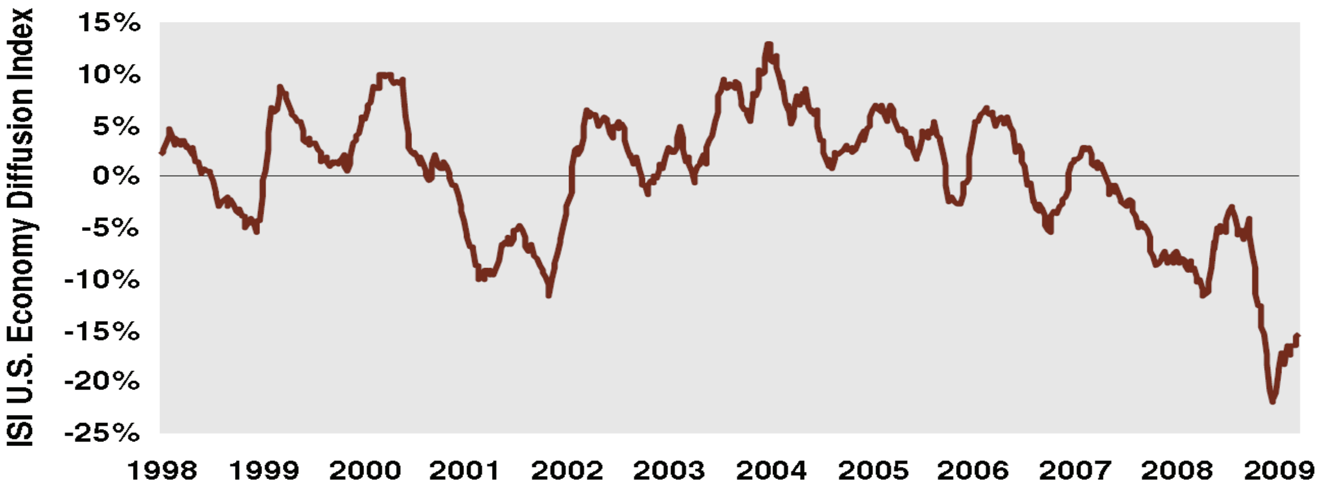
MACROECONOMIC QUICK TAKES

DIFFUSION INDEX TURNS POSITIVE

To detect relative changes in the overall economy, the International Statistical Institute publishes something it calls the diffusion index. Simply put, this index tracks a basket of economic indicators. When more indicators are deteriorating than improving, the index falls — and vice versa. This index plunged deeply into negative territory toward the end of 2008, but the recent trend has not only been strongly positive, it has been more positive than the more subtle rebounds that are now beginning to occur in other economies.

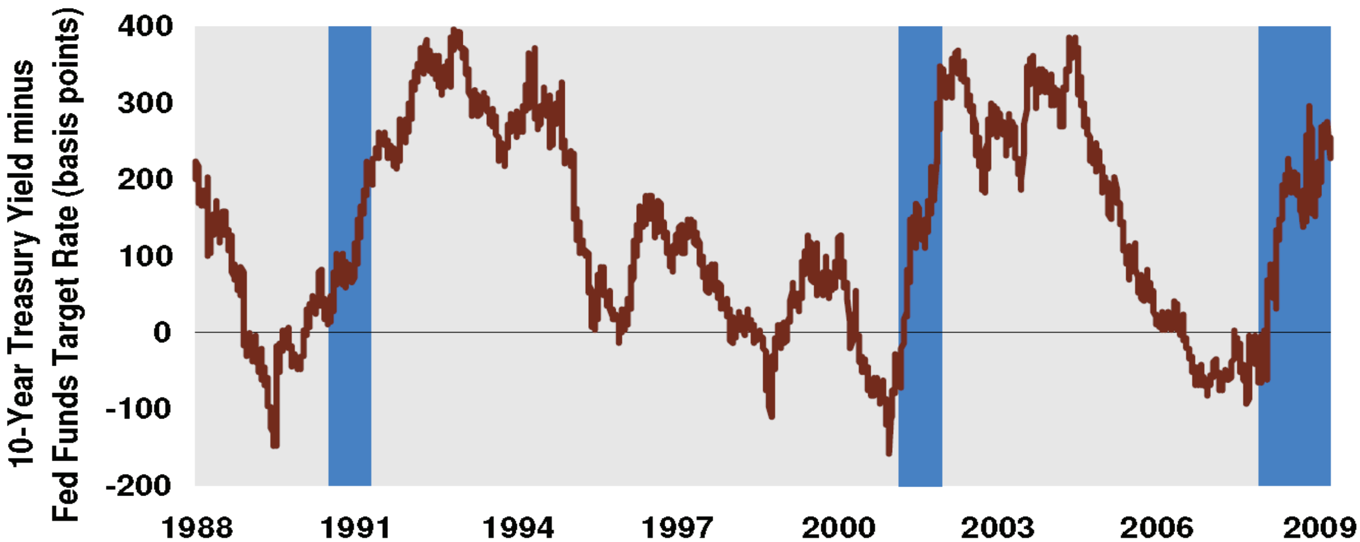


Bottom Line: The global recession began in the U.S. It now looks as if the recovery may have begun here, as well.

THE YIELD CURVE AS A FORECASTING TOOL

For a variety of reasons, long-term interest rates tend to exceed short-term interest rates. Prior to the onset of a recession, however, this relationship sometimes inverts itself. The result is an inverted yield curve. In the following graph, these inversions are indicated by the red line falling below zero. The blue shaded areas represent recessionary periods. As you can see, these inversions have tended to precede recessions. Although many observers thought that the most recent inversion may have provided a false recession warning, hindsight indicates otherwise.

Massive intervention by the Federal Reserve and the Treasury have created forces that have unwound the most recent yield curve inversion.

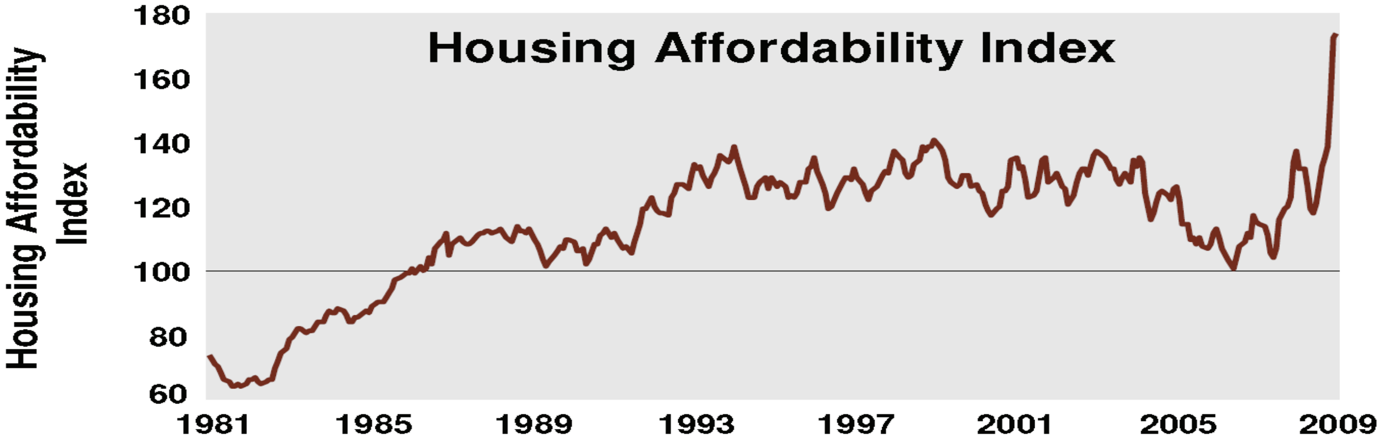


Bottom Line: The relationship between short and long-term interest rates has recently normalized. Although the current recession is severe by any measure, history suggests that the next phase in the business cycle will be a return to some form of economic expansion.

HOUSING BECOMES MORE AFFORDABLE

According to S&P data, the supply of existing homes still amounted to a bloated 9 months' worth of sales as of February while the inventory of new, unsold homes was an even higher 12 months. A more normal inventory figure might be closer to 3 months. So, there still exists a glut of unsold homes. The good news is that historically low mortgage rates, tax incentives, and various housing support and foreclosure prevention plans are making homes dramatically more affordable as can be seen in the graph on the following page.

Bottom Line: The spike in housing affordability is almost certain to begin to translate into increased home buying activity at some point. As this process develops, borrowers should become less likely to find themselves owing more than their homes are worth and lenders should begin to experience reduced foreclosures, delinquencies, and (most importantly) loan losses.



A FALSE RECOVERY?

Although the S&P 500 has rebounded some 29% since March 9th, New York Times columnist Paul Krugman cautions, "one of the great policy dangers, in the face of a severe economic slump, is premature optimism." He also notes, "even in the Great Depression, things didn't head straight down. There was, in particular, a pause in the plunge [*for*] about a year and a half in [*sic*] — roughly where we are now." Markets can be fickle, so another market plunge certainly could be in the cards.

The next chart illustrates how the S&P 500 has fared after the worst 10 quarters as measured by changes in Gross Domestic Production. Not surprisingly, the economic contraction that occurred during the 4th quarter of 2008 was among the worst (it was the 4th worst) in modern history. In each of the other nine cases, stock valuations were markedly higher one year later.

Since the current 29% rebound has already exceeded the one year average of 24%, one might conclude that equity prices have rebounded too far, too fast. While this could certainly be the case, it is worth bearing in mind that the current rebound is beginning from a pull-back that is considerably worse than average. In this context, the recent rally could be viewed as being reasonable.

The relationship between the release of the 10 worst jobs reports and equity prices one year later is also compelling. In all but one case, equity prices rose materially (chart on next page).

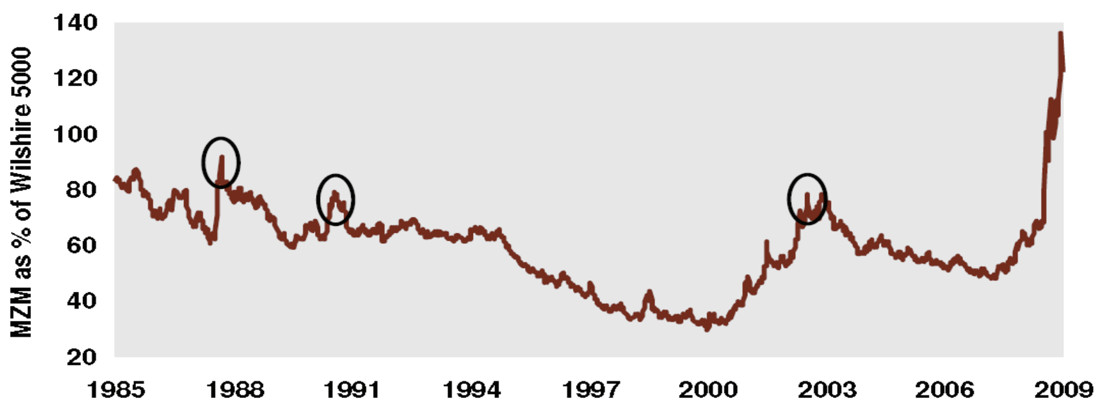
10 Worst GDP Quarters	
Date (of Quarter)	S&P 500 1 Year Later
3/31/58	31.7%
6/30/80	14.9%
3/31/82	36.6%
12/31/08	?
12/31/53	45.0%
3/31/49	14.8%
12/31/60	23.3%
12/31/81	14.8%
3/31/75	24.4%
12/31/70	10.8%
Average	**24.0%**

10 Worst Jobs Reports	
Date (Month/Year)	S&P 500 1 Year Later
9/45	-6.8%
10/49	21.4%
2/58	36.2%
12/74	31.6%
11/53	38.3%
5/60	19.2%
10/70	13.0%
5/80	20.2%
7/82	50.9%
2/91	12.4%
Average	**23.6%**

Bottom Line: Markets have advanced markedly well before a given recession has ended.

WHERE IS ALL THAT CASH GOING TO GO?

The amount of cash sitting on the sidelines as a percentage of the value of the overall domestic stock market has soared recently — and that cash is earning next to nothing.



Circles indicate bear market end

Bottom Line: Some of that cash began to flow back into stocks recently which, of course, fueled the recent surge. More importantly, there's plenty of additional fuel still sitting idle.

In the meantime, we continue to rebalance portfolios in accordance with our clients' longer-term asset allocation strategy. We appreciate your patience during this unsettled time.

— Glenn Wessel