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Investment Commentary—January 2011

For two years now we have fretted over the vigor of the recovery from the Great Recession. In January 2009 we suggested that the climb back would be weak and protracted. A year later we envisaged an economy soon to be languishing in "a netherland somewhere between recession and real recovery." And last quarter we characterized the economy as "stuck in neutral."

While the recovery has been rather tepid and did stall late last spring, it wasn't stuck in neutral for long. In fact, data strongly suggest the economy is picking up steam and that 2011 will see respectable growth. To appreciate how significantly the outlook has changed in a relatively short time, consider that Goldman Sachs was forecasting 2011 U.S. GDP growth at 2.0% just six weeks ago, but now estimates a much peppier 3.4%. While 3.4% is relatively modest as recoveries[1] go, it is brisk enough to slowly (but surely) chip away at the unemployment rate, and may well put the recovery onto a self-sustaining course where policy makers could by sometime in 2012 begin responsibly to think about stimulus withdrawal.

To be sure there are important caveats to this sunny picture, but putting those aside for the moment, how did the outlook improve so considerably in such a short period of time? With seemingly everyone attacking the Fed these days, let's start with a pat on the back for Ben Bernanke. On August 27, 2010, the Fed Chief gave a speech in Jackson Hole, Wyoming foreshadowing the central bank's intention to purchase hundreds of billions of dollars of U.S. Treasury bonds in order to lower long-term interest rates. In monetary parlance buying up government bonds is known as quantitative easing; with this particular gambit being the Fed's second such effort in the wake of the financial crisis, it has been dubbed QE2. Reactions to QE2 have generally ranged from skeptical to derisive. (We stood squarely in the skeptical camp in October, applauding the Fed for making the effort, but doubting the likelihood of great success.) Consider, however, the trajectory of the stock market following the Jackson Hole speech: the low on the S&P 500 Index on day of the QE2 preview was 1,040, not much above its 2010 nadir of 1,011. By market close that day the index had climbed to 2.3%, and it would march steadily higher, rising an additional 3.9%, 7.4% and 11.1%, respectively, in the one week, one month and two months after the speech. Although quantitative easing purports to assist the economy by pushing rates lower, economists refer to alternative "transmission

[1] Technically the U.S. economy completed the recovery phase in the fourth quarter. With GDP apparently reaching its previous peak, business cycle nomenclature dictates that we are now in an "expansion." With unemployment close to 10%, however, it seems inapt at best to put the recovery in the past tense.

channels" by which monetary stimulus can benefit the economy. One such channel is asset appreciation. Another is consumer confidence ("All is well; the Fed is on the case.") Is it completely coincidental that QE2 was put on the table at the end of August, followed by a steep two-month stock market rally in September and October and a nearly concurrent acceleration of retail sales in October and November?

Whether inspired by the rise in the stock market or simply chafing after two years of frugality, the consumer came roaring back this fall. Retail spending in October and November rose at an annualized rate over 10%. While that pace is not sustainable, it does provide a very welcome boost. Even more encouraging is the very steady decline in jobless claims. The four-week average of initial jobless filings is closely followed because it tends to have less statistical noise than employment surveys. Claims peaked in March 2009 at around 640,000. From there, they dropped steadily for about a year to around 440,000, a level correlated with positive (but only barely) job creation. The numbers remained steady throughout the spring and early summer, then spiked briefly in August to around 480,000. Beginning in late August, however (right around the time of Bernanke's speech!), claims began another steady descent, reaching 411,000 by year end. While this level still suggests relatively modest job growth, the trend is very encouraging. If the roughly 70,000 drop from the end of August to the end of December were repeated (and heaven knows it may well not be), claims would be well within the range correlated with vigorous job growth.

Just as the economy was showing signs of coming to life, a funny thing happened in Washington. President Obama and Congressional Republicans agreed on something. Something big as it turns out--an $858 billion tax cut deal. Of course, there were loads of goodies for both sides, but truth be told, as much as we hate to see the deficit expand, the additional fiscal stimulus was not only good politics but pretty reasonable economics to boot[2]. While politicians focus on unemployment, the more important target of fiscal and monetary stimulus is deflation. Idle economic capacity tends to put a lid on prices. The Great Recession created a tremendous amount of slack in the economy and inflation is now running perilously close to zero; were it to drop below zero for a protracted time, debt deflation could ensue. In this scenario, falling prices and wages cause debt to grow in real terms--if John owes Jane a dollar and his wages go down, John has to work longer to repay the loan. Growing real debt forces consumers to cut back spending, which causes prices to fall further, sending the economy into a downward spiral. In a nutshell, debt deflation is the stuff of depressions.

While the risk of a debt deflation is small, it remains a threat as long as inflation remains so close to zero and capacity utilization is so low. And that is the real reason to celebrate the

[2] To be sure, some aspects of the deal are pretty hard to defend on economic grounds: extending the Bush tax rates for the wealthiest taxpayers and investment tax credits for businesses come immediately to mind. Neither of these provisions is likely to spur much spending. In defending the deal on economic grounds, we're looking at the package as a whole, and relative to other politically conceivable alternatives.

improving economic outlook. If the U.S. economy grows in the range of 3% to 4% in the next couple of years, as it now appears it will, spare capacity will be meaningfully reduced, and the small but ominous threat of debt deflation should finally be behind us.

Of course, there are no guarantees that the economy will follow the lead of economic prognosticators. What could go wrong? For starters, the pace of foreclosures has yet to peak; when it does some time next year, consumer confidence could take a hit. Further, the decline in house prices, which was temporarily reversed by the homebuyer tax credit initiated in 2009 and subsequently extended until last April, has now resumed. Additional declines may spook homeowners and hurt consumer spending. That in turn would put more mortgages under water potentially leading to another wave of defaults and foreclosures. Recall, too, that the debt crisis in Europe has not been resolved. It's far from clear that a firewall has been established to prevent the crisis spreading from Greece, Ireland and Portugal to a somewhat healthier Spain. Nor is it clear that Europe has the financial ammunition and/or political will to save Spain should that become necessary. (On this score, Chinese Vice Premier Li Keqiang's recent vigorous expression of confidence in Spain's financial system was encouraging.) Finally consider the runup in stocks that seems to have prompted the resurgent economy. Bullishness is at extreme levels, which often presages a sharp fall in stock prices. While we would not expect any downturn in the market to be protracted, if it were, that too could lead to unwelcome frugality.

Notwithstanding these potential roadblocks, the prospects for the U.S. economy have improved considerably in the last three months and that is good news indeed. Even the chances of near term action on the country's exploding debt[3], admittedly not very good, look a bit brighter than they did a few months ago. Republican promises to fix the deficit helped to install John Boehner as the new House Speaker. Meantime, President Obama will reportedly make the issue the centerpiece of his State of the Union address and is closely studying the ideas put forth by his deficit commission. It's not unthinkable that the President and the Speaker could find common cause in confronting the debt. Boehner needs real accomplishments on reducing spending lest the GOP base become disillusioned. Obama in turn could stand to burnish his credentials with independents heading into his reelection effort, and putting his stamp on deficit reduction might help. Republicans and Democrats working together to make tough choices? We're not holding our breath, but stranger things have happened.

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[3] I may seem to be inconsistent in applauding the tax cut deal, which added $858 billion to the deficit, and then wishing for near term action on the deficit. But the tax cut deal has maximum impact in 2011 tapering off in 2012. Any deficit reduction that Obama and Congressional Republicans agree to would have a modest impact in 2011. The impact would be more meaningful in 2012, but more importantly would lay the groundwork for more aggressive efforts down the road.