Financial Outlook for 2010

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The S&P 500 ended down 38.5 percent in 2008, marking its third-worst year ever for stocks, behind only 1931 and 1937 during the Great Depression. Fortunately, the market has regained some of its luster by rising over 60 percent from the lows experienced this past March (see **Figure 1**). In fact, the Dow Jones Index passed the psychologically important threshold of 10,000 in mid-October. However, there is a very long way to go to recover the $11 trillion in household net worth that disappeared in 2008—$5.1 trillion, or 9 percent of it, in the last three months of the year, the most ever in a single quarter in the fifty-seven-year history of record-keeping by the central bank. To put the total in perspective, the single-year decline equals the combined annual output of Germany, Japan, and the United Kingdom. Recently the trend has reversed and net worth has been rising again, albeit slowly, as both home prices and stock prices are recovering. But at best, only a third of the damage has been repaired so far. Does this recent performance plus the "green shoots" we are observing in the economy mean the markets are back to normal? Or is there something else to fear?

Economic Fundamentals

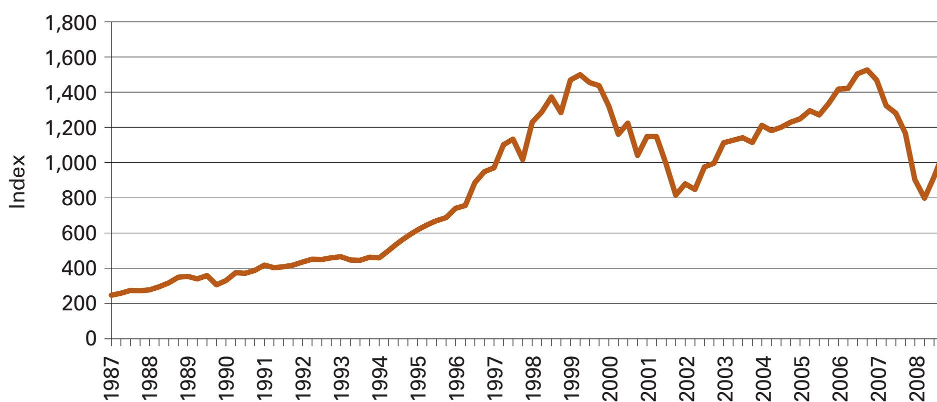
Stock prices are a leading economic indicator: investors buy stocks anticipating the real economy will pick up in the near future. There are many positive reasons to believe this story now:

- In October, the Conference Board reported that their index of Leading Economic Indicators increased for the sixth straight month.
- The massive infusions of government stimulus spending in the United States and around the world have finally taken effect.
- Major banks, although still weak, have weathered the storm and are slowly rebuilding their balance sheets.
- The Federal Reserve is continuing to keep interest rates low to fuel the economy and has announced a Fed Funds target rate of 0.05 percent to 0.25 percent for an "extended period."
- The decline in residential housing prices appears to be over in most parts of the country.
- The weak dollar will help companies grow their exports.

However, there are negative issues that could make the market recovery short-lived:

- U.S. commercial real estate, valued at some $3.5 trillion, has experienced a 39 percent decline in prices on average from the peak in late 2007, according to the MIT Center for Real Estate. This drop greatly exceeds the 27 percent commercial real estate decline associated with the savings and loan (S&L) crisis of the late 1980s and early 1990s, which prompted the government to establish the Resolution Trust Corporation to seize and auction off hundreds of S&Ls around the country.
- Oil prices have been hovering around $80 a barrel, threatening business profit margins and consumer budgets.
- In spite of the recent upturn, industrial output is at 70 percent of capacity, the lowest level in twenty years and 10 percentage points behind its average.
- The massive government deficits may lead to fears of accelerating inflation. The U.S. Treasury is adding $4 billion a day to its obligations.
- Although foreigners currently hold 43 percent of the publicly held Treasury debt, they are starting to show resistance in continuing to fund our deficits. Foreign holders reduced their purchases of U.S. debt 40 percent from the $159 billion in the first quarter of 2009 to $101 billion in the second quarter. Clearly, a weak dollar and low interest rates are not encouraging them to buy more. Most importantly, the Fed also announced in October it will be ending its quantitative easing program, which permits the Fed to buy U.S. debt to help finance our massive deficits. In the second quarter, such purchases accounted for nearly half ($164

Figure 1: S&P 500, December 1987 to September 2009



Note: Hash marks indicate last day of each quarter.
Source: IBRC, using Standard & Poor's data

billion out of $339 billion) of all Treasury purchases.
- The United States still has not fully addressed the huge funding gap in Social Security and Medicare payments for the 78 million baby boomers set to retire over the next seventeen years. The Government Accountability Office (GAO) has estimated the unfunded obligations of these two programs to be $41 trillion over the next seventy-five years. This present value shortfall is equivalent to $352,000 per U.S. household.

If the positives outweigh the negatives, we may experience a "V" shaped recession and we will recover quickly from here. If it is the other way around, we will have a "W" recovery with a painful drop in security prices, perhaps below the March lows, before economic recovery kicks in. Such was the pattern during the Great Depression when security prices whipsawed up and down from 1928 to 1941. True pessimists believe the negatives will predominate and the recession will be an "L" shape with lingering performance at the bottom for a number of years. This was the recent history in Japan. We are betting on a "U" shaped recovery, suggesting it will take more time than normal to fully recover from the downturn, perhaps three to five years. It is going to take time to gradually pay off debt, to rebuild corporate and consumer balance sheets, and to get back to full employment and consumer confidence.

Forecast

Rates: Interest rates will remain low as the Federal Reserve continues to fight the downturn and stimulate housing. For 2010, short-term rates will stay below 1 percent and long-term rates will be below 4 percent. Mortgage rates will average 5 percent to 6 percent. Toward the end of the year, a key concern could be inflationary pressures. To combat these pressures, the Fed would need to raise rates. We will see moderated rate increases toward the end of 2010.

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Profits: Business profits for most sectors will hold up because of the massive cost-cutting (including labor costs) that has been undertaken. Unit labor costs are falling as layoffs raise productivity, working hours are reduced, and compensation growth is slowed. In financial services, banks will need to write off more bad loans, especially for residential and commercial real estate, and many smaller banks will disappear. As of October 23, there have been 106 bank closures and fourteen credit union failures for the year. These numbers will grow.

Now that the Car Allowance Rebate System (CARS) program has ended, the domestic auto sector will be weak as Ford and the government-run companies re-tool to produce smaller, fuel-efficient vehicles. Longer term, the move to hybrid and electric vehicles could spur growth in this sector, as evidenced by the $2.4 billion Electric Drive Battery and Component Manufacturing Initiative contained in the stimulus package approved by Congress.

The retail sector will remain weak for the year and the Christmas season as consumers reduce spending and save more to pay off debts. In the past year, households have started saving 5 percent of their income, up from 0 percent in previous years. Since approximately two-thirds of economic activity stems from consumer spending, the economy will grow faster if the savings rate drops and consumer spending picks up.

Stock Market: We believe the big gains in the stock market have already occurred. As the economic news gradually brightens and employment grows, the market should continue to rise, albeit more slowly. There is a lot of money on the sidelines, including households' increased savings, which will be committed to the markets as fear subsides and confidence rises. Lower stock market values have encouraged the strong companies to once again engage in merger and acquisition activity, further spurring stock prices. As always, prudent investing requires an active approach to ensure proper diversification, including substantial foreign investments, and to moderate risk levels.

Summary

The U.S. economy has survived the most brutal downturn since the Great Depression. There are signs that the worst is behind us. Unfortunately, it will take three to five years to restore the luster to the economy and once again reach full employment.