Market View

PERSPECTIVES ON WALL STREET FROM 90 HUDSON

Quarterly Outlook

October 2010

"Unusually uncertain" is how Federal Reserve chairman Ben Bernanke described the economic outlook in his testimony before the U.S. Senate Banking Committee in July 2010, but as the third quarter wore on, a consensus seemed to form that the recovery was losing steam. Lending support to this were downward revisions to gross domestic product (GDP), unevenness in manufacturing, and a declining rate of inflation. Some interpreted these data as signs of something much worse than a sputtering recovery, and predictions of a double-dip recession, deflation, and a Japan-like "lost decade" filled the headlines.

These dangers, however, appear to be exaggerated. With additional monetary easing potentially on the horizon, a more likely scenario is an economy that continues to "muddle through" with mediocre rates of growth. Still, the risks to this more optimistic outlook are real.

Assessing these risks and the state of the economy in this quarterly roundtable discussion are Lord Abbett Partners **Milton Ezrati, Senior Economist and Market Strategist; Zane Brown, Fixed Income Strategist;** and **Rick Ruvkun, Director of Equity Research.**

Q: YIELDS ON SHORT-TERM BONDS, AS WELL AS SOME RECENTLY RELEASED ECONOMIC DATA, SUGGEST THAT THE ECONOMIC RECOVERY IS WEAKENING. SOME ECONOMISTS EVEN BELIEVE WE COULD BE HEADED FOR A RARE DOUBLE-DIP RECESSION. HOW LIKELY IS THIS SCENARIO?

Zane Brown: Not likely. The Fed seems prepared to embark on another program of quantitative easing if economic growth and inflation don't increase soon. That program would be designed to lower longer-term interest rates so that another slowdown will be avoided. Even without such a program, today's lower interest rates are enabling consumers and companies to refinance at record levels, and that will free funds to help the economy. Companies are accessing low-cost funding through the capital markets by issuing bonds. We have seen more high-yield bonds issued through September 2010 than there were in all of 2009, which was a record year. According to JPMorgan, high-yield issuance amounted to $210 billion, compared with last year's $180.7 billion.

This is having an impact on corporate profits, too. JPMorgan recently estimated that the savings resulting from corporate refinancings will add $3.50 to S&P 500® earnings per share in 2011.

At the consumer level, the rise in the savings rate, from less than 1% to about 6%, has been painful for the economy. But by saving at this rate, consumers will eventually feel they have saved enough, and they'll begin to spend again. That may not be an attitude you'd find in Japan, where the savings rate is higher, but it is one you'll find here. Maybe our savings rate will climb to 7% or even 10%, but eventually American consumers will decide they've sacrificed enough, and consumption will increase again.

Milton Ezrati: Keep in mind that savings is an ongoing flow. If people are saving at 6%, that's 6% every year, year after year. So if incomes rise at all—as they have been—then spending can rise in tandem with income.

I'd like to point out that the idea that the economy will go into a long downturn because consumers are deleveraging is a logical impossibility. If everybody stopped spending in order to deleverage, the economy would slow further and consumer incomes in aggregate would fall. As incomes fall, the debt as a percentage of income would *not* come down, so deleveraging—that is, reducing debt as a percentage of income—would not occur. There may be a very small risk of a double-dip recession, but this particular explanation is wrong.

Rick Ruvkun: The question is, to what extent is the higher savings rate a three- to five-year phenomenon, not just a cyclical phenomenon. If it is a long-term phenomenon, we could enter the same deflationary spiral that Japan has suffered, and it would take years for our leveraged balance sheets to return to normal. That is a possibility that one must consider, and expectations of deflation have increased. More likely, I think, is the chance of a double dip, but I think the chances of that are still only one in five, with a downward bias. The most likely outcome is still my current muddle-through forecast of 1–2% growth.

Brown: A higher savings rate, even for a prolonged period, doesn't necessarily lead us to a double dip, though. It could just keep us in a muddle-through scenario.

Also weighing against the double-dip scenario is that for it to occur, the cyclical industries would have to capitulate. But many have already capitulated. The housing industry, for example, has dropped from around two million housing starts per year to about 500,000, so it would be difficult for them to drop much further.

Ruvkun: But my point is just that in addition to the muddle-through and double-dip scenarios, there is some possibility that we're on a Japan-like deflationary spiral, though there's probably only a slight chance. We can have a difference of opinion on the probability, but the deflation scenario is worthy of discussion because we have a massive output gap. The economy is nowhere near full capacity.

So, I think we all agree that a muddle-through economy is most likely. We disagree on the likelihood of a double-dip recession, but I would put it at 20%, with a downward bias.

Ezrati: I would put it at one in 10.

Brown: With the Fed ready to embark on another program of quantitative easing, it may be less than 10%.

Q: THE ISSUE OF DELEVERING RAISES THE QUESTION, HOW WILL WE KNOW WHEN THE DELEVERING IS COMPLETE, AND HOW LONG WILL IT TAKE TO COMPLETE THE PROCESS?

Ezrati: Delevering is a balance sheet issue, and savings is a flow issue. If our consumers are saving at a rate of $750 billion a year (about 6.4% of income), which is what the savings flow is, they're deleveraging at about 5% or so per year (as a percentage of their liabilities).

Our debt load at the peak of the crisis was about 130% of income; it's about 122% now. If the savings rate remains at the current level, consumers are going to reduce their debt at a rate of 5% a year while their incomes grow.

These are rough calculations, but if income is growing by 3% a year, and consumers are deleveraging at a rate of 5% a year, then they're reducing their debt by about 8% a year. That should reduce debt levels to pre-crisis levels in about four years. That doesn't mean that consumers won't spend at all for four years, but it does mean we're likely to have a muddle-through economy.

Q: A FEW ECONOMISTS HAVE ARGUED THAT DEFLATION ISN'T NECESSARILY BAD FOR THE ECONOMY OR THE MARKET. ARE THE DANGERS OF DEFLATION EXAGGERATED?

Ruvkun: Research by the Leuthold Group shows that the impact of moderate deflation on equity markets is benign. There have been 50 deflationary quarters between 1926 and the present. Sixteen of these had deflation of 2.5% or more (13 of the 16 occurred during the Depression), and 34 had deflation of 0–2.4%.

Historically, when deflation has been between 0 and 2.4%, stocks have gone up. But when it is greater than that, stocks go down.

The problem, however, is that it's hard to keep moderate deflation from evolving into steep deflation. So I doubt that investors will increase their exposure to stocks if we have moderate deflation. I think some may wait to see whether that turns into severe deflation.

Ezrati: Some economists point to the period from 1870 to 1890, when the economy grew at a robust rate despite deflation. But the deflation of this period came from rising productivity as a result of the Industrial Revolution and from the flood of European immigrants, who were paid very low wages. This isn't the kind of deflation that some are anticipating in the current environment, and we're not likely to see it again in this country.

Q: IF CONSUMER RETRENCHMENT IS UNLIKELY TO PUSH US INTO A DOUBLE-DIP RECESSION, IS THERE A MORE LIKELY CAUSE?

Ruvkun: I think a policy mistake, tax increases, an explosion of home foreclosures, a spike in unemployment, or an exogenous event such as a rise in energy prices or a sovereign default could cause a double dip. Letting the Bush tax cuts expire could do it because that would bring forward spending that would have occurred next year.

Ezrati: According to the former chairman of President Obama's Council of Economic Advisors, Christina Romer, in a paper she wrote [with her economist husband, David Romer] before she was a government official, tax increases reduce economic growth. Applying her formula, I estimate that letting the Bush tax cuts expire for just the top two tax brackets will reduce growth by nearly 2.5 percentage points.

Whether this would push us into a double dip depends on what else is going on. If an economy is normally growing at 4.5–5% during a recovery, letting the Bush tax cuts expire for the top two income categories would bring us down to about 2–2.5%. If there are other factors dragging down economic growth, such as a gradual deleveraging process, then that gets us down to maybe 1.5%, and we start getting close to a double dip.

Q: WILL THE MIDTERM CONGRESSIONAL ELECTIONS MAKE A DIFFERENCE IN THESE SCENARIOS?

Ruvkun: If the status quo is maintained, then the trajectory of the policies of the past two years is likely to continue or move to the "left," and this could lead to policy mistakes such as tax increases or protectionism. On the other hand, more balance in Congress could be favorably viewed by the markets.

Ezrati: As I said, I don't think we're much like Japan, but I would add that one of the things that has made us more like Japan over the past 24 months is the prospect of tax increases. In the 1990s, every time the economy began to gain momentum, they would raise taxes and cause the economy to stall.

Another thing that makes us more like Japan is the amount of government intervention in the economy. The Japanese government interferes so much that its economy has been much less flexible than ours. Unfortunately, we've just passed two huge pieces of legislation that make us less flexible than we once were. So governing from the left makes us more like the Japanese, in that we have a more bureaucratic approach to the economy instead of a market-based approach.

Ruvkun: There is a possibility that the combination of massive job losses, high rates of unemployment, and unemployment that is now lasting much longer than in the past will change the way Americans view the economy. If they believe this is a permanent change in the nature of the job market, it could cause them to shift their focus from the economy's opportunities to its dangers.

It used to be that everyone wanted to be an Internet millionaire and could see the opportunities out there. Today, with long-term unemployment so high, workers may be more concerned about job security. This could have a political effect in that workers could look to the political left to protect them. Feeding this trend, or perhaps responding to it, this administration's approach to private sector employment appears to focus more on protecting jobs than on creating them. This raises the possibility of protectionism or additional trade barriers.

Ezrati: One of the things the election could do is that if the Republicans gain a lot of ground in Congress, we'll have gridlock. That's good because we've had a lot of uncertainty due to an extremely active legislative agenda. With gridlock, Washington will once again fade into the background, and the focus will go back to the market. The uncertainty will be reduced, and that would be good.

Q: THERE'S ALSO A DEBATE RAGING ABOUT WHAT THE ECONOMY NEEDS MOST RIGHT NOW: ADDITIONAL FISCAL STIMULUS OR FISCAL AUSTERITY? WHAT ARE YOUR THOUGHTS ON THIS ISSUE?

Ezrati: The problem is, we haven't spent even half of the original $860 billion stimulus package passed in 2009. To be fair, infrastructure projects take time. They require environmental impact statements, a bidding process, and engineering studies. So the infrastructure spending is just getting started.

Brown: If additional spending is going to occur, it should be done on programs that create job growth. More can be done for small businesses than the recent Small Business Jobs Act. For larger companies, incentives could be constructed to encourage spending or investment of record corporate cash balances. And with regard to personal taxes, if the top tax brackets return to higher levels, at least use those funds to promote spending and job growth.

Ruvkun: I think it's fair to say that tax cuts alone are not going to get the economy back to normal, if we resemble Japan at all. Economist Richard Koo believes that we do resemble the Japanese in that we also are going through what he calls a "balance sheet recession," as they did in the 1990s. With a balance sheet recession—that is, when consumers and businesses are focused more on paying down debt than on spending—the government has to engage in fiscal stimulus to fill the gap.

In a balance sheet recession, even if the government were to cut marginal tax rates to zero, that still wouldn't be enough to stimulate the private sector. Until the private sector recovers and debts are paid down, the government must spend. So because we're in a balance sheet recession, additional fiscal stimulus will be necessary.

Ezrati: The spending has to be targeted, because Japan engaged in a lot of stimulus spending and it failed.

Ruvkun: Koo argues that without that stimulus, Japan's economy would have gone into a depression.

Ezrati: Well, that can't be verified, and what we do know is that Japan has debt amounting to 200% of GDP, and that's because of the stimulus.

Brown: Stimulus spending in Japan resulted in the repaving of roads that didn't need repaving because that was a way to keep people employed. So, while that was targeted, it was not targeted to create real jobs. It kept people busy, but there was no investment benefit. I would hope we have better options here.

Ruvkun: We do have infrastructure needs. If you compare our infrastructure to Europe's, there are plenty of opportunities for investment. In Italy, you can go from Rome to Florence in two hours via a high-speed train. Our rail system is not nearly as efficient.

Some would say we should invest instead in nuclear power or in "green" technology, but in any case, we should have this conversation. We need to drop the shrill election rhetoric and develop some realistic growth initiatives. Few people are talking about an agenda for economic growth or international competitiveness or infrastructure.

My sense of what could eventually happen is that we won't have as many tax cuts as the political "right" would like, we won't see as many tax increases as the left would like, and hopefully we'll have some additional stimulus balanced with a pro-growth agenda.

If we have 15% unemployment (including workers who have dropped out of the workforce) and a muddle-through economy for a prolonged period, what's going to return us to normal if we don't have additional fiscal stimulus?

Brown: From a political standpoint, how would that happen? Republicans are lining up against additional stimulus spending, and if they get more people elected to Congress, they would be emboldened with that view. They might see a need for additional stimulus three or four years from now, but how would that happen in the next two years?

Ruvkun: Fiscal stimulus would come into play if unemployment is too intractable. This stimulus would focus on job creation, with an emphasis on infrastructure. In my opinion, reducing unemployment will require additional fiscal stimulus.

Brown: If unemployment a year from now is at 10.5%, then you're right. That could do it. And if we can't achieve growth greater than 2.5%, unemployment may indeed reach 10.5%.

Ruvkun: But a scenario in which Republicans in Congress approve additional stimulus would only happen if we become more like Japan—that is, deflation and low or negative growth—and we experience continued high unemployment. The Japan scenario is a low-probability event, but the odds have gone up, I believe.

Brown: The question of stimulus versus austerity raises the question of its impact on the market. The Fed's zero interest rate policy and balance sheet expansion have caused yields on short-term bonds to go down while the yield curve has steepened substantially. Last quarter, we agreed that in the short term, deflation was more likely, but that in the longer term, inflation was more likely. And that's expressed in the steeper yield curve that we see today.

And that's because people are worried that current monetary easing policy is eventually going to be inflationary. Likewise, additional stimulus could further contribute to fears of future inflation.

On the other hand, yields are low at the short end not just because of deflation fears. They're also driven by investor concerns about where else to put their money, by a lack of trust of the stock market, and by what's going on in the world with other central banks. The short end of the yield curve is where much of the world is putting its dollar reserves. So it's not all due to fear about deflation.

Q: IS THERE ANYTHING ELSE CONGRESS SHOULD DO?

Ruvkun: What bothers me about Congress is that they're all focused on the short term and on getting reelected, and few people focus on structural issues, such as the need to fix Social Security and underfunded public pension obligations. We need a great compromise that would ration some entitlements (especially on a needs basis), focus spending on investments in infrastructure and education, and cut some taxes. But stimulus would have to precede any eventually contemplated tax cuts. We need to first create jobs in the private sector, fueled by investment in infrastructure.

Ezrati: It's not as if the solutions to the Social Security problem are a mystery. The trustees of Social Security have published the solutions and the calculations, as well as their impact on government finances. It's all there on the Social Security Website. The main recommendation is to raise the retirement age to 72. There will probably also be a means test or some kind of additional taxation.

The problem with the public pension problem is that the states and municipalities have contracts that they must honor. In the Vallejo case in California, if the judge finds that the city can get out of its labor contracts as a result of going into Chapter 9 bankruptcy, then a lot of other states and municipalities will do it. If the judge finds against them, then that won't be a viable avenue. Either way, the states are beginning to make adjustments. Illinois has already changed the rules for new employees and lifted the retirement age to 67.

Brown: It really would be refreshing to have Congress address long-term structural problems such as Social Security and entitlement programs. People would respond very positively to that because in the back of their minds there is this huge budget deficit and concern about whether we'll ever be able to pay it off. So addressing entitlement programs would be very encouraging and would reduce fears of inflation.

Q: INVESTORS APPEAR TO BE MORE CONCERNED ABOUT DEFLATION THAN INFLATION, AND THEY CONTINUE TO POUR FUNDS INTO BONDS AND IGNORE STOCKS. IS THIS A CONTRARIAN SIGNAL ABOUT THE LIKELY DIRECTION OF EQUITIES, OR ARE STOCKS STILL TOO RISKY?

Brown: A lot of this flow is driven by investors who are over 50 years of age whose equity portfolios have been hit hard two times in the past decade, and they believe they can't afford to go through that again. So they've decided to underweight equities and put more money into bonds. Since they're getting so little yield on their money market accounts, they've started moving into investment-grade bonds and adding some high-yield as well.

If we end up with a muddle-through economy, one thing investors could do is to buy high-yield bonds. If the economy grows by only 2% a year, companies will still be able to earn enough to make their interest payments. They're not likely to go into default in this kind of environment, and investors will likely end up with an 8–9% yield, and maybe even some price appreciation. That's attractive for those who are fearful of big downturns in the equity market.

I would maintain that even though these investors are more risk-averse, we believe they shouldn't own much in the way of Treasury securities because these are probably at risk. The supply of Treasuries is probably going to rise substantially in the years ahead, and current yields offer little compensation.

Ruvkun: But if the muddle-through economy turns into a double dip, junk bonds may not be where you want to be. On the equity market, I would point out that, if we're not on the verge of the deflation scenario—a scenario we consider a low-probability event—then stocks could do very well over the next 10 years. Data from the Leuthold Group shows that 10-year periods in which the stock market underperforms are typically followed by 10 years of outperformance. So if the deflation scenario is a low-probability event, and an investor has a long investment horizon, increasing the weighting of stocks could be an appropriate strategy for those who have underweighted them.

It pays to consider the probabilities. If you knew for sure that we were headed into a double dip or deflation, stocks would probably not be the right choice. But if you knew for sure we were going to be in a muddle-through economy, stocks would be appropriate. So, given the uncertainty, a pragmatic asset allocator would say now may be the time to at least begin to buy stocks.

Ezrati: I agree with that, and would add that relative to high-yield bonds, stocks look very cheap right now on a number of metrics. Considering where P/E multiples are, the earnings yield on the stock market is about 6%, which means it's yielding a little over 300 basis points [bps] more than the 10-year Treasury. Historically, the earnings yield has been 200 bps less than the 10-year Treasury. In the past, earnings yields have been lower, because with stocks, people were also counting on price appreciation. But this measure is an example of how, on a historical basis, the stock market appears to be cheap. ■

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