

By Christopher E. Grant

The Baskin Robbins Recession

One Dip or Two?

For those celebrating July as National Ice Cream Month, the choice of one dip or two is easy – two, of course. For economists and investors dueling over whether or not the “recovery” is headed for a “double-dip” recession, the decision is considerably more difficult and the outcome potentially far more expensive.

Double-Dip

Rarely have the outlooks of the soothsayers divided into such polar extremes. For example, Paul Krugman, Nobel Laureate and professor of economics at Princeton University recently issued the following dire warning: “The threat is not merely the dreaded ‘double-dip.’ **If the leaders of the developed world hold to pledges they made at the G-20 summit in Toronto and cut government spending, we face nothing less than a ‘third depression’** – perhaps not as singularly devastating as the Great Depression, which ripped the U.S. economy in half, but comparable to the Long Depression that followed the Panic of 1873, a grinding period of chronic social need and dissension.”

What Dip?

On the opposite side of this high-stakes trade is renowned hedge-fund manager, John Paulson, perhaps best known for his mega winning bet against the housing market and the collateralized debt obligations backing it. In Paulson’s opinion, **“We’re in the middle of a sustained recovery in the U.S. with the risk of a double-dip less than 10 percent. It’s the best time to buy a house in America.”** While hedge fund managers are known for changing their minds quickly, we know that,

as of March 31st, Paulson was putting his money where his mouth was as SEC filings showed a nearly \$3 billion position in Bank of America common stock and an additional \$2 billion in Citigroup shares.

Joining Paulson is eight-time MarketWatch Forecaster of the Month, Jim O’Sullivan, chief economist for MF Global. **While O’Sullivan has pared back his full-year 2010 forecast for U.S. growth in response to the turmoil in Europe and the selloff in the U.S. stock markets, he still sees a “self-sustaining, jobs-creating recovery under way.”** In fact, he envisions the economy “growing at a 3.7% pace in 2011, much better than the 3% growth that the rest of the profession is predicting.”

The Choir Sings

As one might expect, the government policy wonks are united in their optimism. Fed Chairman Ben Bernanke has repeatedly stated that he doesn’t believe the U.S. economy will undergo a double-dip recession. At a June 8 dinner, the Chairman stated, “My best guess is we’ll have a continued recovery (but) it won’t feel terrific.” And, according to a summary of the June 22-23 Federal Open Market Committee (FOMC) meeting, none of the 17 top Fed policymakers is forecasting a double-dip.

When asked if Americans will experience another downturn once the federal help to the economy starts tapering out, Treasury Secretary Timothy Geithner responded, “The reason I’m not worried about that is because I think that we’re going to be careful not to put on the brakes before we’re more confident you’ve got a private sector-led recovery in place that’s going to be able to withstand the effects of the restraint.” Even Dominique Strauss-Kahn, the head of the International Monetary Fund expressed

confidence that “the global economic recovery will continue in an uneven fashion without a double-dip.” **At least on this front, we know the policymakers are all reading from the same playbook.**

However, long experience has demonstrated that wishing it were so doesn't make it so. **As concluded by mutual fund-manager and economist John P. Hussman, Ph.D., “the best argument against this outcome is that it is unthinkable.** Unfortunately, once policy makers have squandered public confidence, the market does not care whether the outcomes it produces are unthinkable. Unthinkability is not evidence.” So let's carefully examine the evidence.

The Economy's Four Horsemen

As we outlined back in our Winter '09 newsletter, three crucial drivers that will determine the performance of the economy, and ultimately the markets, are jobs, housing and consumer spending. Out of necessity, we must now add the fourth broad category of sovereign debt which, in the case of the U.S., includes both the Federal and individual state governments.

Jobs Statistics vs. Real People Statistics

The July 2nd unemployment report was no cause for a three-day Independence Day celebration. While the decline of 125,000 workers was no surprise - expectations were already low with a flood of temporary census workers being laid off – the fact that private job creation for the two prior months totaled only 116,000 was dismal. Remember that it takes roughly 125,000 new jobs per month just to keep up with population growth. In a recent article, author/investment advisor John Mauldin pointed out several details about the Bureau of Labor Statistics' (BLS) jobs-counting methodology that few headline readers consider. First, the headline number

we see is from the Establishment Survey where existing businesses are called to count the number of employees. The result is then adjusted for the BLS' birth/death assessment, an estimate of new businesses that have either been created or have “died” within the last month. **For the most recent two months, the BLS' guesstimate assumed that 362,000 jobs were created including 65,000 construction jobs and 158,000 in the hospitality and leisure industry. Really?** I won't quibble over the need for smoothing and seasonally adjusting statistics over the long run, but the numbers behind the numbers aren't pretty in the short run.

What I will object to, though, is all the chest pounding and pontificating over the fractional decline in the unemployment number from 9.7% to 9.5%. In fact, the official statistic dropped only because the number of people counted as being in the labor force declined. If you haven't looked for work during the last four weeks, you are conveniently dropped from the rolls and not counted among the unemployed. Add back those who are so discouraged that they quit looking and the unemployment number would have risen to 9.9%.

Again, the numbers behind the numbers reflect the real pain. Nearly one million people have dropped out of the labor market in the past two months. How challenging is the task at hand? **The economy must add 13 million private-sector jobs (over 300,000/month for 42 consecutive months) by the end of 2013 to bring unemployment down to 6%.** And the FOMC just raised their unemployment rate forecast for 2012 to a range of 7.1-7.5%.

The Roof Caving In On Housing

The housing landscape can't help but mirror the employment/unemployment picture. Let's examine the evidence courtesy of

David A. Rosenberg, Chief Economist at Gluskin/Sheff. Roughly two-thirds or 56 million American homeowners have a mortgage. Estimates are that 14% of those 56 million mortgages are in arrears or in the foreclosure process. **Translation: Eight million Americans have stopped paying their mortgage.** Further estimates suggest that over 90% of the late-paying/non-paying debtors will never get back to being current – some 7.2 million mortgages will inevitably go into foreclosure.

Even the loan modification programs are not working, with half re-defaulting within 12 months even when monthly payments have been cut by 50%. **Try explaining why more than 91,000 homeowners cancelled their loan modifications last month while only 38,728 signed onto the program.**

And house values? **Currently, over 17% of homeowners are “upside down” on their mortgage with the total negative net equity position of homeowners in default or near-default estimated to be as much as \$2 trillion.** Another 10% decline in home prices could push the “upside down” share up to a staggering 27%.

On the building front, the housing sector is in the dumps, back where it was a year ago. After a 15% drop in May, housing starts fell another 5% in June, the lowest level in eight months. On a comparative basis, starts are down 5.8% from the June 2009 levels and off 75% from their peak in 2006. Even with the 30-year fixed-rate mortgage averaging 4.58%, the lowest interest rate since Freddie Mac started keeping track in 1971, applications for home purchases fell 15% in June, dropping to a level not seen since 1996.

But we’ve learned our lesson, right? **According to the Wall Street Journal, Fannie Mae is offering financing to first-time homebuyers who only have a \$1,000 down-payment, and several banks are offering clients home-equity lines of**

credit of up to \$2.5 million. With 90 banks having failed so far this year and crisis culprits Fannie and Freddie nowhere to be found in the newly inked 2,400-page Dodd-Frank Wall Street Reform and Consumer Protection Act, Rosenberg’s conclusion is spot on, “surreal.”

Frugality Is In

Among the most often repeated statistics is that “consumers represent 70% of the economy.” Whether this number is a bit high or a bit low, there is no doubt that consumer spending must be an integral part of any sustainable recovery. So where are consumers headed? In a recently released Pew Research Center study that surveyed how households are changing their spending and saving behavior, nearly half the adults polled intend to boost their savings. One-third will cut their discretionary budget, 30% plan to cut their debt loads and 70% of the population is going to be buying “less expensive brands.”

The “expectations” component of the Conference Board Consumer Confidence Survey showed similar results. **Predictably, plans to buy a new house were near all-time lows. No surprise then, plans to purchase a major appliance fell to the lowest level since January 1995. And new car buying intentions were down to a record low. Even vacation and travel intentions slipped to cycle lows.** Most revealing was the Pew study conclusion that “the new, more frugal lifestyles may outlast the recession and its immediate aftermath.” It would appear that the road to recovery won’t be fueled by home equity lines of credit or ever-growing credit card balances.

The Credit Bubble

A prescient chronology of the inflating of the credit bubble is presented by Douglas C. Noland, senior portfolio manager of Federated’s Prudent Bear funds who

publishes a weekly column entitled “Credit Bubble Bulletin.” Noland argues that, despite a serial boom/bust cycle that began with the decision by the Fed and Alan Greenspan to slash interest rates and re-liquefy the credit markets after the '87 stock market crash, **the 1998 Fed-engineered bailout of hedge fund Long-Term Capital Management was different in that it ushered in the “Too big to fail” mindset.**

With the perception that policymakers would ultimately stand behind risk-taking, enormous amounts of credit entered the market leading first to the dot.com bubble followed by the mortgage finance/Wall Street finance bubble. When it burst in '08, it took the world's economy with it, necessitating a coordinated global policy response that Noland calls the “Big Kahuna” of bubbles, government debt.

As “evidence,” Noland points to the federal debt which has increased \$3.3 trillion in the past seven quarters, an unprecedented 49% increase in 21 months. At the same time, the Fed has grown its balance sheet by \$1.3 trillion, mostly through the purchase of mortgage-backed securities. Similar government leveraging was repeated around the globe with the tacit understanding that policymakers couldn't let sovereign debts fail. Then Greece happened.

When the market determined that Greece's deficit was unmanageable, the cost of its two-year debt soared from 2% in November '09 to 18% in May '10. Contagion fears quickly spread to Portugal, Italy, Spain and Ireland and there was even talk of a Euro collapse. Even though the International Monetary Fund and the European Central Bank have stepped in (Germany, the largest European contributor at \$29 billion and surprise! the U.S. as the largest single contributor at \$39 billion) with a massive loan/guarantee program, the marketplace has a different view of this structural debt

issue. **And if you think the U.S. is immune, consider that it now costs more to buy credit default protection on the state of California or Illinois than it does Portugal.**

Governments are no different from individuals. There is a limit to how much debt can be piled on. History has shown (as detailed in Reinhart and Rogoff's outstanding book, *This Time is Different*) that the limit is not defined by a fixed amount or even a predetermined percentage of GNP. Rather, it is dependent on a fleeting thing called lender confidence. Without massive assistance, lenders would clearly have no confidence in Portugal, Italy, Greece, Spain, and Ireland. So far, they have confidence in the U.S. Where that confidence ends, nobody knows.

What we do know is that **the U.S. will not be able to borrow the \$15 Trillion, 10-year shortfall projected by the current Federal Budget Agenda.** The alternatives to reducing structural debt are plain though hardly simple, cut spending, raise taxes, hold spending flat and grow out of the problem – or some combination of all three. To avoid a crisis of confidence, Congress could start by at least negotiating and passing a budget.

CQ vs. IQ

Particularly after weighing all the current “evidence,” it is wise to step back from “the numbers” and take a look at the greater landscape. Such is the sage advice offered by renowned bond guru and Pimco co-Chief Investment Officer, Bill Gross. Back in his November '08 Investment Outlook, Gross spoke to the necessity for a CQ – Common Sense Quotient – in addition to an IQ in order to succeed in investing. **As a gourmet recipe for success, he recommended a blend of one teaspoon of intelligence and a tablespoon of common sense.** He reminded that “prices are a delicate

combination of mathematical value and human nature – something that quantitative scholars and practitioners rejected to their eventual ruin in their pursuit of ‘efficient’ markets. **Whatever the future holds, remember that a tablespoon is larger than a teaspoon, and that CQ beats IQ most of the time in the investment world.”**

Invest for the World of Tomorrow

While our IQ says that the statistics from our four economic “horsemen” are less than appetizing, **our CQ keeps us on full alert, since investment opportunities invariably arise from such troubled times.** Among the most forward-looking investment professionals is Mohamed El-Erian, chief executive and the other co-chief investment officer of Pacific Investment Management Co., LLC. (PIMCO) Rather than dwell on the

numerous financial problems threatening the investment world, El-Erian sees today as “a very exciting time for investing. **When the world is changing and there are realignments, it means the nature of risks and returns change. You have to invest for the world of tomorrow, not for the world of today.”**

Our current strategy at GGM is not unlike El-Erian’s recommended two list methodology. On the first, write down what you believe to be true. That list should form the basis of your investments. The second list is what you don’t know, and that’s where you keep your options open. As Mr. El-Erian advises, “You keep more dry powder because you’re not sure of all the outcomes.” We are constantly searching out the investments of tomorrow with plenty of dry powder.

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