THE DANA VIEWPOINT

August 10, 2010
Dow: 10,587

THE NEW NORMAL

That's the latest buzz word on Wall Street. Many economists and analysts are feeling that the sluggish economic recovery will result in an extended period of lower returns on investments than prior economic recoveries. This recovery is the slowest of the last four recessions. Gross Domestic Product in the second quarter grew at a 2.4% annual rate down from the adjusted first quarter rate of 3.7%. At the end of 2009 economists were projecting growth of GDP at 3.5%-5.0%. Employment numbers were also reported last week. The economy shed 131,000 jobs as 143,000 temporary census workers fell off federal payrolls. Private sector employment grew by 71,000 in July. Although that was the seventh consecutive month of growth in private sector employment, it is not enough to employ new job seekers entering the market. Analysts estimate that the private sector needs to add 150,000 – 200,000 new jobs monthly just to stay ahead of the population growth. The unemployment rate for July remained at 9.5%. However, this number is misleading, also, as it does not include unemployed persons who have given up looking for work. If those people are included, the actual unemployment number would be closer to 15%.

Why and how is this happening? We can look at three primary factors. Remember, hindsight is 20/20. The housing bubble - this was (is) the most obvious factor. Prices of houses in many parts of the country doubled and even tripled in the early 2000s far outpacing income levels. The Government Sponsored Entities (GSE), Fannie Mae and Freddie Mac were encouraged to write more and more mortgages, and while we only purchased high quality loan pools, at the peak the GSEs underwrote over 50% ($6 trillion) of the mortgage market. This was a bubble of major magnitude, and when it popped, it not only brought down the construction and related industries but many families were hurt by lost jobs and second mortgages. We have been through housing cycles in the past, but this one was like a tsunami. We will recover, but it will take more time than past normal cycles.

Secondly, money lost from housing prices and lost jobs resulted in the sale of common stocks. This had a waterfall effect as the Dow dropped from 14,200 in October 2007 to 7,400 in February 2009 (a 48% drop). The first two factors resulted in the third factor – a drop in consumer spending. Consumer spending is estimated to comprise about 70% of the economy. Consumer spending has obviously been slow but not negative. Consumer spending grew at an annual rate of 0.9% in the fourth quarter 2009 and at a rate of 1.9% and 1.6% respectively in the first two quarters this year.

(CONTINUED ON REVERSE SIDE)

Now the new normal advocates may be correct that we will see below average rates of return on investments for some time. Does this have to happen? NO! The housing bubble is slowly winding down and inventories are being worked off. Housing prices are now more affordable for new entrants plus mortgage rates are extremely attractive. The stock market has recovered half of its loss since February 2009, and corporations have cleaned up their balance sheets, increased productivity and stand ready to expand. Business investment grew at a rate of 17% in the second quarter. Business investment had dropped in seven of the last eight previous quarters. Consumers have also cleaned up their debt and increased their savings.

The only one not on the recovery train is the government. They are the house and they hold the cards. They can lead us out of a slow growth economy with two strokes – cut spending dramatically and keep the tax cuts in place. If you grew up, in a northern climate, your instructor or your parents told you that if you are driving the car and get into a spin, turn in the direction of the spin. Now, on paper that sounds like the wrong thing to do, but it's exactly the right thing to do. The same with taxes - cutting taxes seems like the wrong thing to do as it would seem to cut federal revenues, but it is exactly the right thing to do. It has been done three times (Kennedy, Reagan and Bush) and it has created strong economic growth and increased federal revenues. If the government would do these two things, it would send a message that the environment is positive for investing. It is the private sector that creates lasting jobs and the private sector is poised to take action. We have seen estimates that corporations are sitting on $1.5 - $1.8 trillion (yes that's a "t") waiting for some indication that it is okay to go back in the water. Imagine if this money were to be unleashed on the economy. The *New Normal* would be the *Old Normal*.

Random Thought for August 2010: "To compel a man to subsidize with his taxes the propagation of ideas which he disbelieves and abhors is sinful and tyrannical."

Thomas Jefferson

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