THE Weekly View

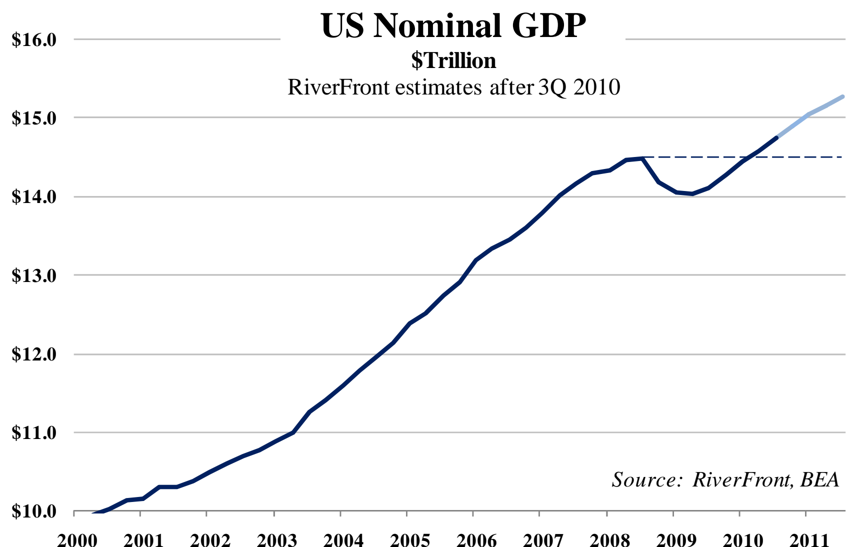
RIVERFRONT INVESTMENT GROUP

Asset Management • Investment Strategy • Advice

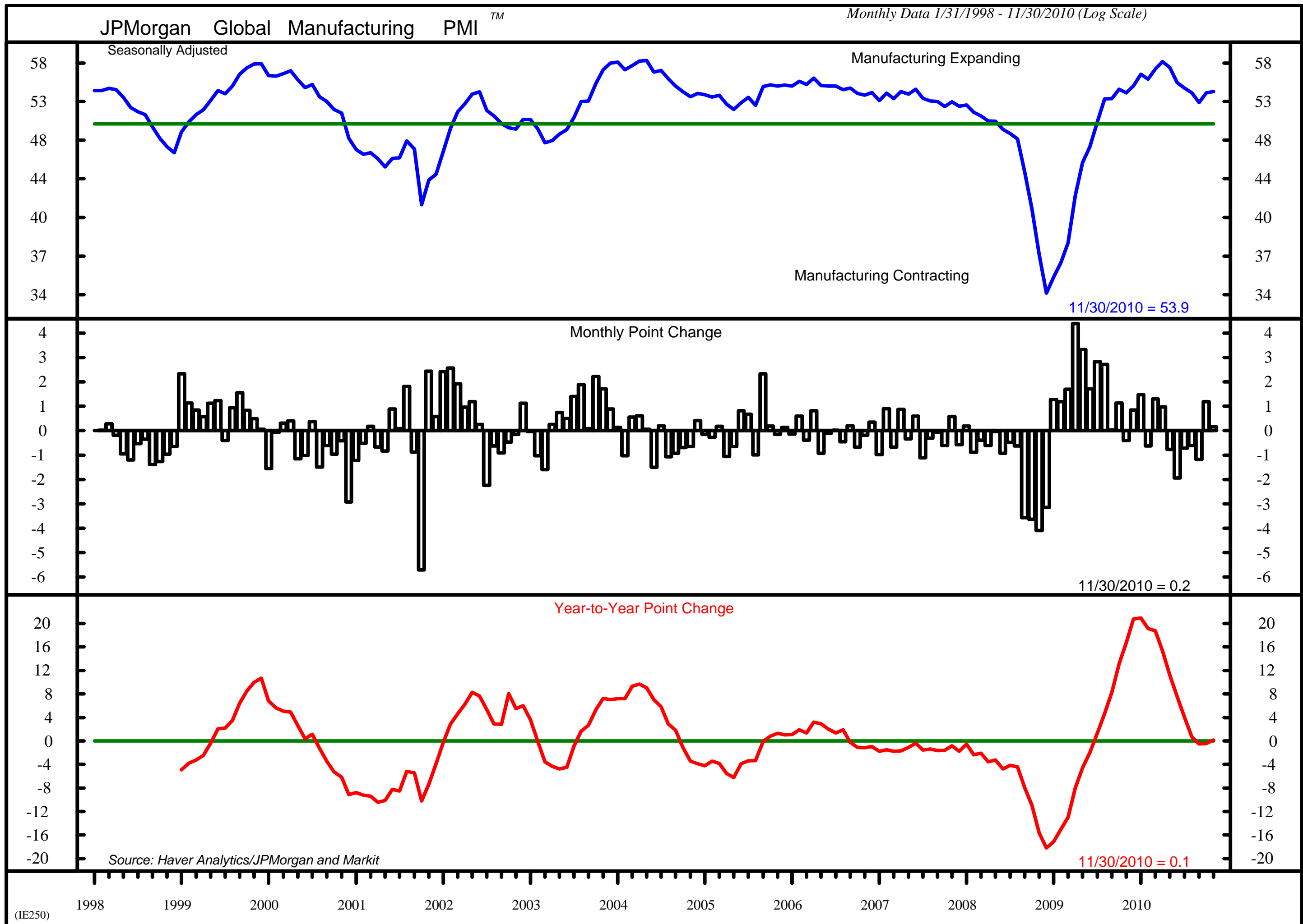
Rod Smyth • Bill Ryder, CFA, CMT • Ken Liu December 6, 2010

Despite a 'Long and Winding' Recovery, Our Outlook for 2011 is Positive

- A tepid November employment report last Friday underscores the long economic recovery ahead. While the economy continues to generate positive job growth, private sector employment has only increased by an average 107,000 jobs a month over the last three months. This has been insufficient to lower the unemployment rate, which rose two-tenths of a percentage point to 9.8%. High unemployment can be partially explained by tight cost controls, which combined with global economic growth of 3.3%, have led to record corporate profits. This, despite recent worries such as heightened tensions on the Korean peninsula (which we view as instigated largely by the North's new leadership and current food crisis), tighter monetary policy in China, and escalating European credit woes, this time led by Ireland. Despite these headwinds, we are bullish and expect another year of growth for both the US and world economies. Thus we expect global earnings to rise and current valuations to support higher stock prices and higher investment-grade bond yields around the world during 2011.
- With no current resolution regarding US fiscal policy, especially regarding tax cut extensions and unemployment insurance, markets have proven remarkably buoyant. We believe this is because there is a growing expectation for some sort of tax deal and because of central banks' willingness to encourage risk taking. This would include the European Central Bank buying Portuguese, Irish, Greek and Spanish debt, as well as the Federal Reserve and US taxpayers keeping Fannie Mae and Freddie Mac afloat. Our economic view remains that the developed world's 'new normal' entails slow growth, until households are sufficiently deleveraged, government deficits are below 3% of GDP, and there is enough confidence in job security and/or business formation to steadily bring the economies to a level of employment that would actually necessitate interest rate *hikes*.
- Global manufacturing purchasing manager indexes (PMIs) remained firmly in expansionary territory in November, with the global average ticking up to 53.9 (see Weekly Chart), while the US PMI fell slightly to a still-respectable 56.6 (the same as Germany's). Moreover, the US' non-manufacturing PMI, which represents the bulk of the economy, rose 0.7 points to 55.0, led by employment and new export orders. This suggests to us that the global *real* economy continues to expand. While it may not seem as if the US is doing much of the pulling, or that global growth is fast enough to suit everyone, global economic growth is critical to start resolving economic and financial imbalances, in our view. Additionally, as the chart on the right shows, US GDP has now comfortably passed the $14.5 trillion peak of 2008 and is likely to pass $15 trillion in 2011. We believe markets recognize that although growth is likely to be slower than in recent decades (and in some regions more than others), the overall direction is still positive. Economic growth can be stronger in an environment of cooperation and trade, but lower in a world ruled by mistrust and protectionism.



The Weekly Chart: Global economy in expansion phase



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There is a difference between 'recovery' and 'expansion' in our minds. Recovery is the process of regaining the output lost during a recession. Expansion is the beginning of a new cycle. Based on the two charts in this weekly, it is clear to us that a new expansion has begun. We believe this is bullish, since expansions usually last several years. According to ISI, "The past nine economic upswings (recovery and expansion) have lasted 62 months on average. We are now in the 17th month of the economic upswing. The last upswing (2002 – 2007) was 73 months, i.e. slightly longer than average." Thus, based on history, the economy could expand until around 2014. Expansions usually end when excesses (growth/inflation/asset bubbles) result in government intervention to deliberately cause the economy to slow. This seems a long way off. With so much excess capacity and subpar growth, we believe the greatest risk to this expansion is that the excesses of the last cycle – housing and debt – return to create a crisis of confidence. We currently rate this risk as low, but not negligible. In the chart above, the top panel is above 50 (the dotted line), indicating expansion. In the bottom panel the year-to-year change is zero, indicating that the pace of the expansion is stable, i.e. neither accelerating nor decelerating.

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