



Quarterly Economic Review and Outlook

Second Quarter 2010

Summary and Major Conclusions

- Real GDP expanded at an estimated 3% annual rate in Q2, while cumulative growth of 3.3% over the past year was well below that of a normal recovery. One-half of GDP growth was attributable to inventory restocking versus growth in final demand, which remains weak.
- The two central themes in the outlook remain intact: (1) The economic recovery will be subpar by historic standards; (2) Beyond the recovery phase, profound structural imbalances will constrain the rate of economic growth for a prolonged period. Fears of a double-dip recession will become more widespread in future months, but relapse into recession in 2011 is not likely.
- The principal risk to the economic outlook is renewed deterioration in financial and banking conditions, triggered by contagion from the sovereign debt crisis in Europe. Policymakers have announced an aggressive rescue package along with long-term fiscal reform that should help to calm markets, but European financial conditions will remain a source of instability.
- In addition to the eurozone crisis, other major risks to the outlook include a renewed decline in U.S. house prices; a policy-induced hard landing of China's economy; acceleration of household sector deleveraging along with a sudden rise in savings; renewed caution among businesses in hiring and investment plans; and deterioration of financial market conditions.
- Following a sharp slowdown to only 1% in upcoming quarters, real GDP growth should stabilize at a below-average pace of 2.5% over the next several years. Job creation remains positive but will fall far short of the pace needed to reduce the unemployment rate. Inflation will likely continue to decelerate over the next year and is expected to stabilize around 1% during 2011.
- In an environment of very low inflation, high unemployment, and ongoing financial stress, the Federal Reserve will maintain a policy of monetary ease through much of 2011. Market interest rates are likely to fluctuate within a trading range at historically depressed levels for the next 6-12 months before drifting higher later next year and during 2012.
- Fixed-income markets are extremely unattractive at current depressed market yields, with annual returns on government securities unlikely to exceed zero over a several year time horizon. Although attractive relative to the government sector, corporate bonds are likely to provide long-term investors with minimal positive rates of return.
- Common stocks are vulnerable to a further setback in the short term, the result of growing investor concerns over a possible double-dip recession, but returns should exceed those of bonds by a wide margin over the next several years. However, until there is greater clarity regarding the economic outlook, the equity market is likely to remain in an extended consolidation phase, accompanied by heightened volatility.
- Following a decade of underperformance, large-capitalization stocks are attractive relative to the small-cap sector on the basis of both earnings growth and valuations, and in the context of a treacherous economic environment that lies ahead. Annual returns on the highest quality large-cap growth stocks could exceed 10% over a 5-year time horizon, well ahead of returns within the small-cap sector.





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ECONOMIC OUTLOOK

The two central themes in my economic outlook remain intact: (1) Although sustainable, the economic recovery that began a year ago will be subpar by historic comparison, and will suffer a loss of momentum during the second half of this year; (2) Beyond the recovery phase, the U.S. economy faces profound structural headwinds that will constrain the rate of economic expansion over the next several years. Because of the extraordinary nature of the recession, investors should not expect a normal economic expansion, but rather a highly fragile slow growth economy along with heightened vulnerability to external shock.

Nontraditional Cycle - Unlike any of the ten previous recessions since 1945, the 2008-09 recession was induced by a global financial crisis, which exposed profound structural imbalances within key sectors of our economy. These structural imbalances within the household, real estate, government, and banking sectors developed over many years, and will therefore require many years for full rehabilitation. The healing process will act to constrain the pace of economic growth and contribute to a protracted period of high unemployment. However, the recovery that began one year ago appears to be **sustainable** and should persist over the next several years, although a double-dip recession should not be entirely ruled out.

CRITICAL ECONOMIC VARIABLES

Our economy faces numerous structural headwinds that will continue to constrain the pace of the expansion during 2011 and 2012. The following factors will determine the pace of economic growth over the next several years as well as the probability of an economic relapse or **double-dip recession** during the next 6-12 months:

Household Deleveraging - Current data on consumer debt suggests that deleveraging of the household sector is still at an early phase and could persist for many years. Therefore, growth in consumer spending is likely to lag that of personal incomes, as households pay down debt and rebuild savings. Although positive in the long term, a sudden and sharp increase in household savings would act to

undermine economic growth in the short term and accentuate the expected economic slowdown.

House Prices - While the worst of the collapse has passed, the housing market remains vulnerable to further weakness. Despite record low mortgage rates, housing demand is soft and rising foreclosures are adding to the very large inventory of unsold homes. My forecast assumes a further 5-10% decline in house prices over the next year; a more severe decline in prices would have adverse repercussions for the household and banking sectors and greatly increase the risk of a double-dip recession.

Financial Conditions - Although far from normal, banking and financial conditions had been in an improving trend prior to the sovereign debt crisis in the eurozone. The European debt crisis has triggered a tightening in U.S. financial market conditions, and represents a primary risk to the economic outlook. The principal risk is contagion from Europe to U.S. financial markets, which would reduce the supply of credit and depress business and investor confidence, undermining economic growth.

Business Confidence - A prerequisite for the transition from a fragile economic recovery to self-sustaining growth is **aggressive expansion of the business sector** in the form of capital investment and additions to payrolls. There is preliminary evidence of a sustained recovery in job creation and capital formation, but business expansion plans appear highly tentative. While profit growth is robust and balance sheets are healthy, the wild card is **business confidence** and uncertainty regarding the outlook for the economy, financial conditions, and government regulation. Retrenchment by the business sector would significantly raise the risk of a double-dip recession.

Job Creation - The future trend in labor markets may be the single most important variable in the outlook. Solid and sustained growth in employment is crucial for continued growth in consumer income, spending, stabilization of the housing market, and improving health of the banking system. A reversal of the favorable labor market trends of the past six months would be a major setback for the fragile economic recovery.





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Government Policy - The conduct of government fiscal and monetary policy is a critical variable in the outlook, particularly the pace at which the emergency stimulus programs are withdrawn and policy normalization is restored. Premature withdrawal of economic stimulus from monetary and fiscal policy would increase the risk of a relapse into recession.

Eurozone Debt Crisis - My forecast assumes that necessary policy actions to alleviate short-term funding and liquidity issues within the eurozone will be adopted, although longer-term solvency issues will remain. Sustainability of the global economic recovery is dependent upon stabilization of the European debt crisis over the medium term, and appears to be the most likely outcome. Nonetheless, the risk of financial market contagion remains a critical wild card in the economic outlook.

China Slowdown - An unsustainable rate of growth accompanied by widespread real estate speculation has prompted policymakers to tighten credit conditions, raising investor fears of a hard landing of China's economy. While difficult to predict with certainty, it appears likely that the implementation of gradual policy restraint will result in a soft landing and orderly cooling of China's overheating economy. Nonetheless, because of its current role as growth engine within the global economy, economic and policy trends within China over the next year remain a critical variable in the overall outlook.

Other Headwinds - Finally, there are several key sectors of the U.S. economy that continue to face persistent structural problems emanating from the recession. These include the small business sector, commercial real estate, and state and local governments. Each of these segments of the economy remain depressed and will continue to act as a drag on economic growth in future quarters.

ECONOMIC FORECAST DATA

There are no major changes in my forecast, which assumes that the U.S. economy has entered a sustained business cycle expansion that should persist through all of 2011 and 2012. However, the pace of the expansion will be sluggish by historical

standards and the economy will remain fragile and vulnerable to external shocks.

Economic Slowdown - Following real growth of 3.3% over the past year, real GDP is expected to expand at a much slower pace over the next several quarters, beginning with Q3. Because of the volatility of monthly economic data, investor fears over a double-dip recession could become widespread. My forecast assumes real GDP growth of only 1-2% during the second half of this year and first half of 2011, followed by moderate acceleration to 2-3% during the second half of next year and all of 2012. Global growth is projected at 3.25% in both 2010 and 2011, led by Asia and Latin America.

- **Corporate Earnings** - A slowdown in the growth of corporate profits is also likely. Following growth of 25% in 2010, profits will likely expand at a 5-10% rate in both 2011 and 2012, using data from the National Income Accounts. My forecast assumes operating earnings per share (EPS) for the companies in the S&P 500 of \$75 in 2010, \$80 in 2011, and \$90 in 2012. It should be noted that these EPS projections are considerably below consensus Wall Street estimates, which suggest the likelihood of negative earnings surprises in future quarters.

Double-Dip Recession - Although a loss of economic momentum will become evident in future quarters, there are several factors that diminish the likelihood of a double-dip recession: (1) Despite numerous structural headwinds, the natural **business cycle process** appears to be in place; (2) Household and business **incomes** are in a rising trend; (3) A study of **history** reveals that double-dip recessions are rare events, absent an external shock; (4) Evidence of improving **labor market conditions** implies continued moderate job creation; (5) The **absolute level** of economic activity is already at severely depressed levels; and (6) Very low inflation allows the **Federal Reserve** latitude and flexibility to provide continued support to the economy as necessary.

Inflation and Employment - The outlook for inflation remains excellent and is a major positive factor in the outlook. Consumer inflation is at the lowest levels





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since the 1960s and should continue to drift lower during the remainder of the year. My forecast assumes an average inflation rate of only 1% during 2011, followed by modest acceleration to the 1-2% range in 2012. With respect to labor markets, the recent pace of **job creation** appears to be sustainable, with nonfarm payrolls likely to expand at a 125,000 monthly rate over the next year. However, gains in payrolls are unlikely to exceed 200,000 until later next year and in 2012.

- **Unemployment** - Because job creation will barely absorb new entrants into the labor force, the unemployment rate is likely to remain near the 10% level for the duration of this year. My forecast assumes a painfully slow decline in the rate of unemployment, ending 2011 at 9% and 2012 at 7.5%. Widespread labor market slack suggests that wages will increase slowly over the next year, with average gains of only 2-3%. The combination of moderate growth in labor compensation and continued solid growth in **productivity** implies minimal growth in **unit labor costs**, which is a positive factor for both inflation and corporate profit margins.

Federal Reserve Policy - The following factors are supportive of continued monetary ease: Very low inflation; high unemployment; ongoing contraction in bank loans and overall credit creation; a fragile housing market; a slower pace of economic growth; and worsening financial conditions resulting from eurozone contagion. The Federal Reserve is unlikely to raise policy rates before the middle of next year and could resume its policy of **quantitative easing** in the event of serious deterioration of financial conditions. Monetary policy is consistent with a continued historically depressed level of long-term interest rates.

FINANCIAL MARKET OUTLOOK

Following the strong rally in the equity, corporate bond, and commodity markets that began in March of last year, financial markets have entered a new phase, characterized by extreme volatility and heightened levels of investor risk aversion. This phase could persist for the remainder of the year and

is dependent upon investor perceptions of systemic risk and uncertainty regarding the global economy.

Fixed-Income Markets - Although a sustained rise in market interest rates is not imminent, long-term prospects for the bond market remain extremely unfavorable. Market yields are at depressed levels and a cyclical rise in interest rates appears inevitable within the next several years. Government bonds are the least attractive major asset class, with expected total rates of return of zero or less over a 3-5 year time horizon. High-grade corporate bonds are somewhat more attractive on a relative basis, but expected total returns are unlikely to exceed the low single digits over the same timeframe. High-yield corporate bonds could produce annual total returns in excess of 5%, but with greater risk.

Equity Market Consolidation - The most likely outcome for the equity market is a prolonged period of consolidation, with stock prices locked in a **trading range**, accompanied by high volatility. There are powerful forces that will limit both the upside and downside for the equity market for an extended period, the most important of which is uncertainty regarding the sustainability of the expansion and risk of a double-dip recession. A sustained equity market rally is unlikely absent greater clarity regarding the durability of the economic recovery. Other key headwinds facing the equity market include renewed deterioration in financial market conditions and the risk of further government regulation. The scheduled increase in tax rates on cash dividends and long-term capital gains beginning in 2011 is another negative for equity investors.

Positive Factors - There are also sources of support for the equity market, the most important of which include the likelihood of a continued sustained albeit sluggish economic expansion; further moderate growth in corporate profits and dividends; extremely healthy corporate balance sheets; very low interest rates; continued monetary stimulus by the Federal Reserve; and reasonable equity market valuations. The depressed level of investor sentiment is also a positive from a contrarian perspective. The most likely outcome of this tug-of-war will be a **sideways trading market** through yearend, accompanied by high volatility. Beyond the next year, current equity market





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valuations imply average annual total returns within a range of 8-10% over a 3-5 year time horizon.

- **Large Cap Versus Small Cap** - The treacherous business environment that lies ahead appears increasingly favorable for large versus small companies. Access to capital, increased government regulation, and heightened global competition should provide relative advantages to large companies. Moreover, whereas small companies are heavily oriented toward slower growing domestic consumer markets, many large companies have access to rapid growth markets in Asia, Latin America, and the Middle East. There is also a large discrepancy in **relative valuations**, with small-cap valuation premiums nearing all-time extremes. Large-cap stocks could significantly outperform small-cap stocks in future years, a major reversal of the past decade.
- **Economic Sectors** - Most attractive stock groups are those with defensive qualities, strong balance sheets, positive growth opportunities independent of the business cycle, and exposure to rapid growth markets of Asia and Latin America. Investors should emphasize the highest quality companies with proven managements. Within the S&P Index, sectors with the most favorable prospects over the next several years include consumer staples, energy, healthcare, technology, and industrials. Least attractive sectors include financials, consumer discretionary, and materials.

Other Asset Classes - Beyond the short term, there are three additional asset classes with longer-term investment appeal: Commodities, emerging market equities, and commercial real estate, each of which could provide patient investors with solid returns over a 3-5 year time horizon. The **common denominator** among these three asset classes is that each remains vulnerable to renewed economic and financial market weakness on a short-term basis, but offer longer-term opportunity. The implication is that a further setback in risk assets in coming months could provide an attractive buying opportunity for long-term investors as evidence of global economic weakness becomes more widespread.

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