July 2011 Commentary

Normally I do not write commentary between quarters but I think the events of this past week and month are particularly noteworthy to provide some brief comments.

Last week the market was focused on the narrowing window of opportunity for Congress to pass a bill that will raise the Federal debt ceiling and address the deficit before the default deadline of August 2nd hits. It's fair to say that Washington DC has shown ineptitude on a grand scale on the part of politicians on both sides of the aisle. The deficit problem is so big that it requires both parties to move away from their core beliefs. The leadership of both sides of the aisle and in the White House are showing themselves incapable (so far) of compromise to get a deal done that has any teeth to it. If a deal gets done, there will no doubt be some relief rally in the stock market. If it lasts is another matter. We are at a major crossroads in our nation's government spending history, and a dramatic turn in a different direction is not going to be easy for many career politicians who have only known an era of writing blank checks for spending. Those days are gone. There will be another round of hell to pay in the 2012 election for many of them that have been sitting at the table for far too long.

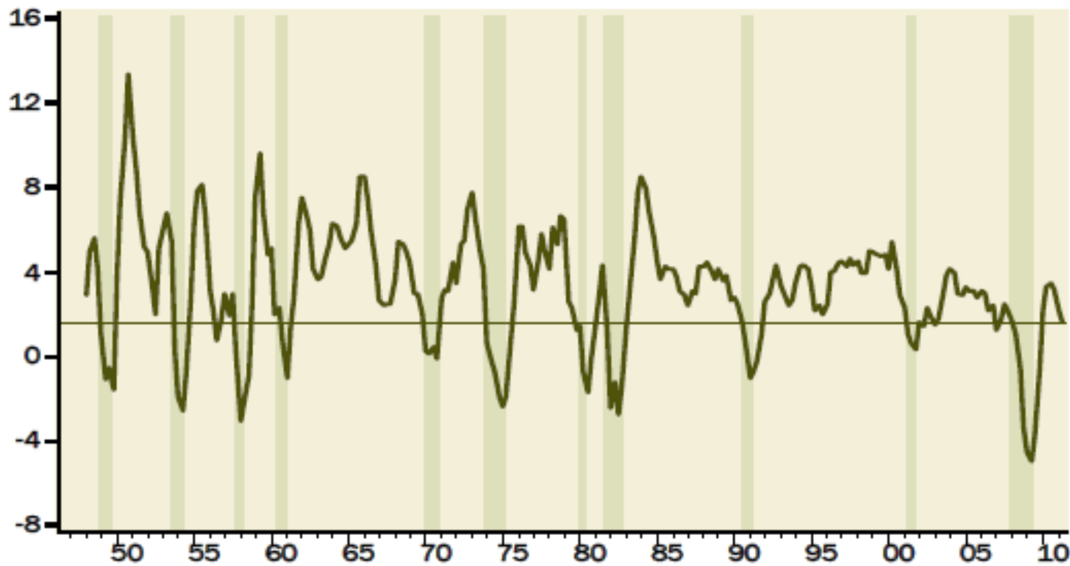
While the debt/deficit drama dominated the headlines all week and was a key factor in the stock market's sizable decline, the real story is the putrid economic data that came out last week. The initial second quarter 2011 (April-June) real GDP reading was 1.3%, well below the Street expectation of 1.8%, which had been marked down from 3.3% just since May. Worse yet, first quarter 2011 (Jan-March) real GDP, most recently calculated at 1.9%, was significantly marked down to 0.4%, or at a barely breathing level. Since the end of the recession was declared in June 2009, the quarterly real GDP profile for the US has been as follows: 1.7, 3.8, 3.9, 3.8, 2.5, 2.3, 0.4 and now 1.3%. If first quarter 2011 was 0.4% in the latest revision, does anyone think second quarter economic activity was better in the second quarter?

On the next page, the chart from David Rosenberg of Gluskin Sheff shows rolling year-over-year (YoY) real GDP growth going back to the mid-1940's. The shaded vertical bars in the graph are recessions. As you can see, the YoY real GDP decline in the last recession was the worst of the past 60+ years at near -5.0%. Equally important, note that the latest recovery is also the worst of the past 60+ years. Normally, the bigger the drop, the economy experiences a bigger snapback effect in the ensuing recovery. From the mid 40's to early 1980's, following a recession, the YoY real GDP growth rates often exceeded 8%. Since 1990, the size of the recoveries has been less and less and our most recent "recovery" is the weakest of them all. Historically, when real GDP growth dips below 2.0% on YoY basis, we usually have a recession (the horizontal line on the chart).

For a government that has all but tapped out its ability to borrow and spend, these most recent data points are a sobering reality to the difficult tasks ahead of us. Government borrowing and policy uncertainty are creating a poor backdrop to the economy and its ability to grow. More companies are expressing this view as they report uneven demand trends and customers unwilling to commit. Forget about better employment data until this veil of uncertainty has been lifted. Keep an eye out for the July ISM and labor reports and the markets reaction to them this coming week.

CHART 3: YOY GDP GROWTH NOW BELOW 1.6% — PAST THE POINT OF NO RETURN?

United States: Real Gross Domestic Product
(year-over-year percent change)



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

Beyond the Wash DC fiasco, the market would have been down given the slowing economic data. Second quarter earnings season, which started off decently, also made a turn for the worse as more companies tied to industrial activity, corporate and consumer spending have commented on weak and uneven demand trends and many gave unenthusiastic commentary about 3rd quarter trends. UPS, which has the pulse of US economic activity, was notably less upbeat on their conference call about what the second half of the year has in store.

Last week, the US market suffered its worst week in over a year with the broad market indices down 4% or more. Through July 31st, the S&P 500 has returned 3.9% and the Russell 2000 Index has returned 2.4% year to date. The Barclays Aggregate Bond Index, a measure of the broad fixed income market, has returned 4.4% year to date. The 10-year US Treasury yield is at 2.80% despite the debt/deficit mess. The low yield level is more of an indication of weak economic growth and low inflation expectations. If we had a healthy recovery and economy, it is likely that the 10-year Treasury yield would be north of 4.0% by now and the stock market considerably higher. But, big macro overhangs exist and likely will for some time to come.

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