Ladies and Gentlemen: Goldilocks Has Left the Building

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To the casual observer, the U.S. economy is humming along. Growth in real GDP in the second and third quarters averaged nearly 4% at an annual rate, well above the economy's long-run potential by most estimates. Core inflation has fallen within the 1-2% range preferred by policy makers at the Federal Reserve. After two successive reductions in the Fed Funds rate, the interest rate peak in the current expansion is still lower than the rate peak in any of the past six expansions. Based on these observations alone, the popular Goldilocks analogy1 for the performance of the economy appears as apt as ever.

Our analysis in this article, however, suggests a very different conclusion. We assess the current state of the economy by building on ideas discussed in our June 13th, 2007 article, "The Pareto Principle and the Goldilocks Economy." In that article, we argued that the impressive economic performance since the early 1990s rests on two pillars:

- The resilience of the consumer, as shown by over 15 years of continuous quarterly growth in real consumption.
- The absence of corporate pricing power, most evident in the fact that core inflation has remained within a narrow band of 1% to 3% since 1996.

We also cited risks to the first pillar, the consumer, as our primary concern. In this update to our outlook, we argue that these risks are becoming reality. We review the headwinds facing the consumer, focusing on the recent deterioration of key leading indicators. We outline the case for increasing the odds of recession in 2008. On a more positive note, we then suggest equities are better positioned than they were prior to past economic downturns, and caution against a bearish portfolio bet.

The Optimist's Dilemma

Just as your favorite sports team's odds of winning depend on the strength of their opponent, to assess the pessimistic view of the consumer, we consider the strength of the optimist's argument. Early in 2007, the optimist's argument featured the most fundamental driver of consumer spending: personal disposable income. Real disposable income increased 3.1% in 2006, implying plenty of income growth to fund increases in spending. After all, betting that the U.S. consumer will spend most or all of each additional dollar of income has been a successful bet.

For those skeptical of the income argument, optimists held another card in their back pockets: corporate earnings growth. After growing at double-digit annual rates from 2002 through 2005, operating earnings per share for the S&P 500 slowed but still increased 7.9% from Q1 2006 to Q1 2007. Earnings growth has boosted dividend income and employment income, too, through bonuses and other incentive-based compensation linked to corporate performance. A significant portion of this additional income is typically applied to consumer spending. Strong earnings have also underpinned asset prices, supporting consumption indirectly through wealth effects.

Based on real income gains and strong corporate profits, there seemed enough good news early

this year to counter the decline in housing activity and rising mortgage delinquencies. Our outlook at that time called for consumer spending to increase at a slow but steady pace. However, as events have unfolded, we believe the optimist's argument has eroded.

First, consider the two primary determinants of disposable income: employment growth and wage growth. Employment growth has fallen gradually to 1.2% from over 2% in early 2005. Since employment tends to be a lagging indicator, we take little solace from the fact that growth has not reached the lows of past recessions. In our view, it is more relevant that employment growth has never, in the past 50 years, dipped through 1% without the economy first falling into recession. With the annualized growth rate over the past six months at just 1.0%, and leading employment indicators such as the number of temporary workers suggesting further weakness, we expect employment growth to slip below 1% by the second quarter of next year.

Wage growth, as measured by the growth in average hourly earnings adjusted for inflation, has contracted by 0.1% year-to-date. Based on the latest surge in oil prices, which is not yet fully reflected in reported inflation figures, real wages are likely to remain stagnant for the remainder of the year. The latest data point for real wage growth shows a growth rate of 1.2% on an annual basis, but all of this growth occurred in the fourth quarter of 2006 and is becoming less relevant to current spending.

Second, consider the outlook for corporate profits. Chart 3 shows the growth in operating earnings per share for the S&P 500, an indication of corporate profitability. The final data point, which is based on S&P's estimate for third-quarter profit with 7% of the underlying data still unavailable, is especially discouraging. After slowing to single-digit growth rates in late 2006 and the first half of 2007, earnings in the third quarter are expected to fall on a year-over-year basis for the first time since the last recession. The earnings outlook is even worse if we consider the large write-offs that have occurred during the quarter, which are excluded from operating earnings. Reported earnings are expected to be down 28% from the third quarter of 2006, according to S&P's latest estimate.

Some analysts will likely dismiss an earnings dip as a temporary response to the credit squeeze that dominated news during the quarter. We believe it reflects a more fundamental weakening of business conditions, triggered by the Fed's 17 interest rate hikes between 2004 and 2006. Although the most obvious effect of the Fed's monetary tightening has been to pierce the housing bubble, we believe the effects are also evident in the trends illustrated in Charts 1, 2 and 3. Tighter policy is helping to slow key economic indicators with a lag of one to two years, just as we learned in Macroeconomics 101.

Weakening trends in employment, wage, and earnings growth demonstrate the challenges to being optimistic about U.S. consumers. These three sources of income and wealth, which had been supporting consumer spending, have shifted from tailwinds to headwinds. At the same time, headwinds created by the decline in housing and mortgage markets have persisted, and by most accounts intensified. The many effects of the housing bust, which require little elaboration after two years of media attention, include rising mortgage delinquencies, weaker household balance sheets due to falling house prices, an increasing payment burden as adjustable-rate mortgages (ARMs) reset higher, tighter credit conditions, and job losses in anything related to housing or housing finance.

Put differently, declining housing and mortgage markets appear to have fueled a vicious circle of mutually reinforcing trends, which has expanded to include broader indicators such as employment and corporate profits. Very recent data suggests that consumer confidence has also been drawn into the vicious circle, with the University of Michigan survey for November falling to

76.1, just barely above its 15-year low of 74.2. By our estimates, this is the most challenging environment for consumers since the current consumption boom began in the early 1990s.

The Critical Role of the Consumer

If our interpretation of recent developments is correct, then the economy's remaining bright spots are found mostly in the business sector. For example, non-residential construction has expanded at an impressive 14.7% annual rate during the first three quarters of 2007, while the annualized growth in exports, which have benefited from strong overseas demand, rose 8.5%. Businesses that benefit from foreigners traveling in the U.S. have also thrived, thanks to the decline in the dollar, which has increased the competitiveness of U.S. goods and services.

Despite these pockets of strength in the business sector, the economy's path is still inextricably linked to the consumer. According to the thesis of our June 13th commentary, the consumer's resilience explains the impressive growth achieved since the early 1990s. Consumer spending has accounted for about 70% of total economic output, while influencing portions of the remaining 30% indirectly. On this basis, we believe that if the consumer falters in 2008, the broad economy will follow.

The Burden of Proof

Many economists monitoring recent developments are actively warning of conditions that could tip the economy into recession. Most are also maintaining a central outlook for continued growth, albeit at a slow pace. For example, an October survey published by Consensus Forecasts suggests the consensus growth forecast for the US economy in 2008 is 2%. This is not surprising, since economists as a group rarely predict recessions.

Like most firms, we are downgrading our expectations in response to the deterioration of key indicators. After nearly two years of expecting slower growth than the consensus forecast, but not slow enough to end the expansion, in our view the burden of proof has shifted to the other side of the argument. We believe the odds have tilted slightly in favor f a recession within the next 18 months, with a probability of 50-60%. A recession would be characterized by a pause in consumption growth and a continuation of the vicious circle, as businesses reduce spending in response to weaker demand. Key indicators to watch include those highlighted in the charts above. We believe continued expansion would require stabilization and some reversal of the adverse trends in employment, real wage growth, and corporate earnings. Alternatively, a recession could be avoided through strong fiscal stimulus alongside further cuts in interest rates.

Bond Markets Return to Fair Value

Increasing economic uncertainty has dominated the capital markets in recent months, especially the Treasury market, where rates for all maturities have fallen over 100 basis points since the yield peak in June. Back in June, our analysis suggested Treasuries were undervalued with yields above 5%.

After sharp movements in the third and fourth quarters, the 10-year Treasury yield is now in the bottom half of the 4% to 5% range that we believe represents long-term fair value. For 2008, our economic outlook implies a greater probability of the 10-year Treasury yield falling below 4% than rising above 5%.

High yield bonds, which appeared expensive early in the year (see our April 30th, 2007 commentary, "Research for the Anxious Investor: Recession Risks and High Yield Bonds"), now

offer considerable cushion against a likely rise in defaults. Option-adjusted yield spreads for high yield bonds have increased from near historic lows of fewer than 3% to over 5% as of mid-November. In other words, bonds across the quality spectrum are more fairly valued than our analysis indicated earlier this year.

Don't Bet on the Bears

Equities also reflect greater economic uncertainty, with implied volatility for the S&P 500 averaging 22.6% from August through mid-November versus an average of 12.8% in 2006.[2] Rising volatility suggests stocks are vulnerable to a correction. In fact, after performing especially poorly so far in November, the S&P 500 closed at 1440.7 on Nov. 23rd, 8% below its peak and threatening to breach the 10% threshold for a correction for the first time in over four years. Further bouts of weakness are likely as long as the direction of the economy remains unclear. However, there are several reasons to remain optimistic that the market's downside will be limited.

First, the price-earnings multiple for the S&P 500 dipped below 20 in early 2005 and has remained between 17 and 20 since then. By comparison, the S&P 500 traded at over 30 times earnings at the peak of the technology boom in 1999 and before the last recession. Second, corporate balance sheets outside the financial sector appear relatively healthy, as shown by a bond default rate that is near historic lows. Third, the falling dollar is boosting foreign demand for U.S. goods and services and triggering currency translation gains on foreign profits. Fourth, revenue earned outside the U.S. for S&P 500 companies reached 44% of total revenues in 2006, up from 32% in 2001, and continues to rise. The implication is that U.S. equities are less sensitive than in past business cycles to developments confined to the U.S. With foreign economies generally stronger than the U.S., increasing globalization should cushion the effects of a decline in domestic demand.

Based on these observations, we do not recommend an aggressive timing bet against U.S. stocks. Although the most recent recession in 2000-2001 coincided with a severe bear market, it is not unusual for stocks to perform well during recessions. Analysis of equity performance since 1950 suggests that investors who sell stocks when the economy peaks are likely to regret their actions.

Over this period, the annualized return for the S&P 500 has exceeded 10% during five of the nine recessions that occurred. Stocks have performed especially strongly through mid-cycle slowdowns that fall short of a recession, which remains a distinct possibility for 2008.

In conclusion, we're finding the Goldilocks analogy increasingly cumbersome. Yes, we believe Goldilocks has left the building. At the same time, though, we're not advocating a bet on the bears.

Footnotes

1 The economy is not expanding so fast that it causes inflation, and not slowing towards recession. In other words, it is neither too hot, nor too cold, but just right.

2 According to data for the CBOE Volatility Index (VIX), provided by the Chicago Board Options Exchange (CBOE).