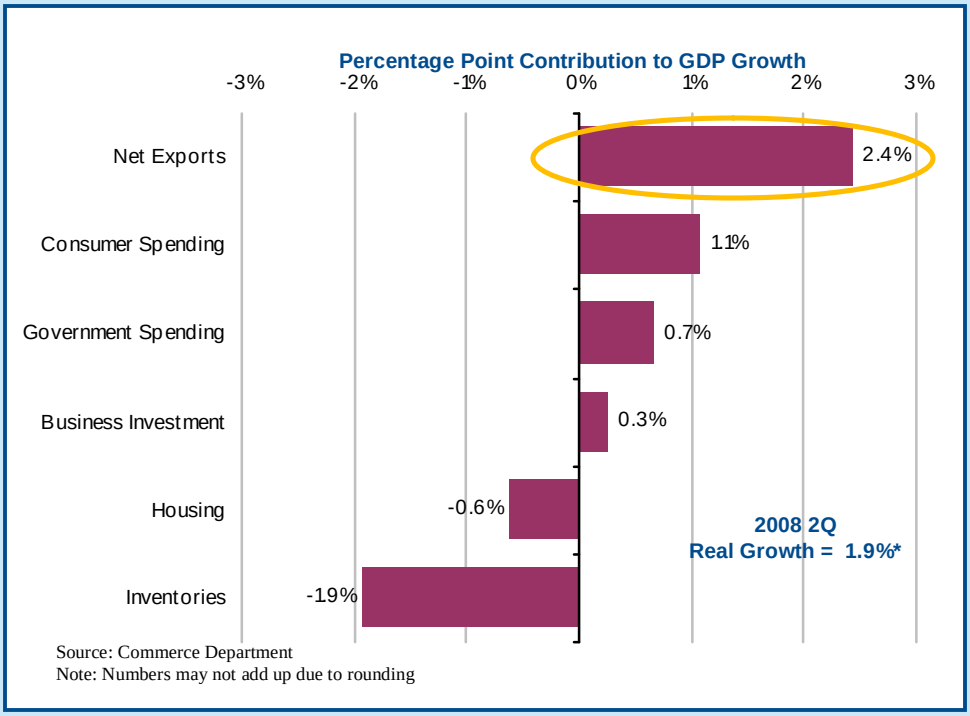
Will There Be Payback for the Fiscal Stimulus?

The US economy grew at an annual rate 1.9% in the second quarter of 2008 according to figures released by the Commerce Department this week. The tax rebate checks that went out in late May supported consumer spending during the quarter. Unfortunately, the impact of this fiscal stimulus is already fading and there is a risk that real gross domestic product (GDP) could turn negative by year-end

Interestingly, revisions to previously released GDP data indicate that the US economy actually contracted 0.2% in the fourth quarter of last year. This has reignited the debate about whether the US economy has slipped into a technical recession. When this question was posed to Fed Chairman Ben Bernanke during his semi-annual testimony in mid-July he responded, "Whether it's a technical recession or not is not all that relevant. It's clearly the case that for a variety of reasons families are facing hardship."

Perhaps no single piece of economic data illustrates the Fed Chairman's point more clearly than the unemployment rate, which has risen from a cyclical low of 4.4% in March 2007 to 5.7% today. This translates into the loss of approximately 2 million jobs according to the Labor Department's Household Survey. The jobless rate is likely to continue to rise in the coming months and we expect it to top 6% before all is said and done.

Exports Are Currently the Main Driver of Economic Activity



Source: Commerce Department
Note: Numbers may not add up due to rounding

Highlights

- The drag from housing appears to be lessening and the boost from trade was the largest since the early 1980s in the second quarter.
- With falling home prices improving affordability, home sales could bottom as soon as the second half of 2008 followed by home starts four to six months later.
- Home prices are likely to go through a more protracted period during which they are flat to down modestly.

Not surprisingly, increased slack in the labor market has caused wage growth to slow markedly. Growth in average weekly earnings has slowed from 4.6% in August 2006 to 2.8% today. This should comfort Fed officials who have expressed concern about higher food and energy prices translating into a more broad-based inflation through increased inflation expectations and wage demands. Yet, at the same time, it poses downside risk to consumer spending, which accounts for some two-thirds of GDP.

Consumer woes have been compounded by rising gasoline prices and declining home prices. The Case-Shiller composite home price index is down 16% from its June 2006 peak –almost double the rate of decline in the 1990s housing bust. And although gas prices eased a bit in recent weeks, they remain 30% higher than last year. This will weigh on consumer discretionary income and spending through year end.

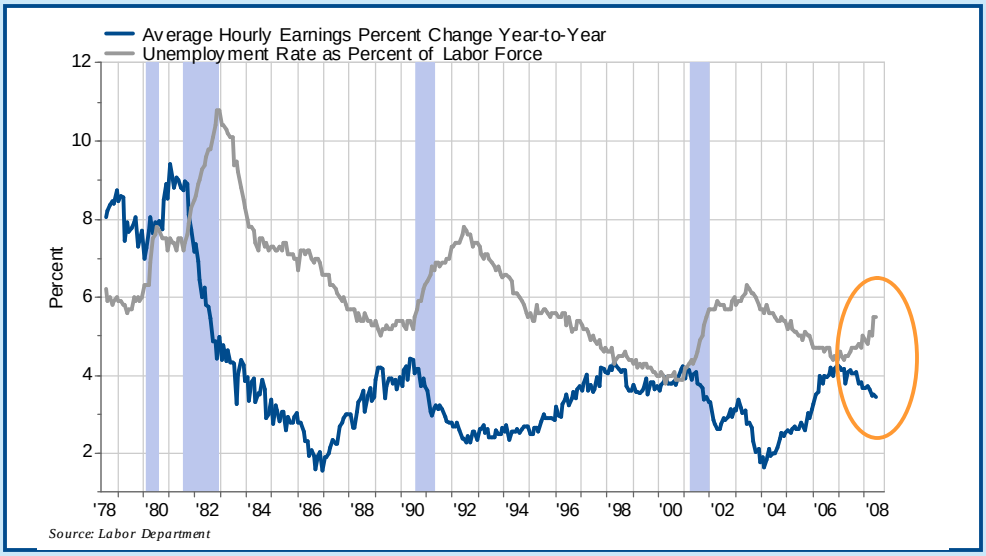
Light at the End of the Tunnel

That said, there were some hopeful signs in the GDP report. Specifically, the drag from housing appears to be lessening and the boost from trade was the largest since the early 1980s. Over the past year, housing has subtracted more from economic growth than at any time since the late 1970s. While a recovery in home prices is still a few years off, the rate of decline in new construction, which figures directly into GDP, is clearly slowing. Indeed, residential investment declined at an annual rate of 15.6% in the second quarter of 2008 compared to a 25.1% drop in the first quarter.

Has the real estate market bottomed? Probably not, but there may be light at the end of the tunnel. It is worth pointing out that the adjustment in the housing sector began almost three years ago and that the declines in many housing indicators are comparable to the drops experienced in past busts. With falling home prices improving affordability, home sales could bottom as soon as the second half of 2008 followed by home starts four to six months later.

However, home prices are likely to go through a more protracted period during which they are flat to down modestly. In the housing bust of the early 1990s, it took nearly four years for house prices to go from peak to trough. Given the magnitude of the price run-up in recent years and the huge inventory of unsold homes currently on the market, it is difficult to make the case that this time will be any different.

The Labor Market Continues To Deteriorate



Highlights

- Both the Federal Reserve and the US Treasury have taken unprecedented actions to help stabilize the markets.
- We believe the fragility of the US financial system will keep the Federal Reserve sidelined until the middle of next year. Put simply, the Fed doesn't want to make a bad situation worse by raising interest rates.
- The equity market and non-Treasury fixed income market are offering much better value for those investors who have capital at the ready and a long enough time horizon to weather any near term volatility.

The other positive take away from the GDP report was the trade sector. The weak US dollar continues to benefit US exports of goods and services, which increased at an annual rate of 9.2% in the second quarter. By contrast, US imports have been shrinking as domestic demand flounders. Consequently, the trade balance has stealthily improved from a deficit of 5.9% of GDP at the end of 2004 to 3.4% of GDP today. This will eventually provide the foundation for a rebound in the US dollar, though that probably won't occur until the second half of next year when we foresee the US economy recovering and the Fed raising short-term interest rates.

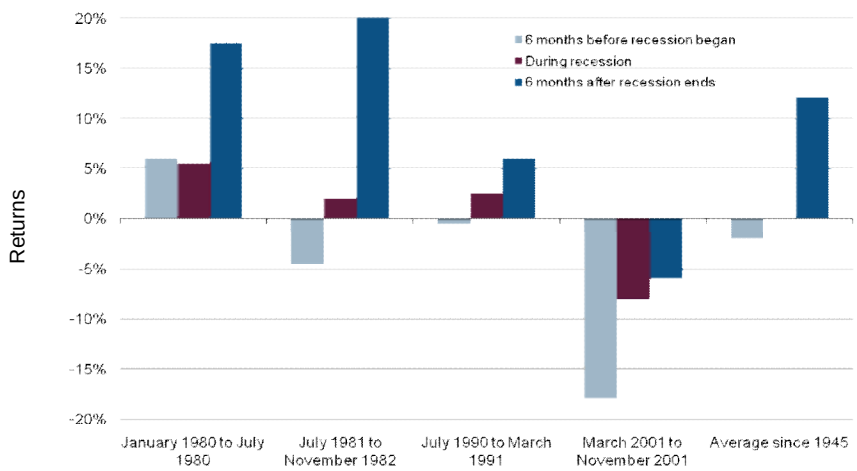
Fed to Wait for Dust to Settle

Both the Federal Reserve and the US Treasury have taken unprecedented actions to help stabilize the markets. The Fed opened the discount window to non-bank broker dealers under the Primary Dealers Credit Facility (PDCF) in mid-March following the collapse of Bear Stearns and the Treasury has signaled that it is prepared to inject equity into mortgage giants Fannie Mae and Freddie Mac making their *implicit* government guarantee more *explicit*. While these steps have met with a certain degree of success, the problems associated with the mortgage market and the large amount of leverage in the financial system will take time to work out.

We believe the fragility of the US financial system will keep the Federal Reserve sidelined until the middle of next year. Put simply, the Fed doesn't want to make a bad situation worse by raising interest rates. Financial institutions have taken massive write-downs and are reining in lines of credit as they move into capital preservation mode. Although the Fed has slashed its benchmark interest rate by 325 basis points to 2% since last August, borrowing costs for the average US consumer have actually risen as the market for securitized lending has shut down and traditional banks become more conservative in their lending practices.

The equity market and non-Treasury fixed income market are offering much better value for those investors who have capital at the ready and a long enough time horizon to weather any near term volatility. The S&P 500 stock index officially slipped into bear market territory in mid-July with the market down more than 22% from its October 2007 peak. However, valuations are looking more compelling than they have in some time with the price-to-earnings ratio below 15 compared to an historical average of 16 since 1960. At the same time, corporate bonds are offering their highest yields since the 2003 period. That said, there is obviously still some downside risk to earnings growth in the coming quarters and it is probably wise to build positions cautiously in the current environment.

Performance of the S&P 500 Before, During and After Official Recessions



Source: Standard & Poor's