Providing Global Opportunities for the Risk-Aware Investor

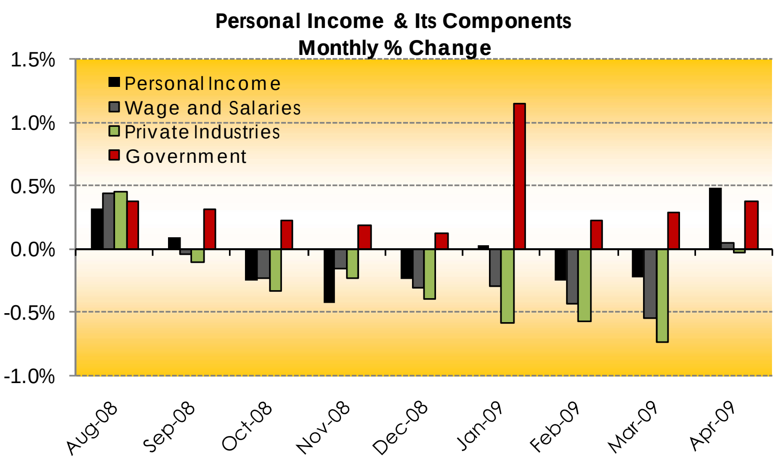
Can the Consumer Get Back on Track?

The equity markets just posted a third consecutive monthly gain on a tailwind of hope that the worst of the recession is behind us. While we agree that the massive re-pricing of risk and market free-fall of last autumn is unlikely to happen again, we strongly doubt the prospects for a V-shaped economic recovery.

The equity markets rarely move in lock step with the economy, however, they *should* reflect the *future* prospects of their underlying companies. Consumer spending accounts for more than two-thirds of economic activity in the United States, and the growth of these underlying companies is highly dependent on this spending. For many years the American consumer drove the engine of growth for domestic companies as well as export-dependent foreign corporations. Once the consumer finally slammed on the brakes, the federal government stepped in to try to bridge the gap to the other side of the recession. This situation, however, is not sustainable. The question before us now is, what if the consumer is neither willing nor able to reclaim the top rung of the spending ladder before the government's life line runs out? The health of the consumer will have a big impact on equity market performance in the near future. Can a damaged consumer resume spending at the level necessary to sustain the equity market gains experienced before the current crisis? We think that the answer is probably not, at least in the near term.

Revving Up the Engine

Before we even get to the point of a consumer resurgence, the government must bridge the spending gap. Is the stimulus working? In terms of the short-run goal of putting more disposable income in the pockets of average Americans, the answer is likely *yes*. Tax cuts, rebate checks, enhanced unemployment and health care benefits, and mortgage modification programs, combined with relatively-lower oil prices, are helping this purpose. The Department of Commerce reported that in April, personal incomes jumped 0.5% on the back of tax cuts and benefit payments. It was the first significant increase, outside of the government sector, in months.



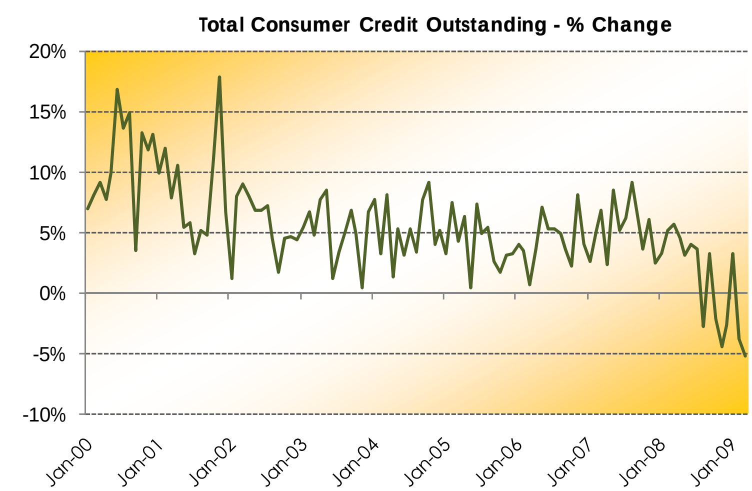
Source: Bureau of Economic Analysis

Over the longer term, the answer is less obvious. We are concerned with whether the stimulus is structured in a way that its medium-to-longer run impact will be effective in sparking economic growth. In an effort to ensure that government dollars spent by states and municipalities would be used to protect American jobs, Congress added a "Buy American" provision to the stimulus bill. In practice, these protectionist measures are backfiring. In our globalized economy, it is almost impossible for companies to ensure that all of their inputs are made in the U.S.A., and finding American-made alternatives may be less cost effective. As a result, some companies are losing orders and actually cutting jobs. These restrictions are also raising the ire of our trading partners, prompting "Boycott American" sentiment. The Federation of Canadian Municipalities passed a resolution last week that could allow Canadian communities to impose similar restrictions on U.S.-based purchases if changes to the "Buy American" provision are not made in the next several months. Assurances from the White House that the U.S. will abide by NAFTA are little comfort to them, since the trade agreement covers only federally procured funds, not projects sponsored by states and municipalities. Information like this calls into question the surety that stimulus spending will reach beyond unemployment benefits and rebate checks to build a solid foundation for job and income growth.

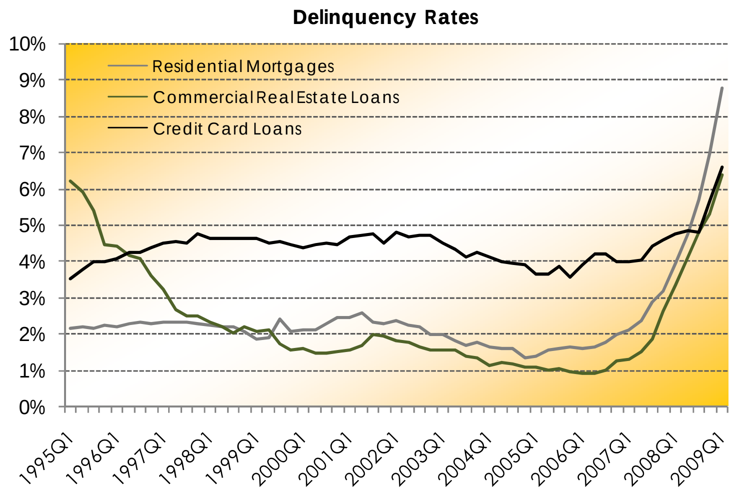
Express Lane Ends

Assuming that public spending initiatives successfully pave the way for a new growth cycle, eventually it will be necessary for the consumer to take the wheel. We fear, however, that several key drivers behind the consumer spending machine will not bounce back in time to support the next cycle.

One of the key pillars that had been propping up the consumer was credit. During the "good years", what wasn't affordable could be financed. Houses, second houses, cars, and vacations were all just an equity line of credit away. Now that Americans have little left to secure this credit, the prospects for this type of spending are dim. Banks face mounting losses from a deteriorating commercial real estate sector as well as increasing loan charge offs, and are still not eager to extend credit. Many Americans will be restricted to non-leveraged spending for the foreseeable future, limiting their impact.



Source: Federal Reserve Board

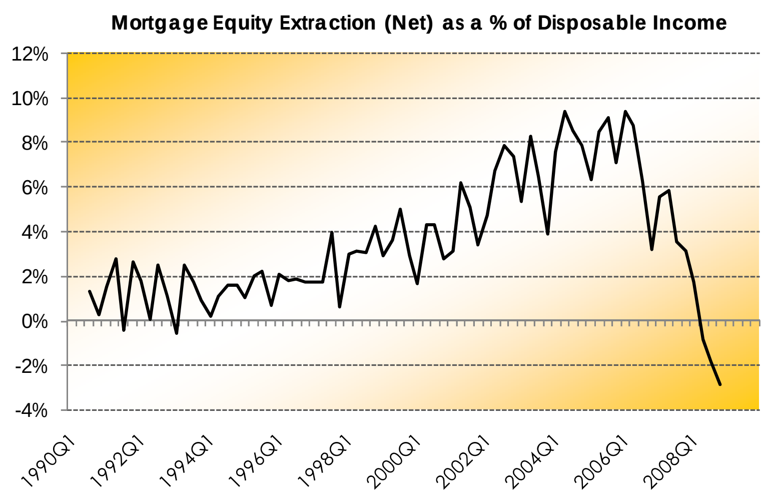


Source: Federal Reserve Board

The fallout from the subprime crisis also creates a challenging credit outlook as more and more people are forced to walk away from paying their mortgages and credit cards, making it more difficult for them to reestablish credit in the future. While the administration has put in place mortgage modification programs to help homeowners struggling to stay afloat, in practice these programs are helping only those already missing payments. Many homeowners are inquiring about modifications, but only those with the worst payment histories are receiving assistance. Homeowners who have yet to miss a payment, but know that possibility is just around the corner, are being told their histories are too good to quality for mortgage assistance. Some are being offered refinancing options, but with hefty fees and large principal payments attached. This pool of at-risk homeowners likely will increase if unemployment keeps rising, further diminishing the number of credit-worthy borrowers.

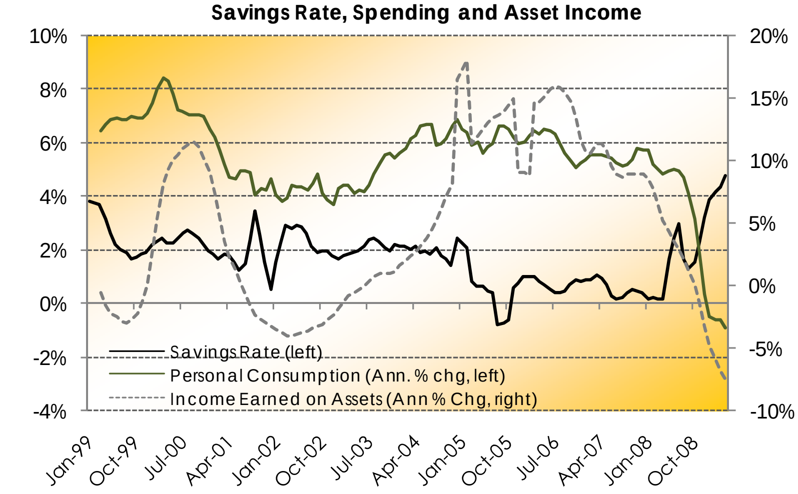
Driving Within the Limit

Prior to 2008, the American consumer felt comfortable spending almost all of his income. The cushion of ever-increasing home values built confidence that there would always be a credit line to tap. During the early- and mid-2000s, the rate of mortgage equity extraction reached almost 10% of disposable income. This was viewed as an additional, consistent source of income, but it is largely no longer available to fuel consumption. Now consumers must use their incomes as a gauge for spending, while paying back the debt that was incurred in the run up. Since the start of the credit crisis, household wealth has fallen by about 20%, and the share of household debt to income has risen. This presents another obstacle for the consumer in regaining his traction.



Updated estimates provided by Jim Kennedy of the mortgage system presented in "Estimates of Home Mortgage Originations, Repayments, and Debt On One-to-Four-Family Residences," Alan Greenspan and James Kennedy, Federal Reserve Board FEDS working paper no.

Going forward, lower expectations for real estate and financial asset appreciation will also force Americans to reconsider traditional income-based savings. The chart at right shows that the personal savings rate hovered near zero during the last several years, moving inversely with the rapid growth in wealth (represented by income earned on assets).



Source: Bureau of Economic Analysis. Data shown are 3 mo moving averages.

This trend reversed quickly as the equity markets slid. While in the long run the prospect of Americans saving more of their income is a positive, in the current environment the consequences have been dramatic. At the individual level, consumers are spending less and increasing their savings in an attempt to deleverage their personal balance sheets. At the macro level, this rapid and coordinated effort to save has dealt a knockout punch to spending, and thus growth. In April, the personal savings rate surged to 5.7%, the highest since 1995.

Without either a return to rapid asset price appreciation or access to credit, consumers will need to maintain a higher rate of income-based savings for quite some time. This will continue to take a bite out of consumption unless household income grows, which may take some time with so much slack in the labor markets. If in fact we do experience a strong economic recovery, other factors could again put a dent in disposable income. Higher oil and commodity prices would likely emerge with a global recovery, and so would the reappearance of inflation concerns. As the monetary expansion of the stimulus flows through the economy over the next several years, we believe inflation will indeed be a top concern, placing an even higher hurdle in front of the consumer.

Dangerous Curves Ahead

In our view, the outlook for the consumer will be precarious for the near term. Access to credit will be limited, and the wealth cushion has shrunk. We expect Americans to increase their income-based savings rate, which will reduce the amount of disposable income they have available for discretionary spending. Our concern at the moment is that the markets seem to be pricing in a best-case scenario for economic recovery. The recent equity market gains assume that the banks are out of the woods, government programs will go off without a hitch, consumer spending will resume its previous pace and that a V-shaped recovery is under way.

Despite our concerns, we believe that investors with a taste for some volatility could dip back into the equity markets and have a reasonable expectation of gains over a 3-5 year horizon. Investors who value risk aversion, like many of our clients, still may wish to sit out until the evidence of a recovery is more solid. Regardless, we expect that the consumer engine will not be running at full speed for some time. The massive process of deleveraging – at the individual, corporate and government levels – will take years. As this plays out, the markets will need to price in lower expectations for consumer spending and growth, potentially dampening equity market gains.

June 8, 2009

Katherine Krantz | Brock E. Moseley

Katherine Krantz
Chief Economic Strategist

Brock E. Moseley
Chief Investment Officer

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