

Weekly Economic Commentary



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Double Dip?

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Highlights

- Policy will likely be back on the front burner this week.
- What policy actions might the Fed employ to boost the economy?
- What indicators are we watching to monitor the risk of a double-dip recession?

Economic Calendar

Monday, August 8 Small Business Optimism <i>Jul</i>	Thursday, August 11 Initial Claims <i>wk 08/06</i>
Tuesday, August 9 Productivity <i>Q2</i>	Trade Balance <i>Jun</i>
FOMC Meeting	Friday, August 12 Retail Sales <i>Jul</i>
Wednesday, August 10 MBA Mortgage Application Index <i>wk 08/05</i>	U of Mich Consumer Sentiment <i>Aug</i>
Wholesale Inventories <i>Jun</i>	Business Inventories <i>Jun</i>
Budget Deficit <i>Jul</i>	

After last week's dramatic market plunge and the downgrade of United States debt to AA+ from AAA by Standard and Poor's, policymakers at home and abroad will be on the spot this week, as the economic data fades in importance, at least in the United States. The data that is due out in the United States this week—weekly readings on initial claims for unemployment insurance, consumer confidence, weekly retail sales for early August, retail sales and small business optimism for July, and merchandise trade and business inventories for June—will be pored over by market participants looking for signs of a double-dip recession.

Overseas, there is a ton of data due out in Japan this week, which will help markets assess whether or not the pace of recovery from the earthquake accelerated in June and July, and there is a full slate of July economic data due out in China this week. Fears that the Chinese economy is, at the same time, generating too much inflation and slowing down too much has raised concerns about a "hard landing" in China. Our view is that China will be able to achieve a soft landing and that the People's Bank of China (PBOC) is much closer to the end of its tightening process, aimed at keeping domestic inflation in check, than it is to the beginning.

European policymakers have some work to do in order to help calm markets, and reassure investors that so-called "core" Europe (Germany, France and Italy) is insulated from the fiscal and banking woes of peripheral Europe (Greece, Portugal, Ireland, etc.). This problem was many years in the making, and as of this writing, there does not appear to be a silver bullet to solve all of Europe's problems at once. Still, markets would welcome a stepped up pace of policy actions in Europe in the coming weeks, which are typically very quiet summer weeks, with most of core Europe out on holiday. Indeed, over the weekend of August 6–7, the European Central bank announced plans to purchase the sovereign debt of Spain and Italy to try to prevent the spread of the fiscal woes of peripheral Europe into "core" Europe.

The Course for Fed Policy

Of course, the real action this week will be at the Federal Reserve (Fed), which holds its Federal Open Market Committee (FOMC) meeting on August 9. Our view on the Fed is that while the hurdle for the Fed to stimulate the economy by buying more Treasury securities in the open market (A.K.A. QE3) remains quite high, the odds of QE3 have increased in the past few weeks.



At the moment, in our view, Fed policymakers probably do not have enough evidence that the economy warrants another dose of quantitative easing, although they are probably in a position to provide “liquidity” to the financial markets should interbank lending freeze up like it did throughout 2007 and 2008.

The Fed makes decisions on monetary policy against the backdrop of its dual mandate granted to the Fed by Congress in 1977: low and stable inflation and full employment. In his now-famous August 2010 speech in Jackson Hole, WY, Fed Chairman Ben Bernanke cited both a weak economy and the threat of deflation as reasons why the Fed may purchase more Treasury securities in the open market (it began those purchases in November 2010). At the time of the Jackson Hole speech, the private sector economy had only been creating jobs for six months—at an average of around 100,000 per month—after shedding nearly 9 million jobs between 2007 and early 2009. Today, the private sector economy has added jobs in 17 consecutive months, and over the past six months, the economy has created an average of nearly 200,000 jobs per month.

On the inflation front, in August 2010, the Fed’s preferred measure of inflation, the core personal consumption deflator, was running at just 1.0% year-over-year, well below the Fed’s comfort zone of 1.5 to 2.5%. In addition, the Fed saw further downside risk to inflation, and indeed, by October 2010, core inflation had dipped to just 0.8% year-over-year, perilously close to deflation. Deflation is defined as falling wages and prices.

Today, thanks in part to the cumulative effects of QE1 and QE2 (which ended in June 2011), core inflation is running at 1.3% year-over-year, and accelerating. Thus, on both measures (the economy and core inflation) the conditions are not as dire as they were in the summer of 2010 when the Fed embarked on QE2.

With so much internal (voting members of the FOMC who have publicly stated that they would not support more quantitative easing) and external (the Fed’s bosses in Congress are in no mood to do anymore stimulus of any kind) pressure lining up against another round of Treasury purchases by the Fed, policymakers appear to be boxed in.

However, the Fed can still impact the economy and markets in several ways, even without purchasing additional Treasury securities. In recent weeks, Fed officials, including Fed Chairman Ben Bernanke, have detailed other ways the Fed could act. These potential actions include, but are not limited to:

- Announcing (perhaps in the statement following this week’s FOMC meeting) how long it intends to keep rates low and when it would begin reducing the size of its balance sheet. This would help to create more certainty in the economy and the markets about financing rates. Other countries, most notably Canada, have used this approach in the past.
- Changing the mix of the Treasury securities it already holds. For example, the Fed could sell some of its shorter maturity Treasury holdings and buy longer maturity Treasuries in the open market. This would push interest rates down on loans used by consumers and businesses looking to borrow and spend, thus boosting growth prospects. The Fed and Treasury did this in the early 1950s.

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- The Fed could also lower the rate it pays financial institutions on excess reserves (over and above what they are required to hold against their loan portfolios) held at the Fed. This would probably not have much of an impact, especially since the rate the Fed pays on these reserves is just 0.25%.
- Finally, the Fed could of course buy more Treasuries in the open market, but do so against the wishes of both its bosses in Congress and several of the voting members of the FOMC. We view this outcome as unlikely, although odds are rising.

How Likely is a “Double Dip”?

There has been increased talk recently about the possibility of a “double-dip” recession occurring in the United States. Our view is that while the odds of a double-dip recession have increased in recent weeks, mainly as a result of the big drop in equity prices, very sluggish consumer and investor confidence and slight deterioration of financial market conditions, a return to modest, trend-like economic growth over the second half of 2011 and into 2012 is more likely.

A “double-dip” recession would mean that the U.S. economy, which has been in a recovery since the summer of 2009, would slide back into another recession at some point in the near future. In our view, while the odds of a double dip have increased in the past few months, we do not think a “double dip” is likely to occur given the current economic and policy backdrop. However, a sudden surge in consumer energy prices, a collapse of a major European bank and a resulting freeze up of global credit markets, a sharp increase in global central bank policy rates, a collapse in overseas economic growth, a rapid reduction in the budget deficit for this year or next year in the United States and/or a dramatic flattening of the yield curve would cause us to change our view.

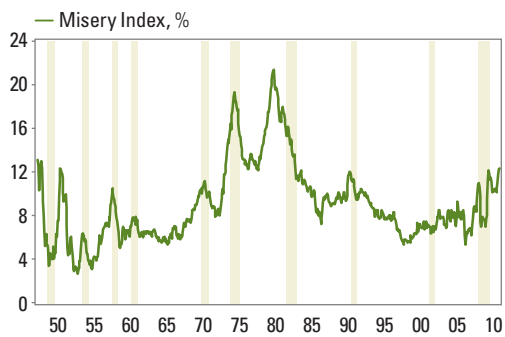
For background, over the past 80 years, the economy has endured two “double-dip” recessions, in 1937–38 and again in 1981–82. In this section, we will look at each of the prior “double dips”, and then compare those periods with the current period. The 1937–38 recession was quite severe, and is often lumped in with the “Great Depression” of the 1930s. The National Bureau of Economic Research (NBER), the apolitical, nonpartisan, academic think tank that assigns dates to recessions and expansions, tells us that the Great Depression ended in early 1933 and a recovery that lasted four years, until mid-1937, ensued. At that point, the Federal Reserve began to tighten policy, the U.S. government raised taxes and cut government spending in order to balance the budget, and the economy hit a wall, plunging into a severe downturn that lasted for 15 months.

Jumping ahead 40 years, there was a sharp, Federal Reserve induced recession in the first half of 1980. The causes of the first leg of the early 1980s double-dip recession are fairly clear:

- The Fed raised rates sharply in late 1979/early 1980 to combat 13% inflation.

In our view, while the odds of a double dip have increased in the past few months, we do not think a “double dip” is likely to occur given the current economic and policy backdrop.

1 While Elevated Relative to Recent History, the “Misery Index” Now Stands at About Half of its Early 1981 Level



Source: Bureau of Labor Statistics /Haver Analytics 08/05/11

(Shaded areas indicate recession)



- President Jimmy Carter went on television in early 1980 and urged people to not use their credit cards.
- Oil prices were surging, in part due to the Iranian hostage crisis, which began in November 1979.

As a result, consumer spending, business investment and housing activity collapsed. The Fed lowered interest rates in early 1980 to end the recession, but inflation, even inflation excluding food and energy, was still high and market interest rates started going up again. In addition, the wage price spiral was still intact, oil and other commodity prices continued to move higher, and the economic recovery in late 1980/early 1981 was shaky at best. The U.S. economy entered another severe recession in July 1981 which lasted until November 1982.

We recently completed an analysis that looked at the behavior of dozens of economic indicators today and in late 1980 and early 1981. Unfortunately, there is not enough readily available data for the 1936–37 period to make a similar comparison. Of the dozens of metrics we looked at (comparing late 1980/early 1981 to today) we found that only a handful are “worse today” (i.e. pointing to “double dip”) than they were in mid-1981, when the second leg of the double dip began.

Those indicators that are worse today than in mid-1981 include:

- Credit spreads today are wider than they were in mid-1981, just prior to the onset of the second half of the double-dip
- Private sector employment gains since end of prior recession
- Consumer sentiment and consumer expectations (although the evidence is mixed here)
- Real Money Supply Growth (evidence is mixed here as well)

Looking at the data, it is clear the 1980–81 period should have been called one big recession. The already fragile economy coming out of the sharp 1980 recession just buckled under the weight of high inflation, a tightening Fed, the lagged effect of soaring oil prices and very weak trading partners, a soaring dollar, and extremely high nominal interest rates that dissuaded investment.

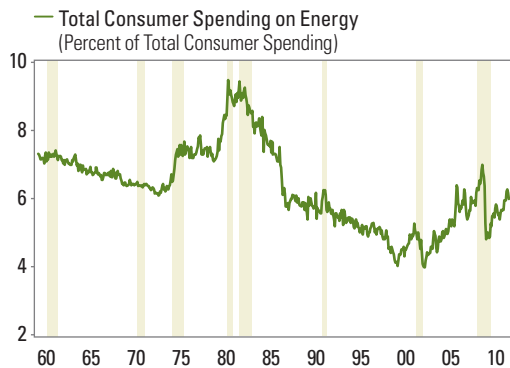
We have none of these things now; In fact, the recovery since June 2009 has been much more robust than the recovery in late 1980 through early 1981:

- Oil prices had risen by 40% and 30% over the prior three and four years in mid-1981.
- Both headline and core (excluding food and energy) inflation was over 10%, prompting the Fed to raise rates.
- Business capital spending was tepid, at best, in late 1980 and early 1981, weighed down by exorbitant financing costs.
- The US dollar surged (crimping exports) while our major foreign trading partners saw modest economic growth at best.

In fact, the recovery since June 2009 has been much more robust than the recovery in late 1980 through early 1981.



2 Consumer Spending on Energy Goods and Services is Below 2008 Peak, and Nearly One-Third Lower Than the Double-Dip Inducing Levels in 1980-81



Source: Haver Analytics 08/05/11

(Shaded areas indicate recession)

- Equity prices, as measured by the S&P 500, were only up modestly in mid-1981 versus the end of the recession in 1980.
- The absolute level of the 10-year Treasury note, mortgage rates, and the 3-month T-bill were absurdly high in 1981, crushing investment and consumption.
- The so-called “Misery Index” (the inflation rate plus the unemployment rate) was in the 20s. It is closer to 10 today. [Chart 1]
- In addition, the ISM (and its key leading components) in the 1980-81 period barely got over 50, let alone to well above 60 as they have been now.
- The slope of the yield curve, the difference between the 10-year Treasury note and the fed funds rate, was negative, often a harbinger of recession.

Looking at the data today, it is hard to make a case for double-dip, but the data does point to a modest pace of growth in the second half of 2011, although growth should be stronger in the third quarter than in the fourth quarter:

- Today, the ISM and its key components have been above 50—indicating an expanding manufacturing sector—for 24 consecutive months most or all of the past 12 months, and many have spent significant time above 60.
- The Fed today is at worst, on hold, (not raising rates as they were in late 1980 and early 1981) and even today we are still feeling the effects of the Fed’s quantitative easing program and prior rate cuts. More “growth-friendly” steps toward easing are likely from the Fed in the weeks and months ahead.
- Over the past three and four years, the price of oil and gasoline are little changed (up about 7 to 10%), while in late 1980 and early 1981 they were soaring, crimping the consumer.
- Today the 10-year/fed funds rate yield curve is hugely positive; in 1980–81 it was negative and inverted most of the time, signaling a recession.
- Our exports are booming today, and although our trading partners are slowing, economic growth in our trading partners today (even post-Europe debt crisis) is more than triple the level in 1981. 50% of our exports head to emerging markets where growth estimates are being revised up and economies are expected to grow more than three times faster than the U.S. economy.
- The dollar is down five to ten percent versus a year ago, while in mid-1981, the dollar was up 15% year-over-year versus mid-1980, hurting exports. A weaker dollar helps to boost our exports.
- Today, business capital spending (led by low absolute interest rates, and low corporate financing costs, plenty of cash on corporate balance sheets, soaring profits and cash flows and a 20% year-over-year gain in equity prices) is a much more robust backdrop for corporate spending than was the case in late 1980/early 1981. The recent sell off in the equity market is a new threat here.
- On housing, the inventory of unsold homes is much lower today than it was in 1980–81, housing affordability is triple what it was in 1981,



and mortgage rates are at all-time lows now. In late 1980/early 1981, mortgage rates were at all-time highs.

- As noted above, one of the few metrics that is “worse” now than in late 1980/early 1981 is private sector job creation. But when you adjust for outsourcing (there is a ton of outsourcing now and there was none in 1981) and productivity (negative to +1.0% in 1980–81), soaring today, job growth is currently on a par with that in early 1981.

In addition, fiscal policy in the United States, while tightening a bit relative to where it was in 2009, is still very loose by historical standards, and a balanced budget is years away, if not decades away. Still, this past weekend’s downgrade of U.S. debt to AA+ from AAA raises the odds that fiscal policy at the federal level will become even more restrictive in the coming years, which, in turn, lowers the potential growth profile for the U.S. economy even further.

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