



Looking Ahead: 2009 Economic and Investment Outlook It is Always Darkest before the Dawn

By Daniel P. Crawford, CFA
Senior Vice President and Managing Director, Chief Investment Officer
NexTier Wealth Management

2008 will be recorded in the annals of financial history as a year that the majority of investors wished they could have a do-over. While do-overs are possible while practicing various activities and in some children's games, rarely, if ever, are they permitted in the real world. 2008 quickly brought all investors back to reality as investment banks went bust, credit evaporated, consumer spending declined significantly, automakers flirted with bankruptcy, unemployment rates rose, and growth in China and other emerging markets contracted.

With the exception of U.S. Treasury securities, practically every major asset class experienced double-digit declines in 2008. By now, most of you are painfully aware of some, if not all, of the circumstances and events that led to our current predicament.

Before we present our *2009 Economic and Investment Outlook*, let us briefly summarize several key factors that pressured the financial markets in 2008 and could potentially guide our economy into the longest and deepest recession since the Great Depression. This short but non-inclusive list of key factors includes:

A broad deregulatory trend that began many years ago: The culprits include an unregulated credit default swap market, Wall Street firms with their misguided and miscalculated attempt to financially engineer new and safe mortgage investments, and dishonest mortgage brokers. In addition, the major unregulated rating agencies, Moody's and Standard & Poors, had a clear conflict of interest since they were paid by the very firms whose security issues they were hired to rate.

The role of former Federal Reserve Chairman Alan Greenspan: Mr. Greenspan simply kept interest rates too low for too long after the technolo-

gy bubble (2000-2002). The easy credit environment poured low interest rate jet fuel on an already explosive housing market as home prices reached all time highs. Abundant liquidity, low interest rates, and investors aggressively stretching for yield shifted the more traditional balance between risk and return into an environment where investors were not adequately compensated for the level of risk they were taking. Wall Street firms were encouraged to generate and package ever more risky investments to satiate the yield starved markets. Greed blinded both investors and investment bankers to the excessive levels of risk to which they were precariously exposed.

The Community Reinvestment Act: The revised Act of 1995 informed lending institutions that proof of income, source of down payment, and credit history would no longer be required for homeowners to qualify for a mortgage. This created an extremely competitive lending environment in which financial institutions relaxed their lending standards to aggressively pursue new and dangerous business. These imprudent lending practices resulted in a record number of homeowner foreclosures and delinquencies.

Americans themselves: Why are Americans to blame? Simply stated – a lack of savings and too much debt. From 1950 to 1985, on average, Americans saved 9% of their disposable income. In 2008, the savings rate dropped to zero. In 1997, consumer and mortgage debt represented 77% of disposable income. Today, consumer and mortgage debt represents 127% of disposable income. The debt to disposable income ratio is too high to sustain economic growth in an economy where the consumer is responsible for 70% of Gross Domestic Product (GDP). Perhaps we have witnessed the end of the golden age of spending by the American consumer only to be replaced by a new age of thrift.

In 2008, the financial markets, specifically the credit markets, almost died while the economy suffered from the flu. The near death experience of the credit markets had a deleterious effect on economic activity and so the downward spiral was exacerbated.

The Obvious Recession

According to the National Bureau of Economic Research (NBER), the economy entered a recession in December 2007. While there is not a universally accepted definition of a recession, most economists look for two consecutive quarters of negative growth (isn't "negative growth" an oxymoron?). However, for this current recession, the NBER examined payroll employment, industrial production, inflation adjusted income, and business sales, all of which had weakened significantly. The U.S. economy did not experience negative growth until the third quarter of 2008 (-.5%), nine months or so after the beginning of the recession. It appears as though Q4 2008 GDP will register negative growth of 5-6%, thus confirming the traditional economist's definition of a recession – two consecutive quarters of negative growth. This late confirmation came when most of us knew the economy was ailing for most of 2008.

The U.S. stock markets peaked in October 2007, several months before the onset of the recession. Again, the U.S. stock markets proved their worth as a leading economic indicator (LEI) by turning south ahead of the economy. Similarly, as an LEI, we believe the stock markets will turn positive prior to the economy, perhaps six to nine months before economic improvement. More on this later.

The U.S. and global credit markets came perilously close to failing and seizing up in the fall of 2008 as short-term credit was scarce and prohibitively expensive. The commercial paper,

auction rate preferred, and inter-bank lending markets, just to name a few, collapsed. One of the largest U.S. money market funds “broke a buck,” a cardinal sin in the money market world, and temporarily halted redemptions.

The pressures in the credit market caused the Federal Reserve to take unprecedented action to provide liquidity to the financial institutions. The function of the Discount Window was expanded. The Term Auction Facility (TAF), Term Asset Backed Securities Loan Facility (TALF), Primary Dealer Credit Facility (PDCF), Term Securities Lending Facility (TSLF), and the Commercial Paper Funding Facility (CPFF) were created. FDIC insurance was expanded. Money market funds and newly issued bank debt were Federally guaranteed. The Treasury launched the Troubled Asset Relief Program (TARP) to the tune of \$700 billion intending to use the funds to recapitalize financial institutions and purchase toxic subprime debt from their balance sheets. So numerous and frequent are these new financial acronyms hitting the headlines, it tends to make your head spin.

The concerted efforts of the Federal Reserve, U.S. Treasury, and legislative branches of the U.S. government (the new Big Three) have given us comfort and confidence that the financial markets will continue to function, although in a weakened condition, and massive failures of large instrumental financial institutions will be averted.

Policy makers have demonstrated their ability to spend an inordinate amount of taxpayer money to avoid a depression. Will it be enough to resuscitate the economy and stimulate job growth?

The Federal Reserve's balance sheet is approaching \$3 trillion, an increase of more than \$2 trillion thus far, as

a result of their remedies to heal the credit crunch and stimulate growth. We are not certain how large the Fed's balance sheet will become. What we do know is that the new Big Three will take whatever concerted actions are necessary to prevent the economy from slipping into a depression. Economically, the U.S. is stretched very thin. Will the U.S. have the resiliency to deal with the next economic crisis in light of our current fragile state?

What will be the unintended consequences of all these government programs and bailouts over the next 10 years? Two of the more serious unintended consequences could be U.S. dollar weakness and significantly higher inflation. We will most likely cover these issues in great detail in the 2010 Economic and Investment Outlook.

Looking Ahead

The Fed can no longer lower Fed Fund rates in an attempt to stimulate growth and create jobs since the Fed Funds rate is close to zero and expected to remain there for the majority of 2009. The Fed will develop and deploy new tactics, such as quantitative easing, throughout 2009. Quantitative easing will further increase the Fed's balance sheet by creating and using money to purchase Treasuries and finance lending facilities – an attempt to lower longer term interest rates. The potential exists for the dramatic expansion of the Federal Reserve's balance sheet to spur inflation beyond 2010. The Federal budget deficit, projected to exceed \$1 trillion in 2009, will also exert inflationary pressures. The degree to which quantitative easing is inflationary depends on how effectively the Federal Reserve drains liquidity from the banking system once its objectives of financial stability and economic growth have been achieved.

It seems a little ironic that low interest rates and easy credit are two of

the critical factors that got us into this mess. Yet, this is exactly what government policy is trying to give us again – low interest rates and available credit so American consumers will go shopping and purchase homes.

The U.S. economy officially entered a recession in December 2007 and finished 2008 with two consecutive quarters of negative growth. Both the 1990-91 and 2001 recessions lasted eight months. Recessions in the 1970s and 1980s each lasted 16 months. If this current recession lasts beyond April 2009, which it will in our view, it will be the longest recession since the Great Depression.

2009 will be a transition year for both the economy and financial markets as the gradual impact from the government programs work their way into the economy. We will limp into 2009. We anticipate negative GDP growth of 1-2% for the U.S. economy in 2009. The first half of the year will continue to experience further weakness followed by below-trend growth in the second half. The unemployment rate will rise to 8-8.5% toward year end, housing prices will fall nationally another 15% on top of the 20-25% already experienced from the mid 2006 peak, consumer spending will continue to slow, industrial production will diminish, and personal income will stagnate. The second half of 2009 will begin to show some strength as government policy responses work their way into the economy.

Job creation is the single most important factor needed to reverse the direction of the contracting economy and improve the housing market. Builders must stop building allowing inventories of unsold existing homes to align with historical averages. Currently, we have an 11-month supply of existing homes on the market versus an historical average of six months. Two-thirds of Americans own their homes, which

is slightly above the historical average of 64%. It may be difficult to stabilize the housing market when the supply and demand sides of the equation are moving in opposite directions, i.e. supply continues to increase while demand diminishes, or at a minimum does not increase.

Inflation will not be of concern in 2009. We anticipate the Consumer Price Index to decelerate in the first half of 2009 and be mildly deflationary for the remainder of the year. This will be led by lower energy prices, the prolonged recession, a global slowdown, and an easy comparison against the strong first half inflation of 2008 (8.7% annualized).

According to the Energy Information Administration, the price of a barrel of oil averaged \$100 in 2008. Even with the benefit of hindsight, it is not precisely clear what factors were responsible for oil hitting an all-time high price of \$147 per barrel in July 2008. It appears to have been caused by a combination of leverage utilized by speculators and hedge funds and increased global demand, all three of which seem to have left the crime scene in a hurry. We anticipate the average price of oil to drop to \$50-55 per barrel in 2009.

The tremendous drop in oil and gasoline prices represents a huge savings to consumers. It is equivalent to a stimulus package of \$150-\$200 billion on an annualized basis. Combine this with the \$750-\$900 billion stimulus package that President-elect Obama has on the table, and suddenly more than \$1 trillion of capital and spending power has been injected into the U.S. economy.

This Year in the Stock Market

As mentioned earlier, the U.S. stock market tends to act as a leading economic indicator, turning south several months before the economy sours and, conversely, heading north while the economy remains mired in a recession. Historically, the U.S. stock market has bottomed on average five months

prior to the end of a recession. Since we anticipate negative growth through the first half of 2009 and recessionary pressures easing during the second half, equity markets could potentially demonstrate strength toward mid-year, which should continue for the remainder of the year giving investors a cyclical bull market inside of a secular bear market.

Several other factors encourage us to be guardedly optimistic about stock market performance this year. First, equity valuations (the S&P 500 trades at 12.4 times estimated 2009 earnings of \$70) are relatively attractive. In addition, tremendous cash balances exist in money market funds (\$3.7 trillion), a portion of which is waiting for an opportune time to re-enter the equity markets. Also, the Consumer Sentiment Index is at the lowest level of its 56-year recorded history (contrarian indicator). Other favorable indicators include lowered investor expectations, anticipation of meaningful and new monetary and fiscal policies to counter the unfavorable economic and credit cycles, and an equity markets dividend yield in the U.S. at its highest level relative to government bond yields since the late 1950s.

Although the economic outlook remains dark and challenges to global growth abound, we believe risky assets (such as equities) are cheap, while risk-free assets like government bonds are expensive. Low yields on risk-free assets will gradually encourage long-term investors to reinvest in riskier asset classes.

Two riskier asset classes that appear attractively valued are high yield bonds and international and emerging market small cap stocks. The spreads between high yield bonds and equivalent maturity corporate bonds and treasuries are at historical highs. In our opinion, the higher anticipated default rates and bankruptcies are fairly discounted in the current prices of high yield bonds.

International and emerging market small cap stocks should benefit from a weakening U.S. dollar and falling commodity prices. Most emerging market currencies are expected to appreciate in the months ahead once investor risk aversion recedes.

2009 will no doubt be a challenging time as the nation deals with numerous uncertainties and increasing anxieties. The recovery from the near-death experience of the financial markets will be long and gradual. However, investment opportunities will present themselves. The prudent investment manager will recognize these tactical opportunities and position investment portfolios accordingly. The days of a simple "buy and hold" investment strategy appear to be on "hold."

A buy and hold strategy clearly has not worked well over the past 10 years. The total return loss for the S&P 500 for the 10 years ended November 2008 (2.66% per year) matches 1929-1939, the worst 10-year performance in U.S. stock market history. The U.S. stock market may have already discounted a 1929-1933 type recession. This is bullish. According to the Leuthold Group, when the 10-year annual total returns fall to 1% or less, the next 10 years produces an average cumulative return of 183%. Let's hope the Leuthold Group is right. We think they are.

For normalcy to return to the financial markets and the economy, we must witness job growth, stabilized housing, no further deterioration in capital positions at financial intermediaries, improvement in inter-bank lending and the availability of credit, and the re-emergence of consumer spending. The risks to our recovery include poor government policy and execution and a return of inflation sooner than expected. Stay tuned for an interesting 2009. NexTier Wealth Management will be there with you.