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U.S. MARKET COMMENT: WHERE'S THE ECONOMY HEADING?

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Where's the Economy Heading?

Like Rorschach inkblots, the state of the economy and capital markets can be interpreted in countless ways. In the present environment, investors are buffeted by an unending debate about whether the economy has embarked on a recovery or headed for a double-dip slowdown, with the supporting data somehow confirming each view. Generally at this time, those who fall in the bullish camp take a relatively short-term view of the economy, emphasizing the stabilizing effects of time-honored cyclical dynamics, while the bears worry about a secular downturn over the longer term. The bulls contend the slowdown and recovery are for the most part playing out as did other postwar recessions; the bears believe the economy has only just begun to unwind the excesses accumulated during the binge years.

A snapshot of the economy at year-end 2002 mostly supports the contention that the current business cycle is largely consistent with prior postwar cycles; indeed, the current slowdown is even more moderate than its predecessors. However, this picture may not adequately capture indicators that appear in the process of weakening. The risk of further economic deterioration is small, not the base case scenario, but its potential consequences are quite ominous. With short interest rates so close to zero, further weakening could usher in consequences that are much more severe than in prior postwar slowdowns.

Variations on a Recessionary Theme

The U.S. economy has held up pretty well in the current cycle, especially considering the headwinds set in motion in 2000 (Table A). Real GDP grew 3.3% for the year ended in September 2002, up sharply from -0.3% growth recorded for the year ended in third quarter 2001, and roughly equivalent to its 3.4% annual trend growth in the postwar period. Both the recession and recovery from economic troughs have been milder than those experienced in previous postwar recessions. GDP growth fell only 2.6 percentage points from the fourth quarter 2000 peak to the third quarter 2001 trough, which is substantially less than the median 4.9 point fall in the nine other postwar recessions. In the current cycle, from its trough to third quarter 2002 peak, GDP growth expanded at a 3.6% clip, compared with its average 7.6 point jump for the comparable period after bottoming. Similarly, the increase in unemployment has been less severe than in prior recessions, whether looking at its current rate or percent rise. The current 6.0% unemployment rate is lower than the 6.8% and 10.8% rates recorded at the end of the 1991 and 1982 recessions (Table A). Unemployment has risen 1.7 points so far in the current slowdown, only half of the 3.3 point median rise in unemployment in the other postwar recessions.

Households and Corporations—The Big Squeeze?

The bears largely base their pessimism on unprecedented levels of household debt, which they contend will crimp future spending, limit the strength of the recovery, and increase vulnerability to an economic downturn (Table B). Total household debt is 77.8% of GDP, compared to its 50-year mean of 51.0%, while household credit is 107.9% of disposable personal income, relative to its 50-year mean of 74.0%. However, as the bulls point out, high levels *per se* are not very meaningful. More critical is the threshold where debt service becomes too onerous—and that tipping point has not yet been reached. First, Martin Barnes with the Bank Credit Analyst cheers the "democratization of credit," the broadening of credit availability, which ultimately is a positive economic force. Second, total debt levels overstate household vulnerability, for 70% is comprised of mortgages, while debt service capabilities remain reasonably healthy. Third, disposable income growth is strong (Table A), and relative to levels reached during the 1991 recession, bank loan delinquency rates are quite low, as are bank loan charge-off rates, and mortgage delinquency rates (excluding subprime mortgages).

Consumer spending has thus far sustained the economy, and while it certainly has not paid to bet against the consumer in recent years, consumption may be weakening. After plunging from 8.0% as of March 2000 to 2.1% as of September 2001, year-over-year spending growth rose to 5.4% 12 months later, but has slipped to 4.7% in recent months. The bulls are not especially alarmed with this latest dip because spending growth began from extremely lofty levels and it remains fairly high. However, with extremely high levels of spending as a percent of disposable personal income (93.3%) (Table B), it would not be too surprising if more bad news further eroded consumer optimism, prompting them to rein in their spending. As a percent of disposable personal income, debt service payments remain quite high, and consumer confidence has fallen sharply since January 2000. Declining confidence is especially worrisome because it is a forward-looking indicator, while other measures of the consumer's health and spending patterns tend to be backward looking.

The bulls take confidence from the inventory cycle, which is poised to contribute to a classic expansion, as corporations rebuild inventories from depleted stockpiles. In addition, they see capital spending in the process of bottoming from historical lows. After plunging from 2000 highs, capacity utilization has ticked up and technology-spending growth has sharply increased since December 2001, implying that 2003 may enjoy a positive surprise in terms of a pick-up in capital expenditures. However, the bulls tend to overlook the fact that capital spending ex tech growth remains in free fall, dropping from 7.0% in December 2000 to -11.9% as of September 2002.

Like consumers, corporations are laden with debt, but they may not be in such bad shape as the numbers otherwise suggest. Debt/net worth of nonfinancial corporate business has reached record highs, nonfinancial corporate debt as a percent of GDP remains near peak levels, and total nonfinancial corporate debt to cash flow remains near all-time highs (Table C). Although the level of corporate debt rose sharply in the late 1990s, declining interest rates allowed debt service capabilities to remain reasonably healthy, and net interest payments of nonfinancial corporations relative to cash flow are significantly below their record 1990 high (Table C). However, the high levels of debt make maintenance of cash flow critical, as any setback in cash flow consequently carries a higher than normal risk of distress.

Concerning corporate profits, where the bulls see marked improvement, the bears perceive weakening momentum. S&P 500 operating earnings, after contracting 39.4% for the year ended June 2001, expanded at a 27.7% clip in 2002 and are expected to grow 20.7% in 2003 (Table D). S&P's new estimates of core profits, in which some extraordinary write-downs are reclassified as routine costs, show profits grew 30% in 2002. NIPA profit growth snapped back from -21.7% for the year ending March 2001, to 17.7% 12 months later, but they have since slipped to 11.1%, and they may be rolling over (Table D).

The Government's Purse—Bottomless or Nearly Empty?

The bulls believe that government stimulus has been effective in moderating the slowdown's severity. The Bush Administration launched massive stimulus packages and announced enormous tax cuts, while the Federal Reserve aggressively lowered policy interest rates and promised to use all its tools, traditional and unconventional, to stop incipient deflationary pressures. It is only a matter of time before the effects of these substantial amounts of stimulus in the pipeline begin to kick in, the bulls believe.

The bears cite the lack of policy traction as proof that the government is confronted with a slowdown unlike any other in the postwar period. Tax cuts in 2001 had an ambiguous effect on the economy. The Federal Reserve has slashed interest rates 525 basis points since May 2000, and the economy and equity markets are still skidding on ice, marking the first time since the 1930s that equity markets are down two years into an easing cycle. With the Fed funds rate at the historical low of 1.25%, the government is running out of ammunition, and deflationary pressures from overseas and domestically will intensify real debt pressures. Furthermore, the Fed's attempt to stimulate the economy through lower policy rates could create another asset bubble, which would burst with even more serious consequences than the tech bubble, many bears believe.

The shift from a budget surplus to deficit has further pressured the current account deficit, which reached 5% of GDP and continues to grow. The United States must suck in over 75% of the world's savings at a rate of almost $2 billion every trading day, making the US$ entirely dependent on overseas capital. The bears worry about the possibility that non-U.S. investors may decide en masse to stop buying US$-denominated assets—or even worse to start selling—resulting in a currency crash that would set off destabilizing shock waves around the world.

In sum, in many respects, the economy has been surprisingly resilient since 2000, with powerful cyclical forces moderating the impact of the slowdown. However, most of the indicators that support this view are backward looking, and they do not capture inflexion points or momentum. Today's cycle carries more risk than others in the postwar period, because an exogenous shock or continued economic deterioration could sap remaining strength, unleashing conditions that may be immune to government stimulus.

Investment Implications

There is one thing that most bulls and bears can agree upon: earnings will not enjoy double-digit growth over the next few years. However, bulls believe that equities are currently undervalued or roughly fairly valued, though it is possible that equities could enter a trading range for several years, punctuated with substantial cyclical rallies and sell-offs. They believe that equities will outperform bonds, while corporate bonds will outperform Treasuries.

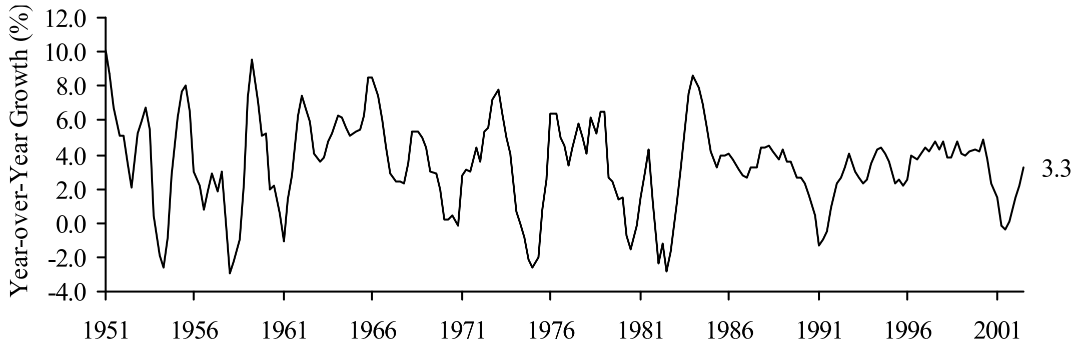
Bears stress principal preservation. They believe that the equity market remains highly vulnerable to overly optimistic earnings growth expectations. They expect bonds to beat equities, though cyclical rallies could break out during the secular downturn. In the fixed income sector, U.S. Treasuries are a safer hedge than corporates, and risk-averse investors should stay away from high-yield debt. However, high-yield corporate bonds could be seen as a viable substitute for low-quality, value-oriented equity exposure, since corporations are using cash flow to pay down debt rather than invest in higher earnings, and so credit spreads should continue to narrow.

While long-term risks remain, we would advise *against* aggressively underweighting equities and recommend buying on weakness. Cautious investors might explore low-beta ways to implement their equity allocations (e.g., long/short equity hedge funds, underweight aggressive growth, allocating some assets to equity managers who raise cash when they cannot find stocks that meet their investment criteria), but a bet on bonds or cash and against equities strikes us as a risky proposition over the long term.

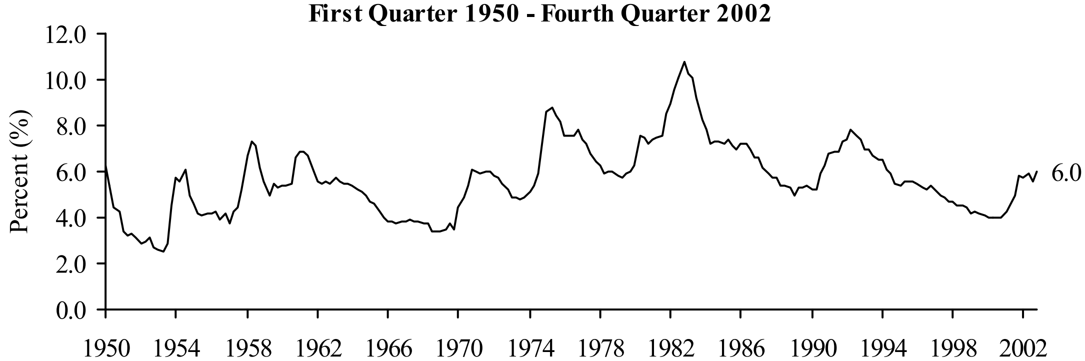
Table A

MACROECONOMIC INDICATORS

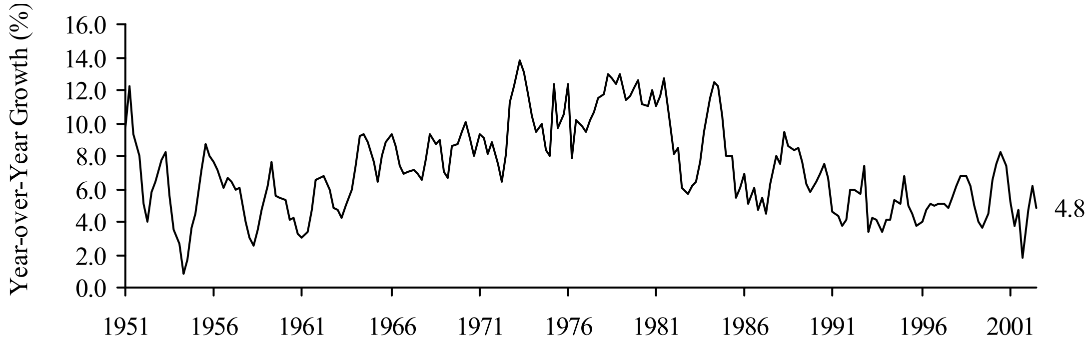
Real GDP Growth
First Quarter 1950 - Third Quarter 2002



Unemployment Rate
First Quarter 1950 - Fourth Quarter 2002



Disposable Income Growth
First Quarter 1950 - Third Quarter 2002



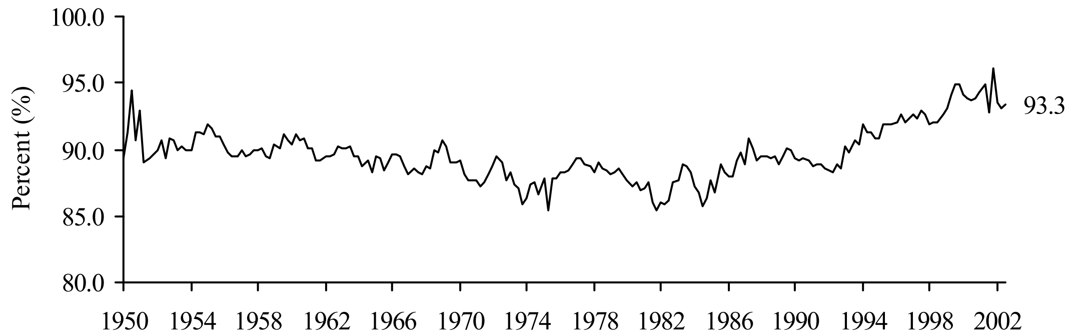
Source: Thomson Datastream.

Notes: Graph represents quarterly data. GDP and Disposable Income data represent year-over-year growth.

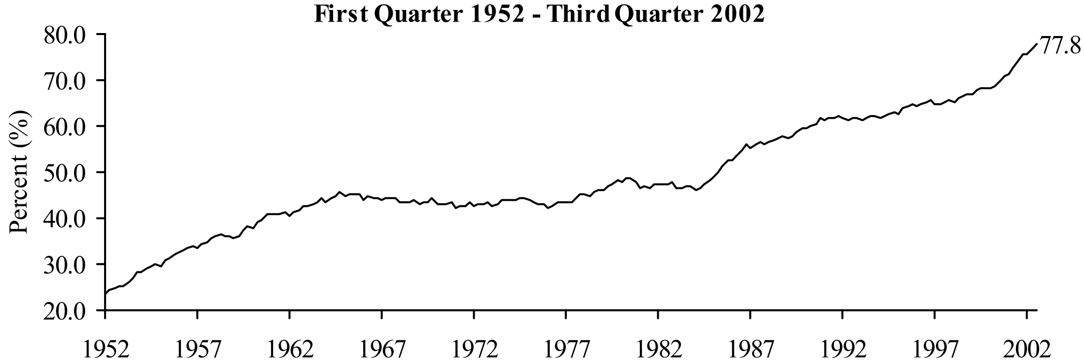
Table B

HOUSEHOLD SPENDING AND DEBT

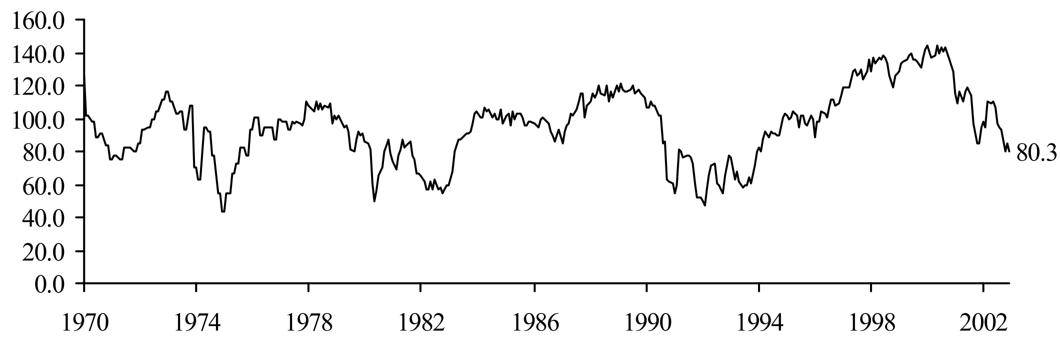
Personal Expenditures as a Percent of Disposable Income
First Quarter 1950 - Third Quarter 2002



Household Debt as a Percent of GDP
First Quarter 1952 - Third Quarter 2002



Consumer Confidence
January 31, 1970 - December 31, 2002

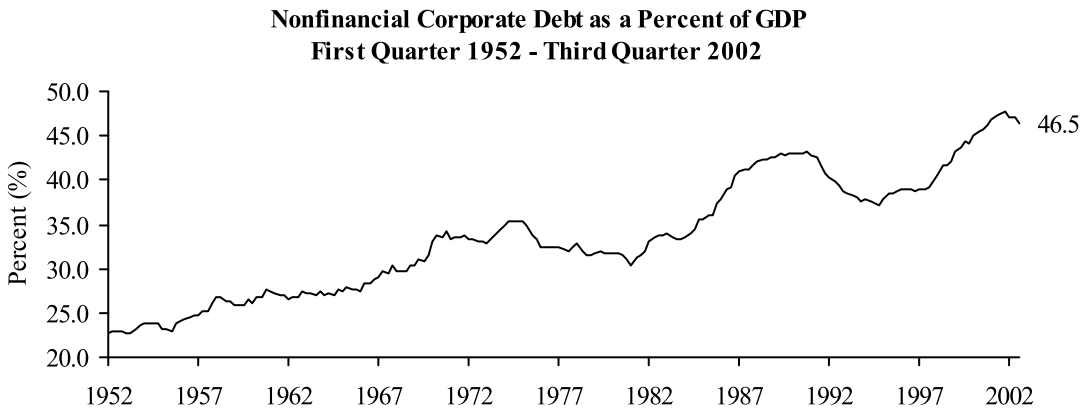


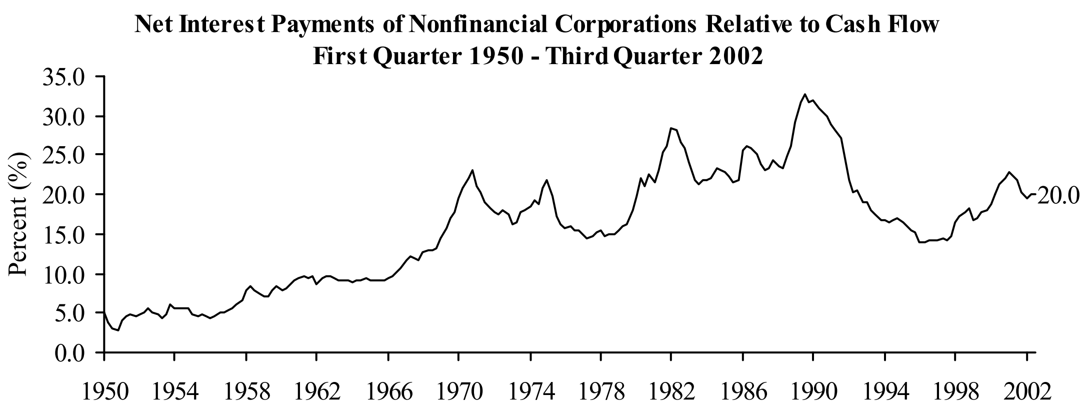
Source: Thomson Datastream.

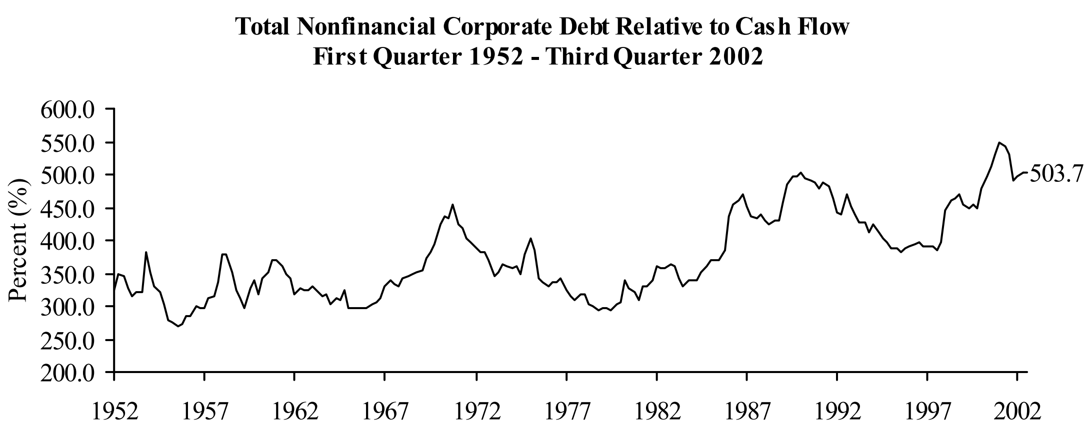
Notes: Graphs represent quarterly data. Consumer Confidence graph represents monthly data.

Table C

CORPORATE DEBT







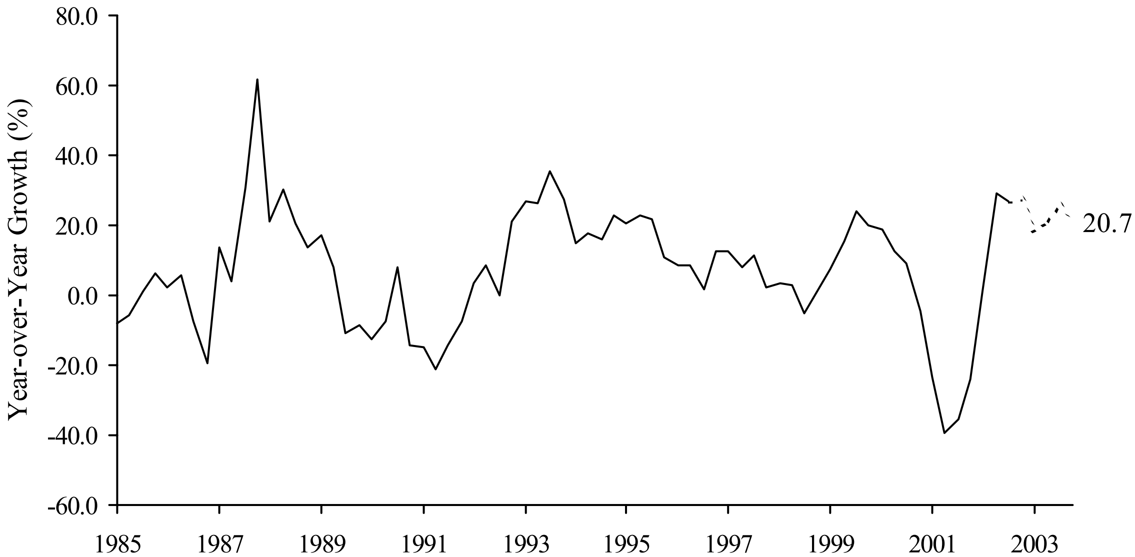
Source: Thomson Datastream.

Note: Graphs represent quarterly data.

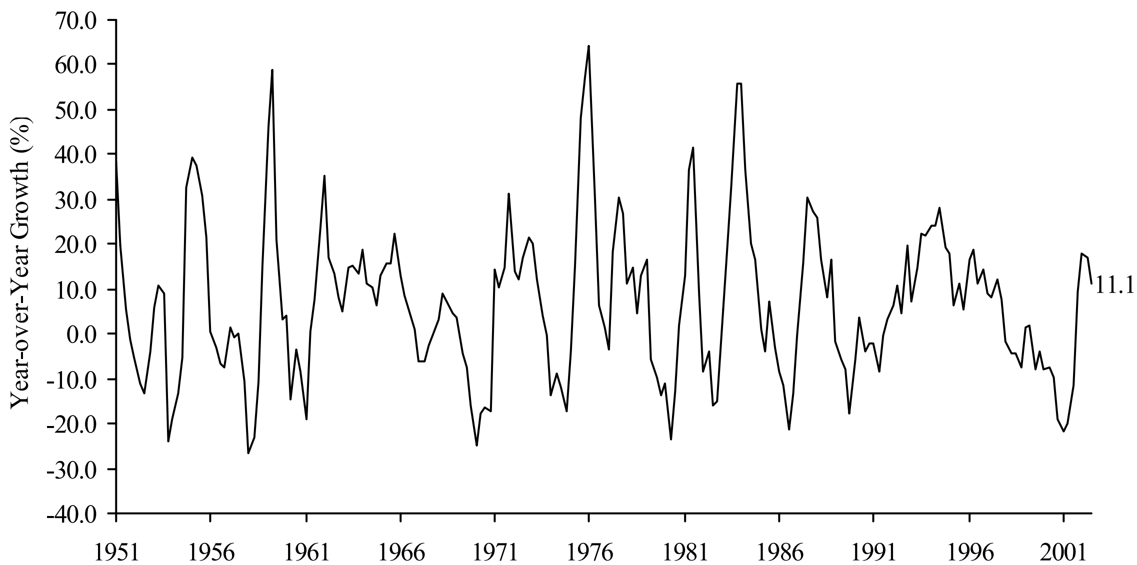
Table D

CORPORATE EARNINGS GROWTH

S&P 500 Operating Earnings Growth
First Quarter 1985 - Fourth Quarter 2003



NIPA Profits from Current Production
First Quarter 1951 - Third Quarter 2002



Sources: Ned Davis Research and Thomson Datastream.

Notes: Graphs represent quarterly data. S&P 500 Operating Earnings Growth data are consensus expectations for 2003.