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A Special Report

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They Say We're Out of Recession, But...

Two weeks ago, the U.S. Commerce Department's Bureau of Economic Analysis (BEA) announced that the U.S. economy, as measured by its Gross Domestic Product (GDP), expanded (*grew*) at an annualized rate of 3.5% over the prior calendar quarter. This was a reversal of the previous four quarters' GDP declines, and headlines in the financial press heralded the "end of the economic recession" plaguing the countryside since December 2007.

I'm not convinced we're there, just yet....

Determining the point in time at which an "average" developed economy shifts from an expansionary phase to a contraction, or vice versa, would be a daunting task at best. Measuring the changes in collective output of a society as large and broad-based as the United States' requires the compilation and analysis of thousands of data points, and presents a much greater statistical challenge. Its components are myriad in scope, and include Personal Consumption Expenditures, Private Inventory Investment, Federal Government Spending, Imports, Exports, and many more.

While the BEA is charged with collecting the data, and producing the government's official calculations as regards component and collective economic output, the "official arbiter" of whether or not the country's experiencing *economic recession* isn't a government entity at all. That particular chore falls to The National Bureau of Economic Research (NBER), a Cambridge, Massachusetts – based "economic think tank", consisting of economists, researchers, academicians and Nobel Prize-types who study all kinds of economic data, and routinely issue "white papers" on subjects few outside the profession will ever read. These people corporately decide *when* a recession "officially" begins, *when* it subsequently ends, and often make these declarations six to twelve months *after* the fact. Most recently, their *Business Cycle Dating Committee* determined in late November 2008 that the economy had peaked *eleven months prior* in December 2007, and pronounced that we've been in a recession since.

So it shouldn't be too much of a surprise to anyone that, unlike the financial media, and a number of high profile market prognosticators, the NBER has yet to "officially" declare the recession's end. Even if it is over, don't hold your breath waiting for them to declare it so. They obviously like to be really, really sure before making such pronouncements....

Admittedly, I am a relatively unlearned observer of the dismal science, with but a few economics courses in college to my formal training, but with all due respect to the work the NEBR does, and to their authority on the subject, I have some real concerns about what I see in the economy. From my perspective, it certainly appears we have some work to do before we can say the worst is over, let alone declare the recession's end.

Here are just a few of the data points I'm sure are causing concern in the office corridors of the NEBR today:

Unemployment

Admittedly a lagging economic indicator, unemployment in this country has now reached levels unseen in over twenty-five years, and, it expected to *rise* from here. According to the U.S. Department of Labor's Bureau of Labor Statistics (BLS), 15.7 million Americans were *officially unemployed* at the end of October, bringing that measurement to 10.2% of the country's civilian workforce. Since the recession's start two years ago, 8.2 million *additional* workers have lost their jobs, more than doubling both the number of unemployed persons in the country in the past two years, and the percentage of the workforce that's officially counted as "unemployed". (It was 4.9% as recently as 12/31/07).

Idle workers present a terrible drag on economic production, not to mention the cost of providing unemployment benefits to them. But as concerning as those "headline" unemployment numbers are, and as dramatic the increase seen in less than two years, the *official* unemployment rate actually understates the problem the economy faces.

If you read the BLS' release more closely, you see that *within* those 15.7 million unemployed persons are 5.5 million "Long-Term Unemployed" workers, a category indicating they've been jobless for longer than 27 weeks. Think about that. One in three unemployed Americans has been looking for work for more than six months! In addition to the 15.7 officially unemployed, *another* 9.3 million Americans are "Involuntary Part-Time Workers", folks who are *not* counted among the unemployed, because they are working part-time (for economic reasons) and are not collecting unemployment benefits. They are sometimes referred to as "underemployed" workers. They'd work full time if they could find it, but part-time jobs, not known for their high wages, are all they can find at this time.

Finally, another 2.4 million Americans are classified as "Discouraged Workers". They are *also not counted* in official statistics, typically because they have exhausted their unemployed benefits, but they are still not working, full, or part-time. While they have actively looked for work in the past twelve months, and describe themselves as "available for work today", they've simply given up looking for now.

Add it all up, and 27.4 million Americans, an amazing 17.8% of the 153.9 million available workers in this country, are either completely out of work, or are "underemployed". Presumably all of them make far less than they need, or would like to make in wages.

Economists can tell me that production has stopped declining. Some can even tell me that certain measures of economic health are improving, but when one in six workers in America isn't working, or isn't working to their fullest capability, we are *not* yet out of recession.

Housing Defaults

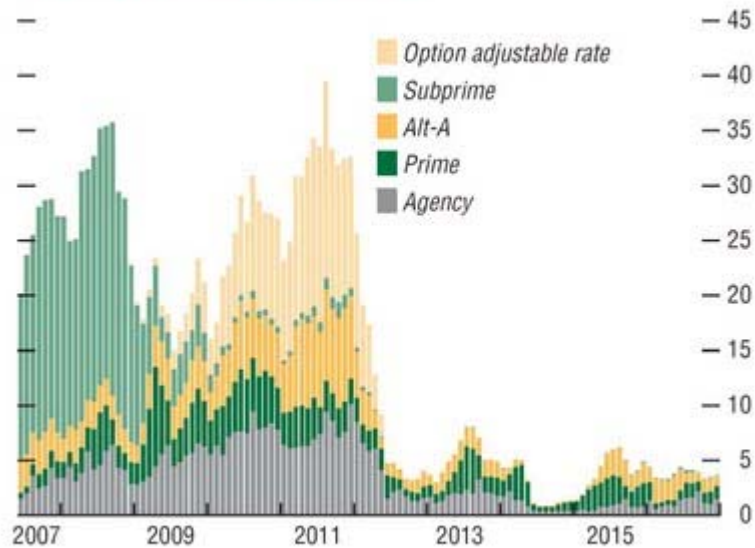
Many believe that the bursting of the housing “bubble” is the root cause of the current economic crisis, and if that’s true, there is no reason to believe this recession won’t persist for some time. Before the massive deflation in housing values savagely destroyed many of the balance sheets of banks and mortgage lenders that found themselves overexposed to these “toxic” assets, the bubble fueled the greatest expansion of personal debt this country had ever seen, by providing the average American with easy (and cheap) access to their home’s “equity”. Many Americans used this borrowed equity to artificially expand their lifestyle, spending it as if it were another source of regular (and dependable) income. The economy during this period was artificially, and, as it turns out, *temporarily* inflated in size with the spending and consumption these inflows provided. The bubble itself was caused by artificially low interest rates, and it spread to all levels of society’s socio-economic structure through lax mortgage underwriting standards. As we can see clearly through the lens of history today, millions of first-time home buyers and even greater numbers of more “mature” homeowners looking to “upgrade” their homes took advantage of these “low-doc” or “no-doc” loans to buy more home than they would otherwise qualify for. In many of those cases, they took advantage of “adjustable-rate” loans, mortgages with lower initial interest rates that would “re-set” at a later point, typically three to five years into its term.

The “Sub-Prime” component of these loans adjustable-rate loans were particularly problematic, since many, if not most of these borrowers bought their homes believing they would *always* appreciate. Further, they assumed that the seemingly never ending supply of these low-cost, easily-underwritten loans would allow them the ability to comfortably refinance when the re-set point arrived, hopefully with a lot more equity (appreciation) imbedded in the home.

A huge percentage of these Sub-Prime borrowers have already defaulted, and had their homes foreclosed upon. Some 2.3 million American homeowners were foreclosed upon in 2008, and we are on track for an additional 3.4 million home foreclosures in 2009. But as the chart below details, there are many, many more mortgage re-sets coming over the next few years. Another concern is that currently-available fixed mortgage rates are at cyclical lows, so homeowners with sufficient equity in their homes to be able to refinance, *have likely done so already*.

Many of those homeowners who remain in these adjustable-rate mortgages awaiting their “re-set point” may have better credit ratings than their “Sub-Prime” counterparts, but most of them purchased (or re-financed) their homes in the years just *prior* to the decline in housing values. Most are “underwater” in terms of having any home equity, and at current valuation levels, they are simply unable to refinance to longer-term, more affordable fixed-rate loans that require equity participation. Those who have the ability to continue paying timely on mortgages greater in size than their homes’ market values will be further challenged by even higher rates (and payments) as their mortgage re-set points arrive.

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

According to RealtyTrac, the real estate data company, a new foreclosure record will be set in 2010, with only marginal improvement likely in 2011. Before this wave of re-set driven foreclosures is over, we'll likely see 13 million American families displaced from their homes.

Another consequence of millions of Americans being “upside down” (*negative* equity) in their homes today, is that in that condition, we're seeing evidence that they are far less likely today to continue to make mortgage payments. In fact, there have been estimates that as many as a quarter of the homes in foreclosure today are “voluntarily” so, wherein the homeowner could actually afford to make the payments, but decides not to, since their mortgages are so far greater in value than their homes are currently worth, and for the most part, these loans are non-recourse in nature. These people perceive their loss to be permanent, or at least persistent for the foreseeable future, and are choosing to “walk away” from a bad investment.

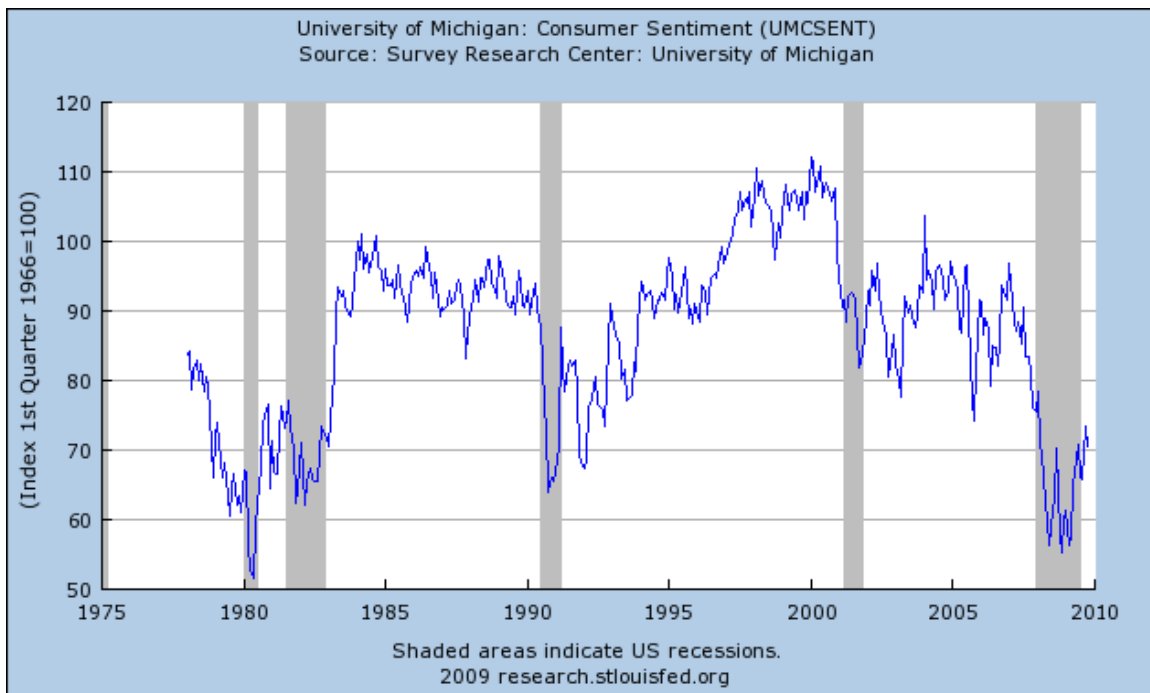
With the wave of mortgage re-sets coming, this “negative equity” problem will persist for at least a couple of years to come, and the impact of these losses on the consumer (and their spending) cannot be understated. Just as the rising stock market (pre-2008) and seemingly ever-expanding housing values exerted a positive, although temporary, “wealth effect” on the American consumer during the boom times, the loss of so much housing equity (and in some cases, their homes) will have a chilling effect on consumers' spending for years to come.

Consumer Sentiment

Consumer sentiment is another “lagging” economic indicator, and while there has been some improvement in this measure this year, it is improvement from a very, very low reading.

The University of Michigan has been measuring Consumers' sentiment through surveys since 1946. Its closely followed *Consumer Sentiment Index* is conducted through 50-question surveys of 5,000 representative families, monthly collected and analyzed. As its name implies, it measures their sense of economic conditions as *they* perceive them, effectively gauging how they "feel" about the economy today, its prospects for tomorrow, and their place within it.

November's release, a Sentiment Index reading of 66.0, was the third consecutive monthly decline in the Index' reading, a reversal of the uptrend seen earlier this year. This uptrend followed a cyclical "low" reading of 55.3 on November 1st 2008, its lowest reading in twenty-eight years. (By point of reference, the Index hit its all-time high reading of 112.0 at the start of the decade, January 1, 2000.)



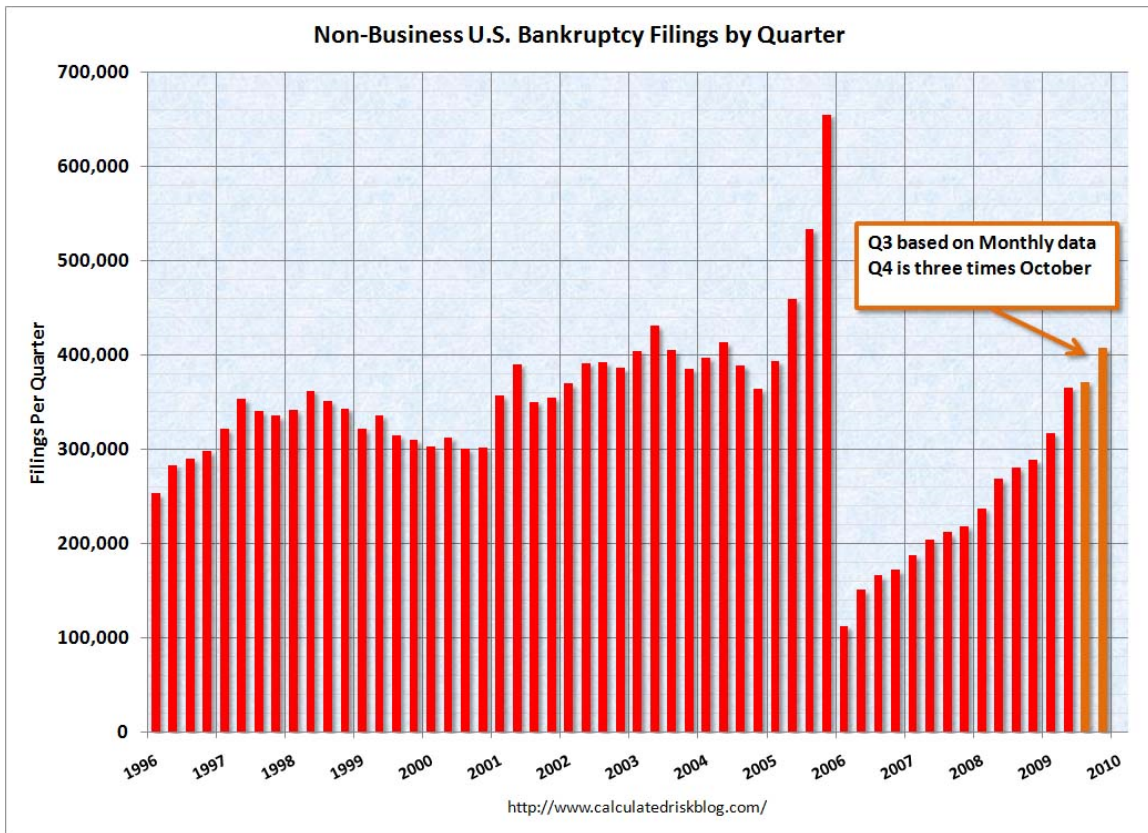
Consumers are clearly scared in the current economic climate, and understandably so. Further, I suspect that if baby boomers could be separated out from the Index' composite reading, the number would be even *lower*. These higher-earning, closer-to-retirement consumers were the drivers of economic expansion in halcyon days, but they are re-evaluating their spending and lifestyle "needs" today in the cold light of dramatically reduced investment account statements. Retirement plans, once a near-term planning horizon event for many baby-boomers, are being delayed.

Consumer "De-Leveraging", Delinquencies, and Bankruptcies

Given their concerns for the economy in general, it should come as no surprise that the consumer has moved to reduce their non-mortgage debt burden at as rapid a pace as seen in decades. According to the Federal Reserve, consumers had \$2.578 trillion in (non-mortgage) debt at the end of September, 2008 (\$975 billion of it in "revolving" debt, and an additional

\$1.603 trillion in non-revolving debt). The Fed's most recent statistical release (September 2009 data, released November 6th) reveals that those numbers have fallen by \$123 billion, to \$2.455 trillion in total debt a year later. Financially healthier consumers are paying down debt where possible, as opposed to fueling an economic recovery with continued spending.

Those who can't pay their debt down are increasingly delinquent in their payments. Five of the six largest credit card issuers reported increases in their delinquency and default experiences in the third quarter, continuing an alarming trend seen the past three years. While some banks are aggressively writing down these debt portfolios (Bank of America wrote down 14.25% of their delinquent cardholders' debts in September), there is widespread concern that many of these issuers are playing the "extend and pretend" game, unwilling to acknowledge the degree to which these "assets" on their balance sheets will deteriorate, as more and more Americans seek relief through debt consolidation services and in the bankruptcy courts.



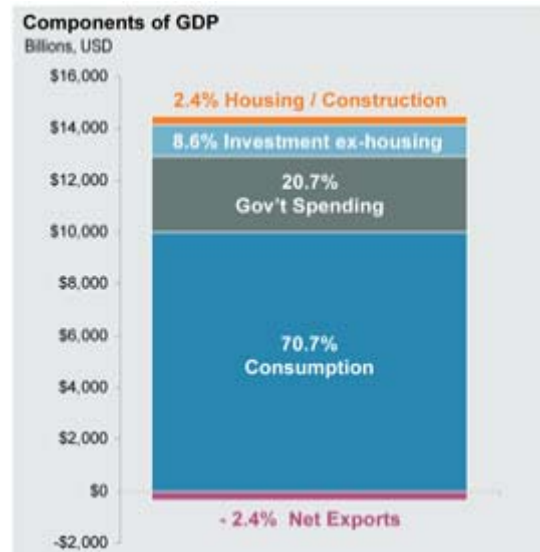
As this chart reveals, non-business bankruptcy filings spiked in 2005, as newer, tougher bankruptcy laws took effect the following year, forcing many to preemptively file, but bankruptcy filings have more than doubled since 2006, and the trend continues to rise dramatically.

Without the Consumer.....

While I've no doubt depressed many readers of this Report with data on increasing unemployment, decreasing home equity, weakened consumer sentiment and their deteriorating balance sheets, if you've read to this point, you should be asking yourself the question:

How does the economy improve in this environment?

That's the proverbial "\$64,000 Question". Few serious economic prognosticators are holding out hope for the normal "V-Shaped" economic recovery any longer, with most divided between a "U-Shaped", a "W-Shaped", or an "L-Shaped" recovery, all of which imply continued weakness for some time to come. The average length of an economic recession since the beginning of the 20th century has been fifteen months. This one is approaching its "official" two-year anniversary in December, and I might suggest that given the condition of the consumer, real economic growth cannot begin to occur until the consumer is more confident, and has a far better balance sheet. Consumption is, by far, the biggest component of GDP, accounting for over 70% of our nation's GDP "output", and consumption, like the economy in my opinion, is not in an "expansionary phase" at this writing.



Source: JP Morgan Asset Management & BEA

There are many *other* components of the economy to be concerned about, the excess "slack" in our Industrial Capacity Utilization, the coming *commercial* real estate defaults, and the ongoing reluctance of banks to lend, to name just a few. But in my opinion, the 800 pound gorilla in the room is, and will continue to be for a time, the severely weakened consumer. It seems to me that much of the tangential data showing upticks in auto sales and home sales can be attributed to the government's attempts to prop up the economy with massive spending (and tax-credit) initiatives. The consumer simply hasn't gotten healthier, and until or unless he or she does, any talk of an end to recession is just that, talk.

What does that mean to investors?

Obviously, the equity, debt, and real estate markets are a reflection of the health of the underlying manufacturing and service concerns whose stocks and bonds trade daily. When the economy is expanding, earnings will typically follow. Corporate management in this country (and around the world) have been nothing short of spectacular in their reactions to, and management through this economic slowdown, proactively and *aggressively* cutting expenses, allowing for improvement in their bottom line earnings reports of late. But the 66% move up from the cyclical intraday S&P 500 Index lows (666 on March 9th, 2009) strongly suggests that what we've just seen may indeed turn out to be too much, too quickly.

It would not shock me to see some type of market correction in the coming weeks or months. In fact, I think of declines in the equity markets from current levels as being close to inevitable. While I openly admit *I have no idea* as to whether these expectations will be realized this year or next, and I certainly personally and professionally pray that any market decline we might experience would be brief in duration, and mild in its magnitude, I cannot recall having seen a rally of this magnitude, occurring over such a short period (just eight months), without some type of pull-back following.

To my "non-economist's eye", the key economic driver of a "V-Shaped" economic recovery, namely, the consumer, is seemingly nowhere to be found today, and since I don't know exactly when the next market decline will occur, it is critical for our money managers to have a portfolio "defense" in place, a "sell discipline" that will actively reduce our clients' portfolio exposures to such events.

All of our "Core" money managers have participated in the market's rise this year, and for that we (and our clients) are grateful. It's been a very good "return" year thus far, but more importantly, these managers demonstrated their abilities to avoid (or reduce their exposure to) market declines in *last year's declining markets*. We sleep better in these difficult economic times knowing they are actively applying these same defenses to our portfolios.

In closing, let me suggest that if you know someone whose portfolio isn't as well protected, or as broadly and actively diversified as our clients' are, please pass this Report on to them. We welcome introductions to qualified investors who seek professional management.

As always, please do not hesitate to contact me or my staff, should you have any questions about this Report.

- JRP

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