

# THE Asset Allocation ADVISOR

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## Economic Outlook

Output, consumption, and employment in the United States are declining as the Great Recession enters its seventeenth month, making this the longest recession since World War II. Although export growth in the first half of 2008 managed to support output and employment even after personal consumption had started to decline, the global decline in economic activity has reduced export growth and brought changes in U.S. economic output in line with contractions in consumption. Reduced personal consumption compounded by falling exports, a moribund housing market, and a lack of business investment have led to large reductions in employment. Nearly six million jobs have been eliminated since the start of the recession.

We expect the contraction to continue well beyond mid-year 2009. Nouriel Roubini's recent forecast of a 36 month recession is the most plausible forecast we have heard to date. We do not anticipate that the stimulus package just passed by Congress will be able to offset the compounding negative effects of multiple factors depressing consumption and output. Even a full restoration of credit and global capital flows will not be sufficient to restore output to pre-recession levels, because credit availability will not address the fundamental cause of slack consumption demand—an almost unprecedented decline in household net worth and a reduction in consumer demand for goods and services as they take steps to restore their net worth.

It is worth noting that Chairman Bernanke's testimony to the Senate Banking committee on February 24<sup>th</sup> stated that the Fed's economic outlook was "subject to considerable uncertainty" and that "downside risks probably outweigh those on the upside." In particular, Bernanke noted the risk of an "adverse feedback loop, in which weakening economic and financial conditions become mutually reinforcing." He continued:

"To break the adverse feedback loop, it is essential that we continue to complement fiscal stimulus with strong government action to stabilize financial institutions and financial markets. If actions taken by the Administration, the Congress, and the Federal Reserve are successful in restoring some measure of financial stability—and *only if that is the case*, in my view—there is a reasonable prospect that the current recession will end in 2009 and that 2010 will be a year of recovery (emphasis added).

The only shortcoming in the Fed Chairman's cautious view of the prospects of a recovery is that governmental actions are unlikely to inspire consumers to consume at pre-recession levels, because consumers have neither the wealth nor the income nor the inclination to support such spending, even if they have access to credit. In economic terms, the consumer's marginal propensity to consume has been reduced by the current financial and economic crisis, and it is unlikely that governmental action will succeed in changing that propensity. We are becoming a nation of savers rather than consumers, for better or worse.

Among the multiple factors depressing consumption and output are the following:

- The largest decline in household net worth in more than fifty years, brought on by a simultaneous decline in housing and equity values – the first time this has happened since WWII.
- Continuing weakness in the housing market.
- A decline in state and local government spending.
- A decline in business investment in view of current slack demand and future uncertainty.

- A decline in global growth and export demand.
- Declining consumer confidence.
- Continuing job losses.
- Constraints on wages and salaries – the elimination of increases in some cases, reductions in compensation in other cases, and the suspension of 401-k contributions in other cases.

the savings, nor the inclination to lead the recovery, presuming that he or she has a job.

**From this perspective, we believe the contraction will continue through 2009 and that pre-recession levels of consumption and output will not be reached for several years thereafter. Recovery will be slow and gradual during which time unemployment is likely to remain elevated, personal income growth negligible, and corporate revenues and earnings depressed.**

The only growth factor supporting the economy for the near term will be federal spending. Neither business nor state and local government are poised to lead a recovery. And the consumer neither has the income,

Following are several charts highlighting some of the factors noted above:

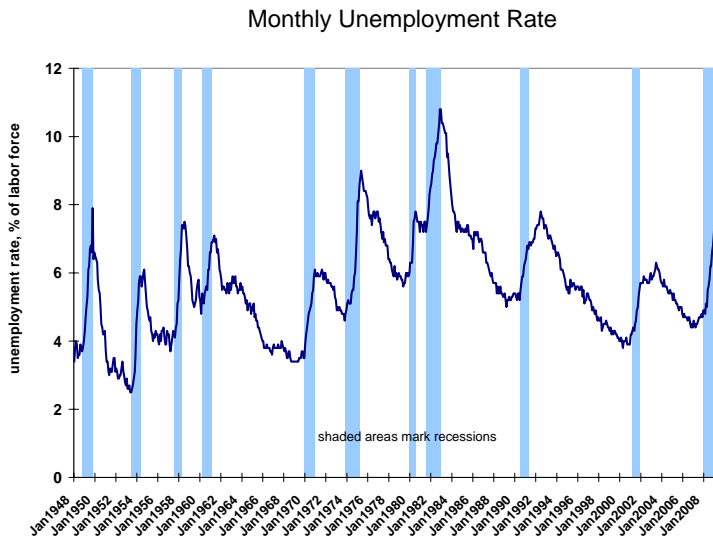


Figure EO.1  
**Unemployment Rate**  
(Source: Bureau of Labor Statistics)

The unemployment rate of 8.5% for March is below the peak of 10.8% at the end of the 1981-82 recession. Continued job losses at the rate experienced since December of 2007 would bring the unemployment rate to near 9.0% by June.

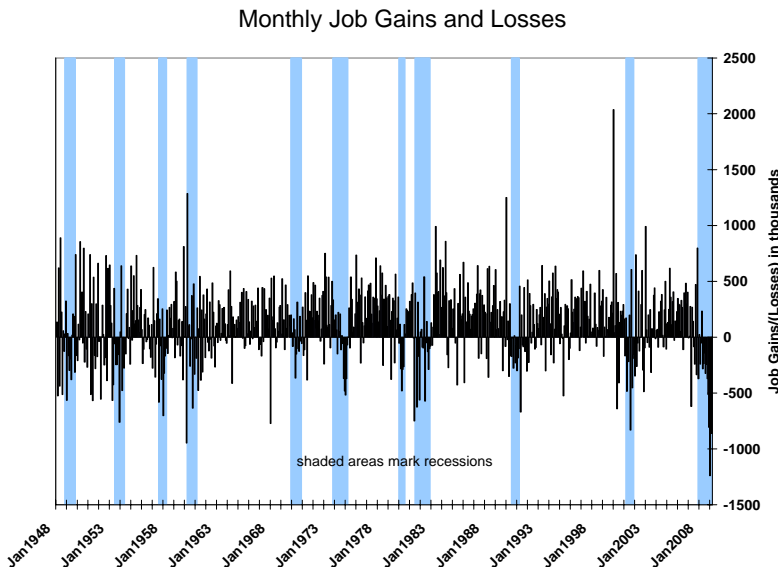


Figure EO.2  
**Monthly Job Gains and Losses**  
(Source: Bureau of Labor Statistics)

Although the unemployment rate remains below the 1982 post WWII peak, job losses to date in absolute terms have been the highest of any post-WWII recession and total nearly six million through March.

Household and Non-profits Net Worth

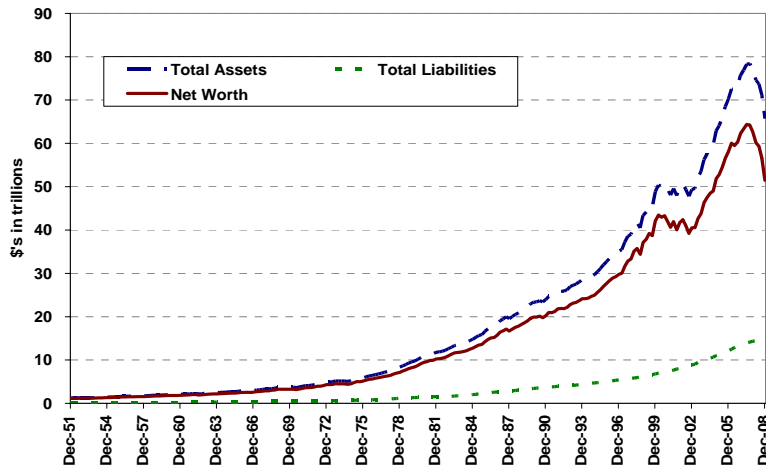


Figure EO.3  
**U.S. Households and Non-profit Organizations, Total Assets, Liabilities and Net Worth**  
(Source: Federal Reserve Flow of Funds Report)

The combined effects of declining housing values, declining equity prices, and increasing debt have led to a loss of nearly \$13 trillion in net worth from June 2007 through December 2008.

Change in Household and Non-profit Net Worth

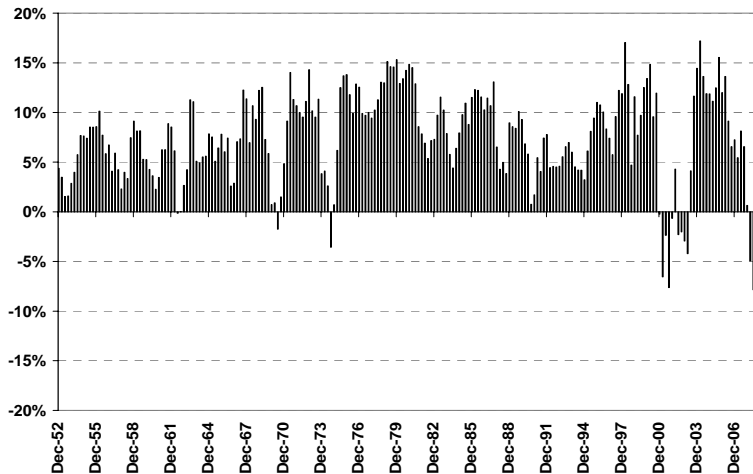


Figure EO.4  
**Percent Change in U.S. Household and Non-profit Net Worth from 12 months prior**  
(Source: Federal Reserve Flow of Funds Report)

The decline in net worth is not only the largest in absolute terms since 1950, it is also the largest in percentage terms since 1950.

Consumer Confidence (Conference Board Index)

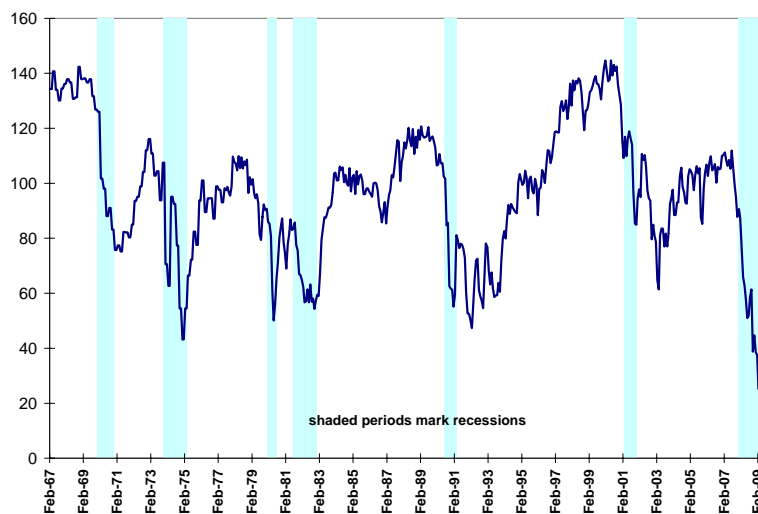


Figure EO.5  
**Consumer Confidence**  
(Source: Conference Board and Bloomberg)

Consumer confidence in February fell to its lowest level ever recorded by the Conference Board. The March level increased marginally. Approximately 24% of respondents expect their income to decrease.

S&P Case/Shiller Housing Price Indices

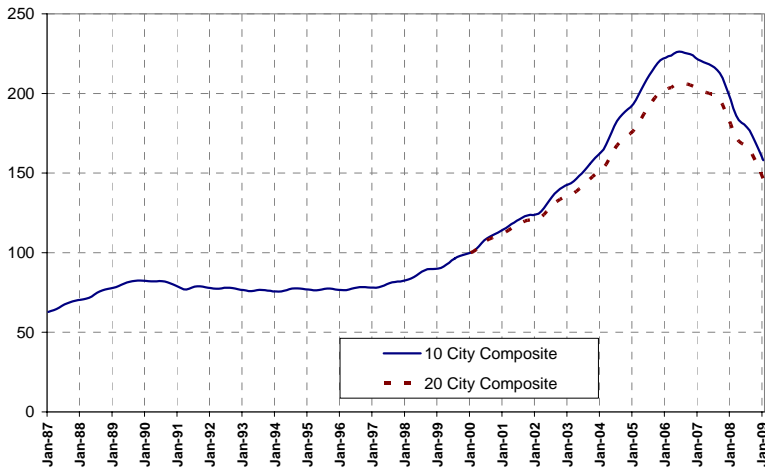


Figure EO.5 (top)  
**S&P Case/Shiller Housing Price Indices**  
(Source: Standard and Poors)

S&P Case/Shiller Home Price Index (10 City Composite)  
Percent Change over prior year

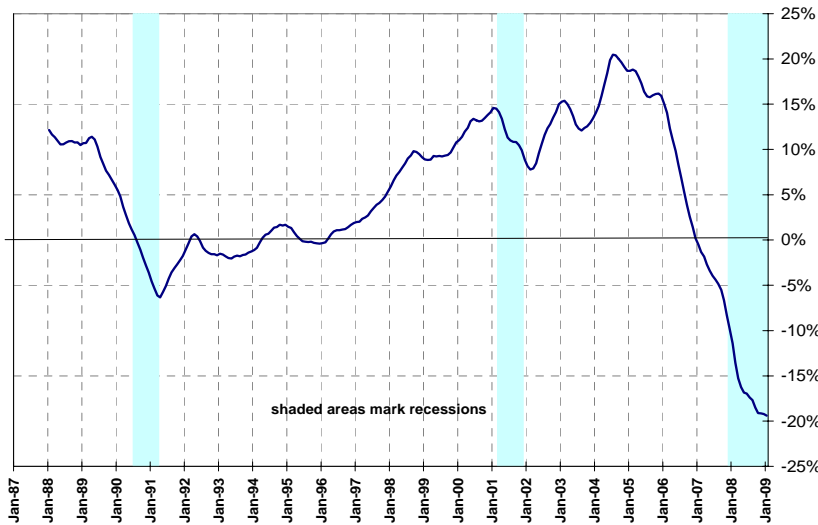


Figure EO.6 (bottom)  
**S&P Case/Shiller Housing Price Index (Composite 10), Percent change from Prior Year**  
(Source: Bloomberg and Advisor calculations)

Housing values peaked in mid-2006. By January 2007, they had declined below twelve-month-prior levels. As of January 2009, the indices had declined more than 29% from their mid-2006 peaks to their approximate levels of January 2004. With the volume of current and anticipated foreclosures depressing the housing market, housing values are expected to continue to decline, further reducing net household wealth and providing more incentive for consumers to save rather than spend.