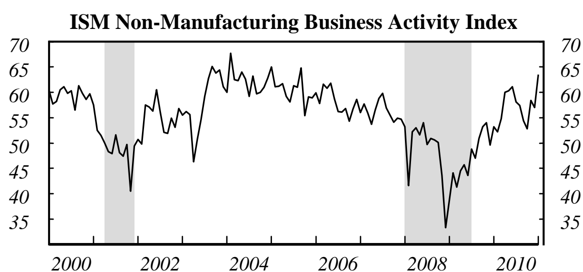
Wentworth, Hauser and Violich

REVIEW AND OUTLOOK - WINTER 2011

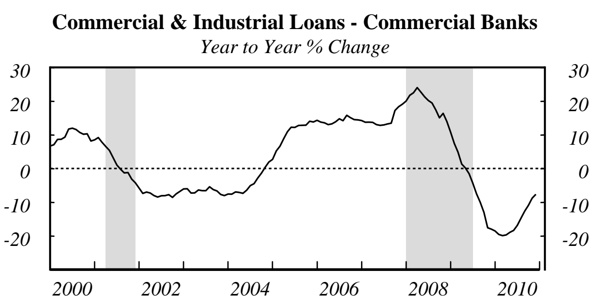
The economic recovery that began in June of 2009, following the eighteen-month recession of 2007-2009, has been under way for the past six quarters through the end of calendar 2010. The recovery to date has been weak by past standards with Gross Domestic Product (GDP), the total output of goods and services within the United States, expanding at only half the rate of prior post-World War II recoveries in their first six quarters. For the third quarter of 2010, GDP grew at an average annual rate of 2.6 percent and was approximately 3 percent above the year-earlier level. The estimates for the fourth quarter of 2010 project a modest increase in GDP to an annual rate of 3.5 percent.

The economic recovery remains tepid but seems to be gaining momentum.



Though the various indicators that gauge the health of the economy remain mixed, the recovery appears to have gained some strength as we enter 2011. The two broadest measures of the economy, the ISM Manufacturing Survey and the ISM Non-Manufacturing Survey (the service sector), both confirm that the economy is in an expansion mode. Retail sales over the 50-day holiday selling season were a robust 5.5 percent above the year-earlier level and total retail sales for December were 3.6 percent above a year ago. Personal income, reflecting modest total employment gains and salary and wage growth, has advanced 3.8 percent over the past year compared to gains of only 0.4 and 0.2 percent in 2009 and 2008, respectively. Other reports including exports, consumer sentiment, initial unemployment insurance claims and regional activity surveys suggest that the economy is gaining momentum.

Bank lending appears to be picking up.

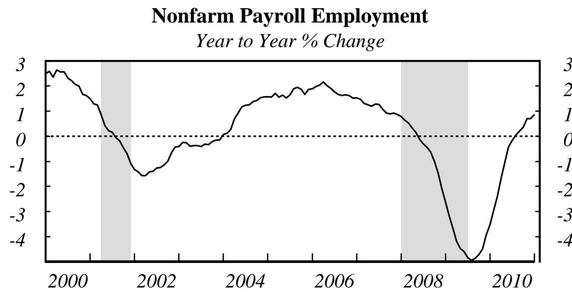


After two years of decline, commercial and industrial lending by commercial banks appears to have bottomed. In the fourth quarter, commercial and industrial loans rose over the third quarter for the first quarterly increase in two years. While these loans are well below their peak of 2008, down some 25 percent, the upturn suggests that banks are beginning to lend. Credit expansion for corporations is a prerequisite for a sustained expansion in business activity. Moody's Analytics projects a rise of 3 percent in commercial and industrial loans in 2011.

The 2010 tax structure will remain in place for two years.

Congress wisely decided not to increase personal income tax rates beginning January 1, 2011. The current tax structure for personal income, capital gains, dividends and the number of tax brackets has been extended for two years. To have raised taxes on even the top 2 percent of earners, those responsible for capital formation and job creation, in a weak economic environment and with 9.4 percent unemployment risked sending the economy back into recession. This group also comprises the majority of small businesses which account for over 70 percent of job growth. However, since this decision was not made until the third week of December, many taxpayers may have shifted economic activity and income into 2010 from 2011 in anticipation of higher tax rates. Such behavior, should it have occurred, may have a dampening impact on GDP in the first quarter of 2011. The tax bill also included a temporary reduction in payroll taxes for employees.

Payroll employment experiencing only modest gains.



The labor market is experiencing tepid employment improvement, a meager 103,000 non-farm payroll gain in December. Over 8 million jobs were lost in the recession and a year and a half into the recovery only about 1 million jobs have been regained. There are about 14.5 million people looking for a job and an additional 9.4 million that are working part-time but want full-time jobs. That places the under-employment rate at close to 17 percent. People entering the labor force total about 1.5 million a year and the decline in household net worth (home prices and retirement savings) will encourage workers to postpone retirement. While a growing economy will increase employment over time, it may be some years before there is a return to the unemployment level of 2007 of 4.6 percent from the current level of 9.4 percent.

Household net worth increased in the third quarter of 2010 to $54.9 trillion after having fallen in the second quarter to $53.7 trillion and is projected to have risen in the fourth quarter. This statistic combines assets such as homes, savings and investments less liabilities such as mortgages and revolving and non-revolving consumer debt. This has an important impact on consumer sentiment and confidence which in turn influences consumer spending. Total household net worth peaked in the second quarter of 2007 at $65.7 trillion, some 19 percent above the current level.

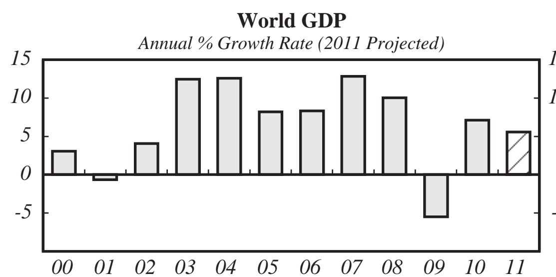
Near record corporate profits as a percent of GDP.

U.S. corporations are posting near-record profits as a percent of GDP and year-over-year increases are double-digit. Profits are being driven by increased productivity, modest revenue growth, exports and aggressive cost cutting. The current level of corporate profits relative to GDP is higher than in every decade since the end of World War II. U.S. non-financial corporations are also flush with cash, holding in excess of $1.93 trillion in cash and other liquid assets. This represents 7.4 percent of total assets, the largest amount since 1959. The strong financial condition of corporations may be a reason for the robust growth in equipment and software spending and will likely stimulate merger and acquisition activity in the period ahead.

The Fed is monetizing the deficit.

The Federal Reserve has embarked on an additional round of “quantitative easing” by buying U.S. Treasury securities and crediting the reserve accounts of commercial banks at the Fed. In the short-term this may keep interest rates from rising but the longer-term implications for inflation and interest rates of the Fed monetizing the deficit could be troublesome.

The global economy is being propelled by the developing countries.



The global economy continues to be propelled by the developing countries, including China, India, Brazil, the Middle East, Africa and the Pacific region. Consensus estimates for regional GDP growth in 2011 are the United States 3.0 percent, Emerging Markets 6.4 percent, Japan 1.2 percent and the euro zone 1.5 percent. Asia is leading the global recovery due to strong domestic demand at the retail level and imports of commodities and capital goods to support its infrastructure growth. Commodity exporting countries including Australia, New Zealand, Indonesia and the Middle East are benefitting from this demand. Capital goods producing countries including Germany, Japan and the United States are experiencing rising exports to Asia, particularly China and India. The International Monetary Fund is projecting robust GDP growth in 2011 for China and India of 9.6 and 8.4 percent, respectively. This is modestly below the expectation for 2010 due to the withdrawal of fiscal policy stimulus and tighter monetary policies to quell inflationary expectations.

There are a number of threats to the economic recovery that could emerge in 2011.

The housing market remains weak.

The housing market remains weak as the S&P/Case-Shiller Home Price Index has declined for four consecutive months and is below the year-earlier level. Home prices remain some 20 percent above their long-term trend relative to personal income. New and existing home sales are bouncing along the bottom of the cycle and inventories of unsold homes are large. A large amount of home mortgages will have interest rate resets in 2011 and 2012, loans that were made at the height of the housing boom in 2006 and 2007 to sub-prime borrowers. Mortgage delinquencies, defaults and foreclosures continue at elevated levels. An unforeseen event could cause the housing market to further implode.

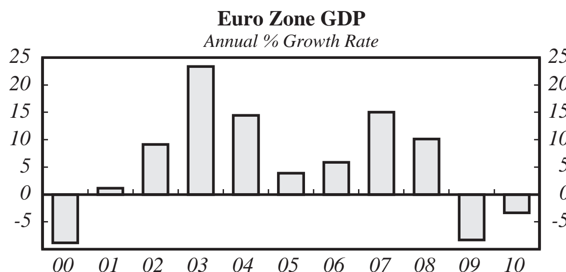
Interest rates have risen over the past two months with the 10- and 30-year U.S. Treasury yields gaining about 100 basis points. This may be a reflection of a stronger economy, concern among buyers of the pending insolvency of the U.S. government as gross outstanding debt approaches 100 percent of GDP or the inflationary implications of the Federal Reserve's monetary policy. A further sharp rise in interest rates could derail the economic recovery.

Federal, state and local budget deficits are not being addressed.

The United States and state and local governments face large budget deficits. The degree to which austerity programs are enacted at the federal and state level will have some impact on the economy. To date elected officials have not exhibited the political will to address these problems. These budgetary imbalances and the unfunded future liabilities of Social Security, Medicare and Medicaid will be the subject of a future *Review & Outlook*.

Perhaps the greatest threat to the global economy in 2011 will be the outcome of the sovereign debt crisis in Europe. In the spring of 2010, Greece had to be rescued in order to issue and refinance its outstanding debt. As 2010 came to a close Ireland faced a similar bailout and it appears that Portugal and possibly Belgium will follow in early 2011. The critical problem will arise if Spain is unable to remain solvent.

The EU was established to integrate Europe so as to avoid wars like those of the 20th century.



By way of background, in 1950 six European countries (Belgium, France, Germany, Italy, Luxembourg and the Netherlands) set up a political and economic union called the European Coal and Steel Community. In 1957, the European Economic Community, known as the "Common Market" was established. The Maastricht Treaty in 1993 established the European Union (EU) under its present name. Steps toward European integration were designed to avoid the extreme nationalism and numerous wars that had engulfed Europe over the prior century. Over the years, the EU was joined by other European and Mediterranean countries, including Great Britain, and currently comprises 27 countries. The EU encompasses a series of laws and treaties that assures the free flow of goods, services, people and capital among its members as well as various common policies regarding finance, trade, law and foreign policy. In 1999 a monetary union was established with a common currency, the euro. There are 17 members of the monetary union with Estonia joining at the beginning of 2011. The European Central Bank (ECB) is the central bank for the euro zone and is charged with maintaining price stability for the euro. While the 17 members have a common monetary policy under the ECB, their fiscal policies (budgets) are determined independently by each member country. There are some common guidelines regarding fiscal policy but enforcement and penalties for violating the guidelines have been vague. Among the qualifications for entry into the euro zone is that government budget deficits as a percent of GDP cannot exceed 3 percent and that total government debt as a percent of GDP cannot exceed 60 percent. Virtually all of the euro zone countries are in violation of these guidelines.

Most members of the euro zone have structural problems that the global recession exacerbated. To varyingly degrees these problems include the demographics of aging populations with low fertility rates, inflexible labor markets and work rules, social welfare systems that discourage work and entrepreneurism and permit early retirement with pensions, unfunded public sector pension and healthcare liabilities, excessive government regulations, mandates and other intrusions, and high levies in the form of personal, sales and valued-added taxation. With the global recession, government revenues fell and government spending ballooned. Several euro counties have problems specific to their nationalities. The real estate markets collapsed in Ireland, Spain and Greece endangering their banks; Italy and Portugal have non-competitive labor markets and low productivity; Germany, the strongest of the euro zone countries, relies heavily on exports which account for 30 percent of its GDP. To finance the resulting budget deficits, government debt soared to the point that in several countries solvency became an issue.

The euro zone is threatened by the insolvency of several of its members.

The euro zone had no plan for rescuing one of its members from insolvency. Historically, a country facing these problems devalued its currency. But Greece cannot print euros, only the ECB can, just as California cannot print dollars, only the Federal Reserve can. When Greece was unable to service its debt in the spring of 2010 the IMF, the EU and the ECB set up a rescue fund, the European Financial Stability Facility. This facility will lend to the recipient countries in return for the enactment of fiscal policies and structural changes (retirement ages, pensions, etc.) that will bring budgets into line. Spain, however, is not Ireland or Greece. Spain is two times the size of Greece, Ireland and Portugal combined. It is one half the size of Germany. Spain is too big to save.

European banks own a large amount of sovereign debt.

German, French and United Kingdom banks own a large quantity of the sovereign debt of Greece, Ireland, Portugal and Spain and a default could plunge the world back into a global credit crisis. The future of the EU and the euro zone will depend on how the sovereign debt crisis is resolved in 2011.

SUMMARY

The United States economy appears to be gaining some momentum as we enter 2011. The global economy also appears to be experiencing solid growth. Corporate profits are robust and the financial condition of corporations is healthy. Inflation remains subdued although developing markets' demand for commodities and energy together with the Federal Reserve's monetary policy may result in inflationary pressures toward the latter part of 2011. This will also place upward pressure on interest rates as the year unfolds.

Resolution of the sovereign debt crisis in Europe will likely determine the course of global economic activity and the financial markets throughout 2011 and into 2012.

Past performance is no guarantee of future returns. Unless otherwise noted charts are from Crandall Pierce & Company. Charts presented in this article are not indicative of the past or future performance of any Wentworth, Hauser and Violich strategy. The opinions expressed represent the opinion of WHV and are not intended as a forecast or guarantee of future results and are subject to change at any time due to changes in market or economic conditions. Information contained herein has been obtained from sources believed to be reliable.

Investment Products: Not FDIC insured * No bank guarantee * May lose value

No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Wentworth, Hauser and Violich. ©2011, Wentworth, Hauser and Violich.

WENTWORTH, HAUSER AND VIOLICH
INVESTMENT COUNSEL

301 BATTERY STREET, SUITE 400
SAN FRANCISCO, CALIFORNIA 94111-3203
TELEPHONE (415) 981-6911
FACSIMILE (415) 288-6153

801 SECOND AVENUE, SUITE 1210
SEATTLE, WASHINGTON 98104-1518
TELEPHONE (206) 219-2450
FACSIMILE (206) 219-2479