

*By Stephen F. Oakes II*

## **The Jekyll Market and Hyde Economy**

*"The greatest danger in low volatility environments is that investors tend to become increasingly aggressive." –Geoff Considine*

The relentless fourth quarter ascent of the equity markets (Dow, +8.1%) reflected rediscovered investor confidence that the credit crisis that brought the financial system to the brink of collapse was now safely behind us. By year-end, the Dow Jones Industrial Average posted a 22.7% gain, the benchmark S&P 500 climbed 26.5% and the NASDAQ soared 45.4%, led by a resurgent technology sector which topped all categories, up 63.3%. Overseas, the "developed markets," represented by the EAFE Index, gained 26.9%, while emerging markets rose 68.8%, further reflecting investors' rush to risk.

The Lehman Aggregate Bond Index, a broad-based index of investment grade corporate bonds, produced a healthy 7.2% 12-month gain, but was again upstaged by the continuing preference for higher risk, as the high-yield "junk" bond category nearly doubled equity performance, gaining a whopping 46.6%. Those not willing to shift to riskier categories virtually tread water in their money market accounts which yielded a paltry 0.2%.

Investors also passed on three-month Treasuries, opting out of a 0.06% yield that was "manipulated" down by the Fed from what was already a "floor grazing" 0.14% third-quarter level. Meanwhile, the more "market driven" 10-year Treasury yield of 3.85% trended higher than last quarter's 3.3% rate and the 2.5% level at '08 year-end. This increase in rates helped explain why the average return of long-term Treasury bond mutual funds took a -17.3% beating, last year's worst performing category. What is notable is that the widening gap between short-term rates and longer-term yields seem to signal a fear of eventual inflation caused by a burgeoning budget deficit.

Economic pressures are further signaled by the decline in state tax revenues, which have plummeted 10.7% year-over-year. Today, 36 states are struggling to close budget shortfalls, some with gaps as large as 20 percent or more. With federal government stimulus dollars scheduled to soon dry up, states will be faced with financing limits in a more expensive municipal bond market, and may have no choice but to further cut services and payrolls.

On the employment front, while weekly jobless claims of 432,000 at year-end were a modest improvement from the prior quarter-end level of 516,000, "less bad" is still far from "good." Further, while the reported number of unemployed (actively seeking a job), stands at 5 million, the broader measure that includes both discouraged workers who have ceased "looking" as well as those "underemployed" (part-time looking for full-time), balloons the official unemployment rate from an already dismal 10% to a staggering 17.3%, a truer picture of the job market.

With household debt averaging 57% of GDP over the last 55 years, now at 98.6%, and an economy roughly 70% consumer spending driven, the question we have to ask ourselves is whether or not it is realistic to believe that a deleveraging consumer, one-fourth of whom are strapped with an "underwater mortgage," are going to become the fuel needed for a robust economic recovery in 2010. Are the economic data indicative of an impending "double-dip" recession or will the market find a new catalyst to hang its hat on? Such is the predicament of the "Jekyll Market and Hyde Economy."