

## Employment Picture, Growth – Recession? and Market Decline – Its Causes, Magnitude and Possible Future

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### 2011 Outlook

**GDP GROWTH:**

1.2%

**UNEMPLOYMENT:**

9.0%

**INFLATION:**

1.75%

**FED FUNDS RATE:**

0.25%

The August employment report came out last Friday and for the first time since 1945, the number of net new jobs created by the U.S. economy was zero. The U.S. economy has either created or shed jobs every month since 1945. This is a weak report, plain and simple. There is no hiding from reality. Not only did the economy fail to create any net new jobs for the month of August, but the report reduced the number of jobs created for both June and July. Many pundits have already broken the report down in detail. Workers at Verizon Corporation are on strike, which increased the unemployed ranks temporarily. Similarly, many workers in Minnesota have returned to work, lowering the ranks of the unemployed. However, at the end of the day, the economy needs to create roughly 150,000 jobs per month just to stay up with workforce expansion as a result of population increases. The economy has created that number of jobs in only 8 of the 20 months since the beginning of 2010. *In other words, for various reasons which are deep, the U.S. economy is not “feeding the bulldog” regarding job creation, and hasn’t been doing so since 2007.*

### GDP Thoughts

We have been of the “bearish” camp for some time regarding GDP growth at an expected 1.5% for all of 2011, but even our bearish number needs to be adjusted downward. We are now expecting the U.S. economy (on a real basis) to grow no more rapidly than 1.2% for all of 2011. Additionally, we have been more pessimistic towards not only growth but the possibility of a return to recession. We have stated that the possibility of the economy falling back into recession over the next few quarters is 35%. We are now raising that possibility to 40% following this dismal employment report.

We don’t believe our changes are “reactive”, as data for the last few weeks has been rather consistent – painting a picture that the once-strong industrial side of the U.S. economy is starting to falter. From regional Fed data to the recent manufacturing Purchasing Managers Index (PMI) – macro data is pointing towards a rapid slowing in industrial output. Most economies in Europe back this view, as manufacturing indexes in most areas of Europe have turned weaker (except Germany). Lastly, our domestic industrial analyst, Frank Wei, has been noticing a marked weakening of expectations from U.S. equity analysts who, on a company-by-company basis, have been lowering profit estimates rapidly over the last few weeks.

So, we believe it prudent to lower expected GDP growth, as the employment picture is weakening rapidly. This report, along with financial market activity, may indeed lower consumption growth patterns, and business investment plans. Per our earlier piece entitled "Reading the Roadmap", we have laid out, in detail, our view that the U.S. business cycle may be shorter than has been the case over the last 25 years. Our rationale covers a variety of factors. With this in mind, one has to conclude that the probability of the U.S. economy slipping into recession by the end of 2012 is reasonably high, as mid-2012 will mark the beginning of the fourth year of this current expansion. In concert with this view, we expect corporate earnings expectations to retract.

## Market Decline

The world's equity markets have been in retreat for more than a month. We see nine "points of emphasis", or "Reasons for Decline" which we would like to outline at this time.

**Reason #1: Economic income statement reasons for decline:** *There is an apparent deceleration in economic momentum. Are we headed towards recession? At this time, we believe the weight of the evidence supports a very slow-growth economic environment, rather than an outright contraction being on the immediate horizon. However, we believe the probability of an economic contraction is rising, and is reasonably high, particularly as 2012 unfolds. At the same time, we are noticing a contraction in corporate earnings estimates is starting to occur.*

**Reason #2: Economic balance sheet reasons for decline:** *Both in Europe and in the U.S., the great debate surrounding the "Black Swan" issues of excessive debt and leverage are in full bloom. This has emphasized that the financial, governmental and banking systems in Europe are in flux. The direction and durability of the Euro as a currency, and the ECB as a central bank is in question. In the U.S. the anxiety and the malfunctioning of the legislative process has been brought into the public spotlight. Both of these issues have been anticipated as the Long, Hard Slog plays out. It is becoming very apparent that a decision needs to take place, by the German population, that they are willing to financially back foreign sovereign credits on the continent. Without this backing, the bond market may indeed continue to punish those governments who are unable or unwilling to get their fiscal houses in order. This punishment may come in the form of higher interest rates as credit quality rate spreads widen. In our opinion, Europe is precariously close to economic contraction territory. In the U.S., politicians have been on recess for the month. The quiet time is coming to a close, as folks get back to work in Washington. We look for the financial markets to start refocusing on the problems within our own political system.*

**Reason #3: Summer doldrums.** *Typically, the summer months are weaker for the equity market than the other seven months of the year. Since 1900, the two worst months for the stock market have been September and October, with the market, on average, losing 0.24% in value annually over the last 110 years. As a matter of fact, according to our friends at Ned Davis Research, October stands out as the only month which has, on average, shown a negative average rate of return of all 12 months – once again data going back to the year 1900. So, we believe the "summer doldrums" issue may still be in play.*

**Reason #4: Presidential cycle.** *Typically, the summer of the third year of the Presidential cycle is weak.*

**Reason #5: Technically, the market has "broken down".** *As the market was breaking down, the following support "ranges" should have been in effect: weak support between 1219 and 1174 with stronger, more durable support between 1129 and 1040. While the market has violated the first, weak support "range" of 1219 to 1174, the stronger, more durable support range of 1129 to 1040, for the time being, has held. As of this writing the market is trading at 1184, after falling to a closing-low of 1119. Assuming this range holds to the downside, upside resistance should become apparent in the 1174 to 1219 range (the old, weak support). Indeed, the S&P traded back into this range, closing at 1218 on August 31<sup>st</sup>. If the market is successful at scaling through those levels, the market should run into very stout resistance in the 1265 area. For the time being, the market has failed to penetrate the 1219 level and make a concerted run at the next resistance level of 1265. At this time, technically we can see more downside risk than upside potential. Additionally, we believe the possibility of retesting the recent lows (down about 5% from current values) may indeed occur.*

**Reason #6: Credit Default Swap (CDS) rates** reflect the market's view of a particular bond defaulting. As these rates rise, it is a sign that the market believes the probability of default is rising, a sign of financial stress. CDS spreads are rising rapidly in Europe – pretty much across the board, including Germany. CDS spreads stabilized and declined during the first half of August. Since then, they have accelerated upwards again, back to the old highs. Bond market participants are fearful that the possibility of default of many sovereign credits has reaccelerated, which is weighing heavily on the world's stock markets.

**Reason #7: Capital appears to be flowing rapidly into the U.S. banking system**, a sign of investor uncertainty. Some of this flow is coming in from abroad – as the world's investors are seeking “safe harbor”. Short-term interest rates are still low, and will probably remain so for an extended period of time. Demand for capital remains low, and is apparently declining at the margin. The 13-week rate of change for commercial and industrial loans has declined to 8.7%, down from a growth rate of 13% earlier in the summer. So while the Fed continues to create an “easy” monetary framework, driving the “supply” of money upward, the demand for capital appears to be slowing.

**Reason #8: Economic slowing** driven by two primary forces (worldwide): 40% of worldwide GDP has been living with tightening central bank policies (Europe, China being the two main drivers). The other driving force has been oil prices. From the fourth quarter last year to the end of April, oil prices increased by \$22.50 per bbl – up 25% in four months. This has had a chilling effect on worldwide economic momentum. At its current price of \$88.50 per bbl, oil is down by 22% since the peak. Over the last 60 days, oil prices have declined by \$12.00, down about 12%. Is this too little too late?

Jean-Claude Trichet has recently backed away from further rate increases, as he has said “risks to the medium-term outlook for price developments are under study in the context of the ECB staff projections that will be released early September.” We believe the ECB will stop raising interest rates and may eventually start to bring rates down. Yesterday, Brazil reduced rates. So, much of the world is moving away from a “tight money” policy. China is still a wildcard on this issue. Oil prices have stabilized over the last four weeks. It appears oil prices may remain in the \$80 to \$90 per bbl range for a period of time, allowing for gasoline prices to continue to moderate.

**Reason #9:** It has become more apparent to many that **Europe's banking system has real problems**. Capital adequacy is one main concern. Additionally, it appears that many believe the ECB will be unable to solidify the Euro as a central currency without the full backing of the German populace and leaders. Over the last month, the Dow Jones Industrial Average is down 5.1%. Over that same period, the major European markets:

Amsterdam:	-9.1%
Frankfurt:	-20.6%
London:	-7.0%
Paris:	-13.0%

It is becoming apparent to many in the investing world that the crux of the banking or balance sheet problems currently resides in Europe. As of this writing, there has been no real solution put forward and embraced by the leaders in Europe. Consequently, we believe this risk is still present.

## Final Word

For the time being, we are suggesting the downside move in the world's equity markets appears to be of the “intermediate” type – down no more than 20% from its peak. We don't believe this to be the start of a new, cyclical “bear” market, backed by an absolute economic contraction. However, we believe from a macro, top-down standpoint, little has been done to relieve us of our worries that the probability of recession on a worldwide scale has intensified, with the latest reports from both the U.S. and Europe raising our concern.

We believe the world is looking at a slow-growth environment for the next 12 to 18 months. In this type of environment a slip into an outright economic contraction or recession is reasonably high. We currently place those odds at 40%.



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