

## Is the Fat Lady Singing?

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### 2011 Outlook

**GDP GROWTH:**  
2.5%

**UNEMPLOYMENT:**  
9.0%

**INFLATION:**  
1.75%

**FED FUNDS RATE:**  
0.35%

Are we heading back into recession? That, in our opinion, is the main driver of what may happen to the world's equity markets over the short-to-intermediate term. For the time being, we have not seen enough evidence to suggest that, yes, we are heading back toward an economic contraction. However, the evidence we *have seen* suggests to us the **probability of an economic contraction has risen**. The worry list which the world's investors are focusing on continues to grow. Let's count a few of these worries.

1. Economic recession – are we heading toward contraction?
2. Government “reduction” in spending – what impact may this have on the nation’s “income statement”?
3. European banking/currency problems. When are these problems going to end, and what type of impact may these problems continue to unleash on the U.S. economy?
4. What does the major move in gold represent?
5. Is the Fed going to launch “QE3?” If so, why and what may occur?
6. Employment picture. When (or will) the economy grow to a point that jobs are created?
7. Is there an easy way out of the “Long, Hard Slog?”
8. Technically, from a stock market standpoint, where do we stand?
9. With revised Gross Domestic Product (GDP) data, how sustainable is this period of strong corporate earnings growth?
10. Is the U.S. stock market truly “cheap?”

There are many questions. We will attempt to provide some answers. First, let's look at the issues surrounding the economic “income statement” items from above.

## Are We Heading Toward a Recession?

The quick answer is that the probability of a recession starting sometime in the next six months is rising. We do not believe we have seen enough evidence to suggest that, yes, we are heading back toward recession. What are we looking at to give us this view?

- Six-month rate of change of the Leading Economic Indicator (LEI) index. During the last six months, the LEI has risen by 5.4 percent. **Since the end of World War II, the U.S. economy has not slipped into a recession without the six-month rate of change of the LEI being at least -3.5 percent.** We are quite a ways away from that possibility – at this time.
- Shape of the yield curve is very positive. As of the end of July, the spread between short- and long-term government interest rates was 3.84 percent. This is extremely high. If one looks back since 1945, the economy has never slipped into a recession when the spread between long- and short-term rates has been this high.
- The manufacturing side of the economy is still expanding. True, the Institute for Supply Management (ISM) index recently came out at 50.9, down from earlier reads into the high 50's. Momentum within the industrial sector is falling. Normally, the ISM index is well below 50 when the economy slips into contraction mode.

These three indicators (along with other items) lead us to believe the economy is not currently heading toward recession. However, we need to recognize that the momentum in economic activity has slowed significantly, on a world-wide scale. With this in mind, we believe the probability of recession occurring during the next six months has increased.

## Employment Picture – When Will Jobs be Created? When Will We See “Full Employment?”

To answer this question, we need to understand how Gross Domestic Product (GDP) is constructed. GDP is an economic “income statement” summary which tells, after inflation, how rapidly the economy is growing. GDP growth rates are driven by two major, macro factors. The first factor is productivity. Productivity gains in the western world, over the long-term, have averaged about 2.0 percent per year. During a good stretch these numbers may increase to the 3.0 percent or so range. During a bad stretch, productivity gains may be in the 1.5 percent range. Productivity measures the production of the work force. So, as people work harder, or smarter, productivity gains tend to happen. Productivity gains tend to go hand-in-hand with capital spending. It appears to us we are in that 1.8-to-2.1 percent productivity growth stretch. Added to productivity gains are gains in the workforce. This is fairly clear as the number of people coming into the workforce is predictable; and, the demographic makeup of each country is fairly well understood. The workforce normally grows between 0.8 percent and 1.5 percent annually. Currently, it appears the workforce is growing by about 0.8 percent. So, the economy needs to grow by 2.6 percent (1.8 percent + 0.8 percent) to maintain current unemployment rates.

For the economy to absorb the unemployed, GDP growth will need to grow faster than 2.6 percent. During the last 12 months (using revised data), the economy grew by 1.6 percent. Therefore, it is understandable why the economy is having a tough time absorbing the unemployed.

When will the economy accelerate growth to absorb significant amounts of the unemployed? Unfortunately, we believe this process may take years to unfold. Business and consumer confidence is key to this issue, which does not seem to be in the cards – at least during the current cycle.

## Is the Fed Going to Launch Additional Monetary Easing Measures (QE3) to Stimulate Economic Activity?

The quick answer to this question – we hope not. It has become apparent, at least in our minds, that we have little need for additional money in the banking system. The Fed has many tools in its arsenal, to stimulate money supply. It has few weapons to stimulate money demand, except for price (interest rates).

We contend there is plenty of money to be lent in the system (supply of money). There is a lack of demand from credit-worthy borrowers within the system. Since interest rates are at very low levels, it appears to us the Fed may be “pushing on a string” if they launch additional monetary enhancing policies. At the end of the day, additional monetary stimulus may prove inflationary during the long-term, with little added short-term “income statement” benefit.

**In summary, regarding our current economic “income statement” outlook, we believe GDP growth will remain low – perhaps with some uptick from the last few quarters. However, the weight of the evidence currently favors the view that an outright economic contraction is probably not in the cards during the next six months.**

Now – on to the economic “balance sheet” issues which are currently overhanging market activity.

### **European Banking/Currency Issues. When are These Problems Going to End, and What Type of Problems May These Issues Force Upon the U.S. Economy?**

This question is very complex. Consequently, we will launch a piece specifically addressing this issue. However, our view has been and continues to center on the sustainability of the European banking system and the European Union (EU). In a nutshell, risks are present to ask serious questions regarding the sustainability of the European Central Bank (ECB) in its current format. Will all of the current participants in the ECB remain? As we have written in the past, we wonder about this. Presently, there is a de-link between authority and responsibility in the European monetary and banking system. One party has the authority for balancing fiscal budgets (sovereign individual governments) and another party has the responsibility to make the banking system whole if such budgets are not balanced properly (i.e. the Germans). This de-link between authority and responsibility is highly unstable, no matter the circumstances. European economic activity currently represents well over 20.0 percent of all world-wide economic activity. This area is highly unstable. As long as this instability is maintained, balance sheet risks (currency, banking system, etc.) will remain.

### **Is There an Easy Way Out of the “Long, Hard Slog?”**

The “Long, Hard Slog” has been documented heavily in our writings since we first introduced the concept in the fall of 2007. Basically, they state that our debt structure in the U.S. is unsustainable. We as a people have been living beyond our means for decades (since the mid-1980’s) and our debt burden as a society has become unsustainable and unstable. The markets came to this same conclusion in 2008 to 2009 and now much of the western world has joined this push toward deleveraging– or paying down debt. As debt is repaid (something that is necessary), consumption growth slows. Consequently, as we continue to de-lever our balance sheets, our national income statement suffers. Is there any other way out of this dilemma?

Given these circumstances, we see little other course for our country to take. We have long written that GDP growth would be slower than normal for some period of time going forward. We are now in the middle of the “Long, Hard Slog” as the government is now joining the parade.

### **Given All of This, Where Does This Leave Not Only the U.S., But Also the Rest of the World? Are We Seeing the Start of the Next Great Bear Stock Market?**

We suspect, not yet. At this time, the weight of the evidence before us suggests we are seeing very weak economic growth, we will probably retain reasonably high levels of unemployment and banking system worries (primarily in Europe) will continue for some period of time. We believe the current move to the downside in the equity market will subside, and stocks may rally by year-end 2011. However, we suspect that the risk of an outright recession is higher now than has been the case for some time, and the probability of a recession starting sometime in the next 12-to-18 months is reasonably high.

We recently wrote on the topic above in our recently published piece, “Reading the Roadmap – Back to the Future.” Please see this piece for a detailed perspective on our view of the business cycle, and possible changes to that cycle as compared to our experience from the past 20-year period.

Lastly, it is important to put into context the current move on the downside and the rhythm the market has established since the bottom in 2009. We are 27 months into this bull market. This is the fourth correction we have seen since that bottom.

<u>Date</u>	<u>Change in Stock Prices</u>
March – June 2009	+43.5%
June – July 2009	-9.1%
July 2009 – January 2010	+32.3%
January – February 2010	-10.1%
February – May 2010	+15.4%
May – June 2010	-12.5%
June – May 2011	+35.6%
Average Advance:	31.7%
Average Decline:	-10.6%

As of this writing, from the recent high in May 2011, the S&P 500 has currently declined by 8.5 percent. Consequently, the correction we have witnessed to date is not highly unusual from the typical correction we have seen since the bottom of the major bear market of 2008 to 2009. From a technical and historical rhythm perspective, we suggest the current correction will fall short of the 20.0 percent correction definition of a bear market.

### Final Word

There are a number of questions posed above that need to be answered. We are currently developing another piece to specifically address many of these issues. **The title of this piece, “Is the Fat Lady Singing?” refers to the end of an opera when a robust soprano, at times, will wrap-up the performance. Is the market “fat lady” singing? We suspect not, but the tenors are probably warming up.**



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