Market Insights

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Double Dip for Europe and U.S. Is a Coin Toss

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Sharp declines in global equity markets and weaker-than-expected economic data have caused investors to worry that the world economy may relapse into another recession.

Executive Summary

Standish's Global Market Strategist Tom Higgins has revised downward global growth projections for the second half of 2011 and believes there is a 50% probability of recession in the U.S. and Europe. The Standard & Poor's (S&P) downgrade of the long-term U.S. government credit rating from AAA to AA+ with a negative outlook, he says, has threatened to further undermine consumer and business confidence. He says the piecemeal approach European policy makers have taken to addressing the sovereign debt problems in peripheral Europe now poses the greatest systemic risk to the global economy.

Probability of Recession Increasing

Sharp declines in global equity markets and weaker-than-expected economic data have caused investors to worry that the world economy may relapse into another recession. Over the past 22 stock market downturns since 1900, the average peak-to-trough decline of the Standard & Poor's 500® Index is -27%. In contrast, from its most recent peak on April 28, 2011 to August 8, 2011, the S&P 500 fell 17%. On a historical basis, this decline is not a clear recession signal. In fact, most forward-looking indicators are still pointing to slower growth rather than outright contraction. Additionally, more reliable leading indicators — such as average weekly hours, jobless claims, and new orders for durable goods — are not yet pointing to a recession.

Nevertheless, the sluggish pace of economic growth in the U.S. and Europe make both economies vulnerable to shocks that could easily tip them back into recession. According to revised data,[1] the recent U.S. recession was deeper and the recovery shallower than previously reported. Consequently, real GDP has yet to surpass its pre-recession peak. The economy also appears to have been much less resilient to the spike in oil prices associated with rising tensions in the Middle East and the supply disruptions from the Japanese earthquake/tsunami than it first appeared. According to our estimates, GDP growth averaged just 0.4% in the first half of the year. More recently, the S&P downgrade of the long-term U.S. government credit rating from AAA to AA+ with a negative outlook has threatened to further undermine consumer and business confidence.

1 U.S. Bureau of Economic Analysis and Standish estimates as of August 11, 2011.

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The situation is arguably worse in Europe. Unlike the U.S. downgrade, for France to lose its AAA rating could have broader implications for the eurozone, since France is a primary contributor to the European Financial Stabilization Fund (EFSF). The EFSF is the main bail-out facility for the peripheral European economies; therefore, any change in France's credit rating would have a direct impact on the rating of the EFSF as well. We believe European policy makers are not helping matters with their piecemeal approach to addressing the sovereign debt problems in the peripheral member countries (Portugal, Ireland, Italy, Greece and Spain). Therefore, we have revised down our projections for global growth to 3% from 4% in 2011 and believe there is a 50% probability of recession in the U.S. and Europe.

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Exhibit 1 — Global Growth Outlook

	% of World Output (12/31/10)	Standish 2011 GDP Forecast	IMF June 2011 GDP Forecast
US	19.7%	1.5	2.5
Euro Area	14.6%	1.0	2.0
Japan	5.8%	-1.0	-0.7
Other Advanced	12.2%	2.0	4.0
Emerging Markets	47.7%	5.0	6.6
World GDP	100.0%	3.0	4.4

Source: The International Monetary Fund and Standish as of August 2011

Not a Run of the Mill Recession?

Financial market turmoil complicates economic forecasting. We are aware that declining financial markets imply tighter financial conditions for businesses and that declining stock prices can have a negative wealth effect on consumers. However, in the current environment there seems to be an absence of the typical imbalances that trigger recessions. During the 2007-09 recession, the imbalance involved financial sector leverage and US subprime mortgages. In the 2001 recession, the imbalance was in corporate balance sheets and over-investment in technology. Today, by contrast, corporate balance sheets appear relatively healthy and much of the leverage has been wrung out of the financial and household sectors.

This has led to speculation that something more disruptive than a run of the mill recession may be afoot. Specifically, there is growing concern that the U.S. may be in a liquidity trap. A liquidity trap is defined as a situation in which monetary policy is no longer effective at stimulating aggregate demand in an economy. The most prominent example is the Japanese economy, in which twin asset bubbles burst in the equity and real estate markets back in 1989 and short-term interest rates have been at or close to zero since the mid-1990s. Over the past 15 years, Japanese nominal GDP has fallen roughly 7%, and the only reason real GDP has been positive is because the economy has experienced -1% average annual deflation.[2]

The one saving grace for the U.S. economy may be its flexibility. In Japan, by refusing to allow banks to write off bad debts and continuing to pump money into insolvent financial institutions to keep them lending, the the government refused to allow its economy to adjust after the 1989 bust.

The risk of a liquidity trap in the United States and Europe is heightened by unfavorable demographic trends that render generous entitlement programs unaffordable. In the U.S., there are 5 workers supporting each retiree today, but this dependency ratio is anticipated to drop to 2.9 workers by 2050. The situation is even worse in Europe where the dependency ratio is anticipated to fall from 3.3 workers per retiree today to 2.0 by 2050 and in Japan where it is projected to drop from 2.9 to 1.7 by 2050.[3] As the number of workers supporting each retiree declines, governments may have to step in to fill the void. This will put further pressure on the already-strained fiscal positions of these countries, forcing policymakers to make difficult decisions about cutting spending and raising taxes. Either way, demand is likely to suffer, thus increasing deflationary pressure.

The one saving grace for the U.S. economy may be its flexibility. In Japan, by refusing to allow banks to write off bad debts and continuing to pump money into insolvent financial institutions to keep them lending, the government refused to allow its economy to adjust after the 1989 bust. Recently in Europe, bank regulators have been reluctant to stress-test banks for a Greek default despite widespread recognition that such an event is inevitable. By contrast, following the subprime crisis in the U.S., not only did banks write down nearly $1.3 trillion in bad debt but the U.S. Treasury also injected capital into the nine largest financial institutions after running stress tests on their balance sheets to keep the financial system afloat. Unfortunately, these measures still may not prove enough to keep the U.S. from falling into the same trap.

2 International Monetary Fund.
3 Organization of Economic Cooperation and Development (OECD).

Policy Makers Running Out of Options

Last year when the U.S. economy hit a soft patch, the Federal Reserve responded with a second round of quantitative easing (QE2) by purchasing $600 billion in US Treasuries. The purchase program was judged successful in so far as it bolstered confidence and sparked a recovery in equity markets, which boosted growth through what the Fed called the "portfolio balance channel." In short, we were in line to avoid another recession.

However, a year later, the Fed's policy options are not looking nearly as attractive. At its August meeting, the Fed changed its forward guidance by acknowledging that the downside risks to growth had increased and that economic conditions were likely to warrant exceptionally low short-term interest rates through mid-2013. The Fed statement indicated that officials had discussed "the range of policy tools available to promote a stronger economic recovery" and "will continue to assess the economic outlook in light of incoming information and is prepared to employ those tools as appropriate."

We believe a move to reinvest the proceeds from maturing securities into longer-dated securities is unlikely to have much of an impact, with Treasury yields already trading at record lows.

These tools fall into three categories:

1. A change in the reinvestment policy on the Fed's $2.8 trillion portfolio to extend the duration of the portfolio.
2. Lowering the Interest on Excess Reserves (IOER) to 0% from 0.25% to encourage banks to lend out the reserves rather than park them at the Fed.
3. Another round of quantitative easing (QE3), which would expand the Fed's balance sheet and possibly change its composition.

None of these options offers a panacea. We believe a move to reinvest the proceeds from maturing securities into longer-dated securities is unlikely to have much of an impact, with Treasury yields already trading at record lows. We would also be surprised to see much increase in lending if the Fed lowered the IOER to 0%. We believe the reason banks aren't lending has little to do with the interest they are earning on reserves; rather, we believe banks aren't lending because there is little demand for credit from creditworthy borrowers. In terms of QE3, we believe most

Fed officials probably don't have the stomach for it at the current time given political opposition to the last round of QE and the fact that the program would have to be in the trillion dollar range to be effective. At best, any of these measures might provide a boost to confidence that could lift equity prices as they did last year. Yet, if the US economy is pushed into a recession by an outside shock, it is unlikely that a rally in risk assets would last.

Thus, we wait and hope that policy makers in both the US and Europe can avoid making another mistake, but our optimism is fading and that leaves our recession probability at a coin toss.

The most obvious source of an outside shock would be from Europe where leaders have failed to address the risk of a systemic banking crisis. Cross holdings of peripheral European debt in the banking industry have come down, but remain too high for the system to cope with a sovereign default without the re-capitalization of at least part of the financial sector. Although the European Central Bank (ECB) is providing short-term liquidity to banks and has stepped up purchases of Spanish and Italian debt to ease the pressure in the short term, investors recognize that this is not a long-term solution. The ECB also has a bit more room than the Fed to lower interest rates, but not by much.

Thus, we wait and hope that policy makers in both the US and Europe can avoid making another mistake, but our optimism is fading and that leaves our recession probability at a coin toss. As such, we have positioned portfolios more defensively (i.e., closer to benchmarks) until we have greater clarity on the macro outlook and the potential policy responses.

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Tom is the Global Macro Strategist for Standish. He is responsible for developing views on the global economy and making relative value recommendations among global bond markets, currencies, and sectors. Before joining Standish in 2010, Tom was employed as the Chief Economist for Payden & Rygel Investment Management in Los Angeles and served as International Economist at The Conference Board. Tom received his Ph.D. and M.A. degrees in Economics from Fordham University and holds a B.A. in Economics from Drew University. Tom has eighteen years of experience analyzing financial markets. He is a member of both the American Economics Association and the National Association of Business Economics (NABE). Tom was President of the Los Angeles Chapter of the NABE from 2006-2007. He is a past board member of the Los Angeles Economic Development Corporation and the California Council on Economic Education. Tom was the 2010 Recipient of the Robert T. Parry Award for Exemplary Contributions in the Field of Economics.

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