ECONOMIC HAPPENINGS

Beginning of the End?
There is hope. Finally, after an unprecedented four consecutive quarterly declines in U.S. GDP, the economy posted a modest 2.2% gain in 3Q'09. Although slower than the previous report of 2.8%, the fact that there was any growth at all was greeted with a sigh of relief within the Obama Administration, the Bernanke Fed and financial markets. This growth indicates that the worst economic contraction in 70 years is ending and that the fiscal and monetary measures undertaken during the panic phase of this global financial crises were, at the very least, somewhat justified.

If growth is sustained, whether the result of policy actions or the natural aging of the economic contraction; consumer psychology should gradually reverse from despair to guarded optimism. With 4Q'09 GDP expected between 3.0 – 3.5% and with the possibility that the economy may post modest job growth in December for the first time in two years, policy makers, at least at the Fed, have begun the discussion and planning for an exit of crises management actions.

In this light, the Fed said that because of the re-normalization of financial market workings, many of its emergency liquidity programs are being little used and will be terminated in late February. They also reiterated that the $1.25 trillion U.S. agency mortgage securities purchase program will end on March 31. Finally, they have begun discussions on how to exit quantitative easing (QE) and soak up excess banking liquidity. As for ending QE, the Fed will first have to limit balance sheet growth which should occur around the time they stop buying agency mortgages. The tougher action, and one that I think will not occur directly in 2010, is to actually reduce its balance sheet (currently at about $2.0 trillion versus about $1.0 trillion prior to the crises). As for withdrawing liquidity from the financial system, they should begin by doing repo with the street which will have a direct effect on short term rates. At some point, however, they may act to reduce their balance sheet and withdraw liquidity through the sale of longer term assets which will have a more direct effect on long term rates.

But Obstacles Remain
Amid signs of a growing economy and debate over the Fed reversing the unprecedented measures implemented over the past year, I want to emphasize the opening theme of this report; we are only at the beginning of a process that, we hope, will mark the end of this extraordinary episode. And while I am more optimistic today at the start of a new decade than I was a year ago, there are many hurdles needing to be overcome if the economy is to regain its vibrancy. Clearly, job growth is key and the outlook for modest job growth in 1stH'10 is promising. But, after the loss of 7 million jobs it will probably take five years or more to regain those lost positions while an unemployment rate above 8% for the next several years is going to be a drain on U.S. fiscal resources. Bloated Federal budget deficits for the foreseeable future will be a burden on the economy and tax payers; pushing interest rates higher and threatening the fragile housing recovery. De-leveraging of corporate, financial and homeowner balance sheets has far more to go and will restrain consumption. Yet, despite all this, the outlook for 2010 is for a gradual return to normalcy that should see the unemployment rate peaking in 1stQ'10 at about 10.3% and then declining towards 9.5% by year 2010. GDP, meanwhile, measured on a 4th quarter over 4th quarter basis, should advance around 3.3%. The Fed, we think, will start to raise rates in 3rdQ'10, but market rates will anticipate this and rise beforehand. By year end 2010 we think Fed Funds will have risen to a still exceptionally low rate of about 1.25% while two and ten year treasury rates should approach 2.35% and 4.25% respectively versus 1.10% and 3.85% now.

Lost Decade

It's hard to believe that ten years have past since the beginning of the new millennium. While our computers survived the hysteria of Y2K, the markets soon after suffered the bursting of the dot.com bubble. The horrific terrorist attack of 9-11 led to wars in Afghanistan and Iraq. At mid-decade the citizens of the Gulf Coast suffered the devastation of Hurricane Katrina. A period of relative calm and buoyant equity markets carried us through 2006 and to new highs for the DOW 30 and S&P 500 in late 2007. But the bursting of the housing bubble and subsequent financial meltdown brought the decade to a crashing conclusion. Had you bought the S&P 500 on the last day of 1999 @ 1469; on a pure price basis you would have lost 24% as the index closed 2009 at 1115. Including dividends, the loss, according to the S&P GSCI Enhanced Total Return Index, was still 10%.

Other asset classes performed better. Investors in gold had an approximate 275% return during the decade while commodities returned 260%, oil 200% and hi-grade corporate bonds & treasuries about 90%. Even existing home prices, despite falling about 30% from the 2007 highs, performed better than the S&P by returning about 30% for the decade. The lesson: stay diversified.

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