

## How Low Can You Go?

August 24, 2011

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### 2011 Outlook

**GDP GROWTH:**  
1.5%

**UNEMPLOYMENT:**  
9.0%

**INFLATION:**  
1.75%

**FED FUNDS RATE:**  
0.25%

It seems a race is on between analysts as to how rapidly GDP estimates can be brought down, and the playing out of the guessing game—"Recession or No Recession." As we have stated in recent pieces, we currently believe there to be a 35% probability that the economy will slip into recession over the next few quarters. Currently, we stand by that view.

Certainly there have been a number of troubling reports recently. The Philly Fed report was damaging. Existing home sales data was poor, as were new home sales. Today the Richmond Fed report showed industrial activity in their district has contracted. The ISM Index (broad-based manufacturing activity index) is still positive, but barely. It appears one area of positive economic vitality (industrial output and orders) is at risk of contraction.

Due to the data mentioned above, **we are lowering our projected GDP growth forecast for the U.S. economy from 1.8% to 1.5% for all of 2011.** Data indicates that if the third quarter were to end today, GDP growth for the third quarter would probably come in around 2.0%. Additionally, we see little on the horizon (stimulus, changes in consumer or business behavior) to indicate a significant shift to the upside in economic activity by the end of the year. We are currently looking for the fourth quarter GDP to register in the 2.1% to 2.3% range. During the first half of the year, the economy grew at an annualized rate of 0.9%. If the second half shows growth of 2.1% (which is our "baseline" thought), full-year GDP would then come in around 1.5%.

### Details Looking Forward

Why would the economy show some degree of acceleration during the second half as compared to the first? Some thoughts:

- Oil prices have come down significantly since the first half of this year. During that period, oil prices traded between \$84 and \$114 per barrel (bbl) or an average of \$99 per bbl. Since then, oil prices have traded between \$95 and \$79 per bbl for an average of \$87 per bbl or a decline of 12%. Since the high in late April, gasoline prices nationally have declined by more than 16%, adding more spendable dollars to the consumers' wallets.
- Auto sales are expected to ramp to the upside over the next few months. After hitting a low during the second quarter due partially to parts shortages and inventory problems, auto sales appear to be set to rise by 5% over the remainder of this year. Vehicle assemblies during the second quarter ran at an annualized rate of 7.9 million units, an unsustainably low level driven by the Japanese earthquake.

- Thirty-year mortgage rates ranged from 4.8% to 4.1% during the first half of the year. Currently, 30-year mortgage rates are at 3.61%, down 18% from the average during the first half. We understand that many in the market are unable to take advantage of these lower rates through refinancing, but it appears refinancing activity is brisk. This should add additional dollars to consumers' wallets.

As stated in our latest piece, "Recession of Confidence", the risks in the economy are centered not on an "excess" of some sort—which is typically the case when the economy is threatening to fall into contraction—rather the risk is a lack of confidence in our national and worldwide institutions. The ability of many consumers and businesses to "transact" is present; however, the willingness to do so is lacking in many cases. It is this lack of confidence, lack of faith if you will, that lead us to the conclusion that an economic contraction may indeed be forthcoming. We rate the probability of a recession occurring over the next few months at 35%.

We are of the opinion that the business cycle will more than likely be shorter in the foreseeable future than has been the case, generally, over the last 25 years. We fully documented this opinion in our "Reading the Roadmap" piece, so we won't go into major detail here. However, if we are correct in our assumptions, the "natural" probability of the economy starting a contraction sometime in the next 1.5 years is reasonably high. We believe the economy is and has been on the "back half" of the current expansion for some time. We wrote on this issue earlier in 2011.

### World's Markets – No Place to Hide When Risk Tolerance is Reducing

Economic risks are building. The world's capital markets surely understand this risk. Below is data showing the degree of market price contraction which has taken place in various parts of the world since the high in prices witnessed early in May.

Country	Index	Percent Change from May 2
U.S.A	S&P 500	-17.4%
U.K.	FTSE 100	-16.1%
Germany	DAX	-27.3%
France	CAC	-25.7%
China	Shanghai SE	-14.2%
Japan	Nikkei 225	-13.8%
India	Bombay SE	-13.5%
Brazil	Bovespa	-19.9%
Gold Prices		+20.3%
Oil Prices		-27.6%

In summary, there have been few equity markets in which to hide. The EAFE Index (foreign markets adjusted for currency fluctuation) has declined by 20.1% over this period of time. Additionally, not all commodities have risen over this period—as gold has risen dramatically, while oil has declined at an even more rapid pace. On what should an investor focus?

We answer this question in one word: quality. Don't only focus on income statement strength. While these variables (profit growth, revenue growth and stability of profit growth) are all very important variables at this time, we also advise focusing on balance sheet strength. Generally speaking, a strong income statement will influence a company's stock value. A strong balance sheet will help keep the company in business.

## Final Word

We are lowering our expectation for GDP growth from 1.8% to 1.5% for 2011. We will be releasing our initial first-blush estimates for 2012 growth soon. As the markets swoon due to economic uncertainty and confidence erosion, it is important for investors to focus on quality. We advise to sharpen one's focus on quality during these periods.



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