

Repeat of 1974 and 1982 'V-shaped' economic recovery unlikely

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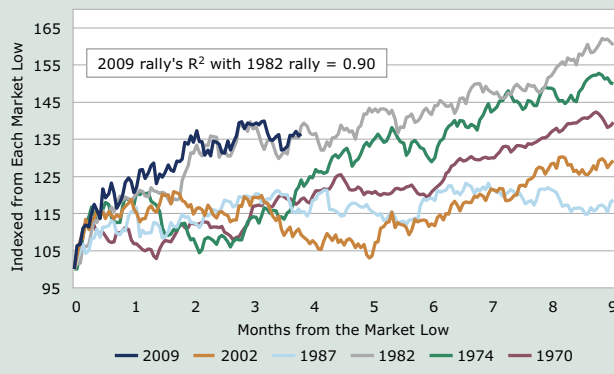
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As mentioned in past reports and shown in chart 1, the current U.S. stock market rally has mimicked the 1982 rally with near perfection. U.S. economic data is also similar to the '82 recession, as well to that of 1974. Due to these similarities we have examined the current consensus for economic growth and compared it with 1974 and 1982.

consumption spending due in large part to excess debt. Total household debt as a percent of personal disposable income more than doubled from 64% in the early 1970's to 133% in 2007. As a result, in the past year alone the savings rate has jumped from 0% to 6.9%, and seems likely to stay at higher levels for an extended period. In addition, the number of people working part-time due to economic reasons has doubled since the start of this recession, and as shown in chart 2, the duration of unemployment has never been this bad. In just the first three months of 2009, almost 140,000 individuals exhausted their extended unemployment benefits, and more than 600,000 people exhausted their regular benefits in May alone.

Chart 1: Current U.S. Equity Market Rally Has Mimicked 1982

(Historical Bull Market Rallies - First Nine Months)



Source: Bloomberg

Consumption is the largest and most important component of GDP, representing 71% of the total; it is greater today than it was in the '70s & '80s when consumption was only 63-64% of GDP. There is considerable debate among investors regarding how strong consumer spending will be in coming quarters. Current consensus suggests a sluggish recovery in

Chart 2: Joblessness Dragging On Longer For More People This Time

(% unemployed for more than 27 weeks*)



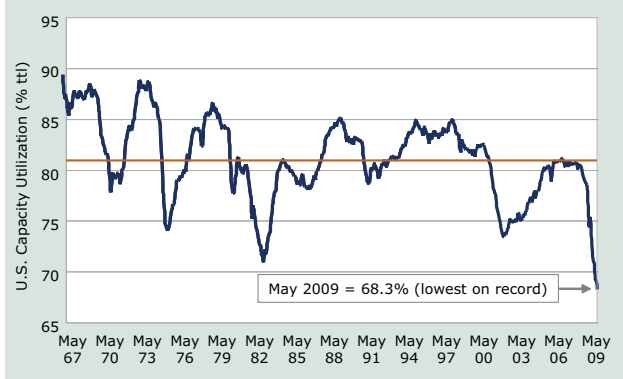
*Normal duration of regular unemployment benefits

Source: U.S. Bureau of Labor Statistics

Business fixed investment may also recover more slowly than in 1982. U.S. capacity utilization hit 68.3% in May, meaning there is more excess industrial capacity than at any time on record. As shown chart 3, the level is worse than in both '74 and '82. The record

amount of spare capacity indicates that industry has little need to spend capital to increase production (even if demand picks up significantly). In addition, residential investment was a bright spot after the '74 and '82 recessions, contributing an average 17% to the total percentage change in GDP for the five quarters following those recessions. But given the current housing inventory, a meaningful pickup seems likely to be a ways off. In both '74 and '82, residential investment only started contributing positively to GDP once the supply of new homes had fallen an average 41% as a proportion of annualized new home sales. The decline in the current cycle is only 17%.

Chart 3: Enormous Slack Means Capex Unlikely To Recover Soon



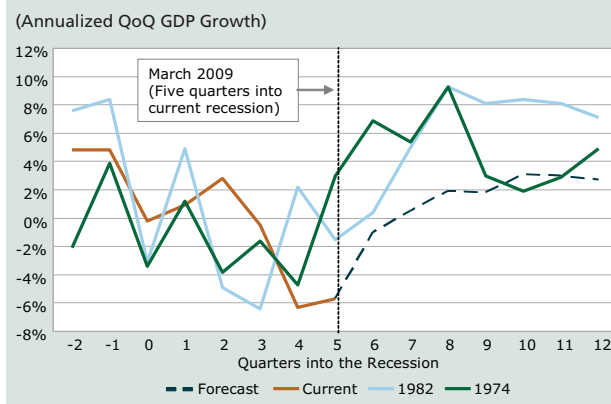
Source: U.S. Federal Reserve

U.S. government spending has and likely will continue to drive the economy. The government has increased spending to a record US\$4 trillion in 2009, a 34% increase from 2008. It has announced it will spend \$3.6 trillion in 2010, but since GDP is measured on a quarter-over-quarter basis, the risk of disappointing growth figures increases substantially as we move through 2010 (see chart 4). Since the bulk of 2009 spending is expected in Q3 and Q4 of 2009, it wouldn't be surprising to see at least a 15% quarter-over-quarter drop in government spending sometime in the first half of 2010. In total, government spending is expected to contribute to a \$4.03 trillion cumulative deficit over the next three years, almost certainly leading to nationwide tax increases.

But even with considerable evidence of a slower than normal recovery, it is by no means a sure thing. MFC Global Investment Management's Chief

Economist, Bill Cheney, notes that the pessimistic view puts too much weight on consumer debt rather than net worth; the negative change in net worth is likely behind us; as net worth improves in coming quarters, so might consumer spending. Bill also notes that even while it is true that business capital spending and spending on consumer durables will be weak by historic comparisons, it is the change in these numbers that impacts growth of GDP; and given that we are starting from levels that are far below trend, it is possible that we will see some exciting growth rates for several quarters. This suggests the consensus may be too pessimistic regarding the strength of recovery. Backing this up, it is notable that many economists have recently revised higher their second half 2009 and their 2010 GDP forecasts.

Chart 4: Late 2009 Stimulus Could Mean Weak Quarterly Growth Early In 2010



Source: Bloomberg; GDP Estimates from Thomson Baseline

My personal view is that the current recovery is too dependent on government spending in the U.S., China and elsewhere, and that much of this spending will prove to be unproductive. The U.S. and most Western countries are spending money they don't have and will eventually raise tax rates to pay for it. China is building capacity for exports that is not needed. I expect second half 2009 GDP to surprise on the upside as fiscal policy initiatives kick in and inventory destocking ends. But I think as we move through 2010, economic growth will prove disappointing. As a result, I expect the stock market's tight correlation with 1982 will not continue through next year.

Other sources: U.S. Bureau of Economic Analysis, U.S. Congressional Budget Office

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