

# INVESTMENT QUARTERLY

## *More Progress – but still a long way to go*

At the risk of sounding redundant, the purpose of the title is to suggest optimism but with a heavy dose of realism. Drawing from a number of sources that tend to reflect our own views, we learn that U.S. gross domestic product (GDP) is expected to grow by 2.6% in 2011, down from an estimated 2.8% in 2010 – fueled in most part by corporate spending. However, consumer spending, which led the way out of most previous recessions, is not doing so this time. Rather, it is expected to have grown 1.7% by the end of 2010, about half the pace of growth following previous recessions, due to concerns about lost wealth (investment account balances and real estate values) and fears of losing jobs. Consumer spending is anticipated to recover somewhat in 2011, growing at a 2.7% pace. Extreme consumer pessimism appears to have subsided but remains cautious, at least by pre-recession standards.

Furthermore, the savings rate held at 5.8% in the second quarter, well above the 2.1% of 2007 but far below the pre-1990 average of 8.9%. Car sales are beginning to come back, but the November sales pace is some 25% below light vehicle sales for 2006. Credit card receivables continue to decline – the NY Times reporting in early December that only 17% of shoppers were using credit. We may find that consumers have raided the piggy bank to avoid Scrooge-like behavior during the holiday season – December's savings rate looks to be half that of November.

Also working against the recovery, in addition to the recent strength of the dollar, is the likelihood of Congress withdrawing any further fiscal stimulus in 2011. However, the major factors holding back the recovery are still housing and unemployment. The U.S. housing market continues to soften. After the expiration of the tax rebates in the spring, sales and prices dropped back to their earlier negative trend. Although the average home price is below its historic average relative to income, and interest rates are very low, the high unemployment rate, the tightening of credit standards and the lack of savings mean fewer households can qualify to buy a home. At the same time, the glut of houses in, or close to, foreclosure are holding prices down even more.

With respect to employment, the meager November jobs gain snuffed out the ray of hope raised by the October figures. The unemployment rate bounced back to a seven-month high of 9.8%. High unemployment scares consumers. Weak job growth means weak income growth, further damaging consumer spending. From the employer perspective, rising corporate profits should spur hiring, but recent history is not encouraging. Part of the problem is that companies are more apt to spend their cash on stock buy-backs and acquisitions that increase share prices but not hiring. Many companies that are hiring are doing it in fast-growing markets like China and India.

With this view of the Economy, let's now look at scenarios for 2011. Recently, the Financial Times (FT) published three plausible scenarios. Two things are useful here: 1) each scenario suggests a rough probability, and 2) each takes a global view, reminding us of how dependent we are on others.

Using the FT descriptions:

The Tortoise scenario: markets carry on as they did in 2010, undulating in response to the latest economic news. Exceptional stimulus from governments and resilient demand from China allows a continued slow and messy recovery from the crisis; the weight of continuing corporate and household deleveraging, the weak U.S. housing market plus the threat of tighter monetary policy if sustainable growth appears on the horizon puts a lid on gains. Chances: about 70 per cent.

[Ed. In the U.S. exceptional fiscal stimulus looks very unlikely with the composition of the new Congress]

The Hare scenario: U.S. consumers start spending, China moves on serenely and investors get into the market. As companies spend their cash, equities enjoy a big rally. Everyone is happy except bond investors. Chances: about 10 per cent

The Disaster scenario: Bond markets refuse to finance the U.S. deficit and drive a crisis in the euro zone. With government credit ratings no longer effective in shoring up the creditworthiness of U.S. and European banks, asset prices plumb depths not seen in 2008-09. China lands hard. Chances: maybe as high as 20 per cent.

[Ed. Given the response of governments in 2008-09, this strikes me as much too high a probability]

The critical variables in all these scenarios are the U.S. bond market and the Chinese economy. If both stay out of trouble, disaster is off the table. A significant drop in U.S. unemployment and significant rises in house prices might signal a take-off. Without these, expect the Tortoise.

With the economic cloud cast by the foregoing comments, what is the outlook for the Market? First off, three historic milestones occurring in 2011 suggest the potential for a good year: 1) the third year of a presidential term, 2) the start of the 3<sup>rd</sup> year of the current bull market, and 3) the economy enters its third year of recovery. Although historic statistical evidence indicates the potential for a good year, it does not guarantee it. For instance, the rationale for third year of the presidential cycle outperformance rests on anticipation of stimulus money. Given the amount of stimulus already expended, the current round of quantitative easing, and the tenor of the new congress, there may be little left. In addition, the overhang of debt that needs to be addressed at the federal, state, local and personal levels creates impediments both practical and behavioral.

With reference to where we are in the current economic and market recovery cycles, the weight of professional opinion appears to foresee a year that is neither a bull or bear market, but rather a stock market with modest single-digit returns albeit with heightened volatility. Intermediate bonds are seen to be in a trading range with low- to mid-single digit returns. These, taken together, essentially reflect the term I used in my April 6<sup>th</sup> Investment Quarterly – “investors should prepare for lower-than-average historical returns with heightened government regulation, lower consumption and slower growth.”

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DJIA (31Dec2010)	11,577.51
S&P 500 (31Dec2010)	1,257.64