MACROECONOMIC QUICK TAKES

RECESSION MAY BE OVER … MAY NOT MATTER

In mid-September, Fed Chairman Ben Bernanke suggested the U.S. recession may be over. Of course, that's welcome news, but the recession won't officially end until the National Bureau of Economic Research (NBER) says it has. When that pronouncement does finally arrive, however, don't expect investors to react too strongly. Why? In an endless quest to gain an edge over other investors, market participants have tended to react to anticipated events with far greater force than to the official confirmations of historical ones. The old adage "buy on the rumor and sell on the news" is rooted in this notion.

By the time the NBER sorts through the data that allows it to officially confirm the end of a given recession, investors have generally received ample advance opportunity to react to the series of clues that have often foreshadowed such an announcement.

RECESSIONS START AND END ARE CONFIRMED WELL AFTER THE FACT

Recession Date	NBER's Announcement Date of Recession Start Date	Lag	NBER's Announcement Date of Recession End Date	Lag
1/80-7/80	6/3/80	5 months	7/8/81	12 months
7/81-11/82	1/6/82	6 months	7/8/83	8 months
7/90-3/91	4/25/91	9 months	12/22/92	21 months
3/01-11/01	11/26/01	8 months	7/17/03	20 months
12/07-?	12/1/08	12 months	??	??
Average		8 months		15 months

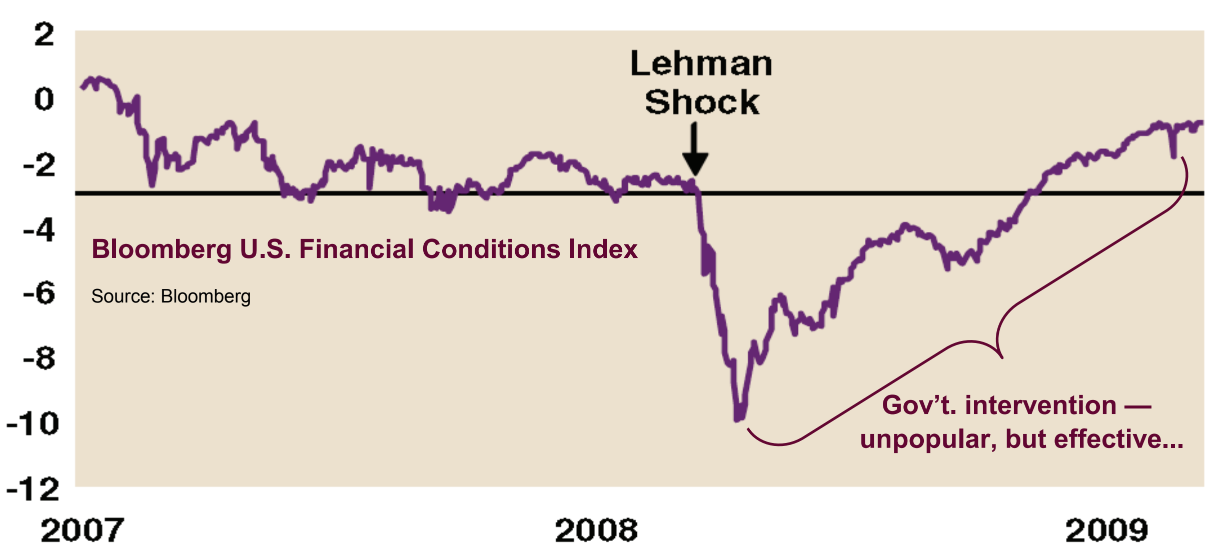
Source: National Bureau of Economic Research

If Mr. Bernanke is correct and the recession has, in fact, ended in the U.S., investors seem to have been expecting that news for quite some time — actually, since March 9th. Between then and now, equity prices have advanced well over 50% (chart on next page). For those of you who are more comfortable steering clear of equities until after a given recession is officially over, the message is two-fold: 1) By the time the NBER officially confirms the end of the current recession, its relevancy to investors will have long passed, and 2) markets try their best to react to news before it occurs. As important as it may seem, having a sense of the overall business climate is far less important to investors than having a sense of how that climate might be changing.

EQUITY PRICES RISE WELL AHEAD OF OFFICIAL RECESSION END

So, what might the Fed be considering as it figures the U.S. economy may no longer be contracting? For starters, the credit markets, which form the backbone of commerce, are functioning much more normally than they had been. Bloomberg's Financial Conditions index captures this improvement (below).

CREDIT MARKETS CONTINUE TO IMPROVE

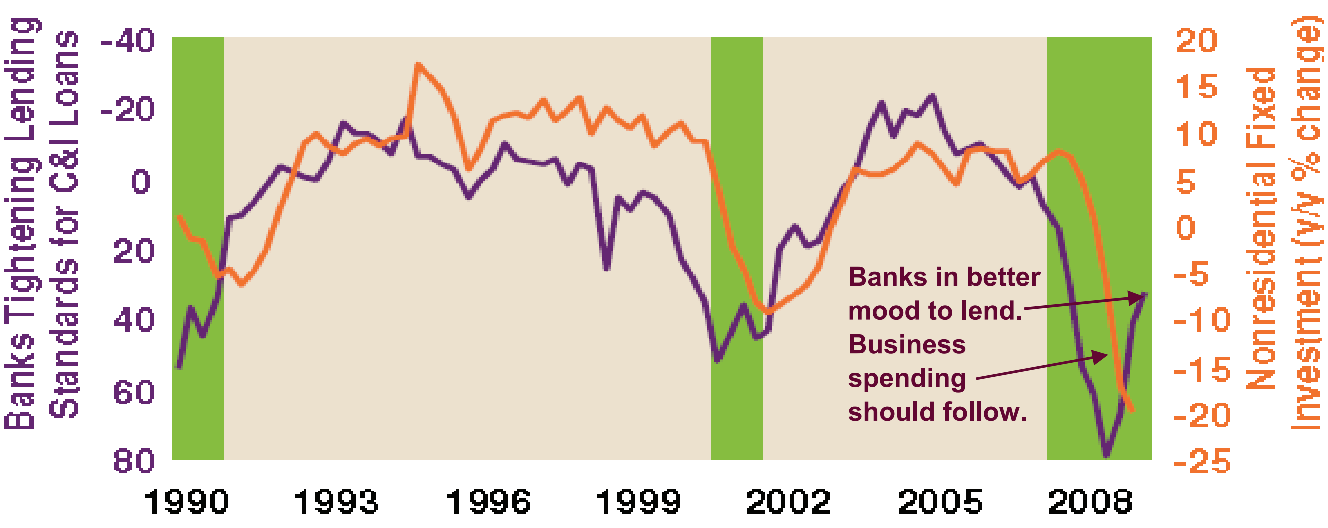


Sustainable economic expansion can occur only to the extent that credit is available on reasonable terms. However, low-cost credit is not the same as available credit. While interest rates have been low for quite some time, the general availability of credit has been limited as banks have scaled their lending activity back in an effort to bolster their capital ratios. However, banks are now at least somewhat more inclined to lend than in the recent past.

Why is this important? Because economic expansion cannot occur until consumers and/or businesses begin to ramp up their respective spending. With the typical consumer shedding debt and reducing his/her discretionary spending, the next leg of economic expansion in the U.S. will certainly not be consumer driven as it has been in the past. Government spending has gotten the economic ball rolling by spurring demand, but continued expansion will rest squarely on the shoulders of business. In order for businesses to spend and invest more, banks must be willing to lend more. Good news appears to be around the corner.

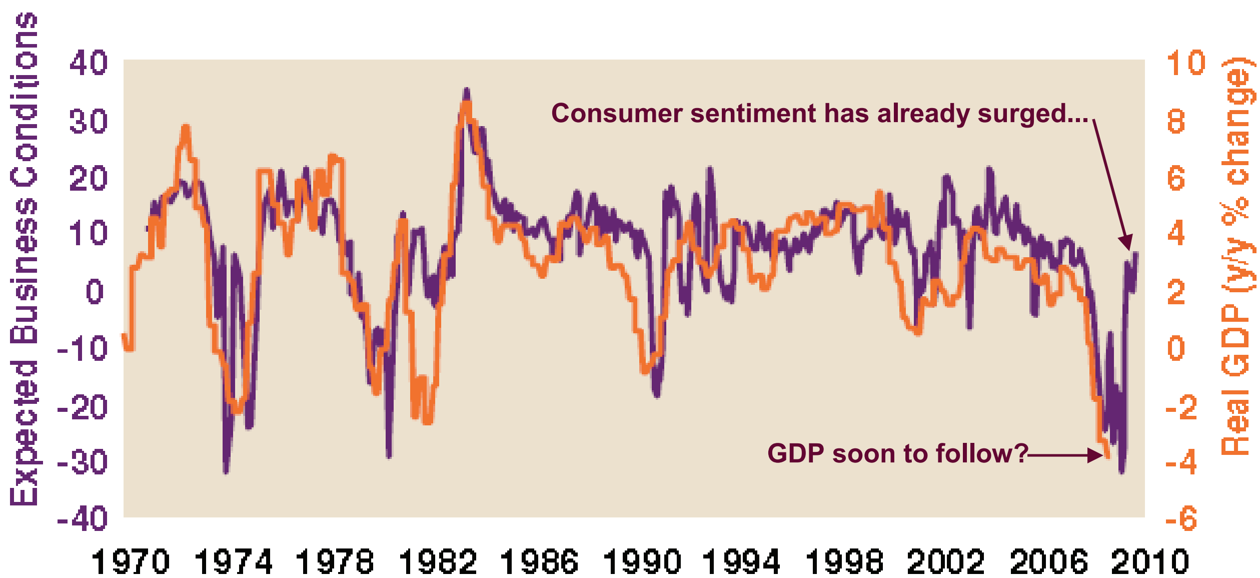
BUSINESS LENDING LEADS TO CAPITAL SPENDING

The following chart illustrates the historical relationship between banks' lending standards and business spending. More precisely, as banks have recently begun to relax their lending standards (depicted by the rising purple line), business spending has tended to follow (the orange line). Based on this historical relationship, it would seem that business spending may be on the cusp of a material upturn. As business spending increases, improvement should begin to be seen across a host of economic indicators.



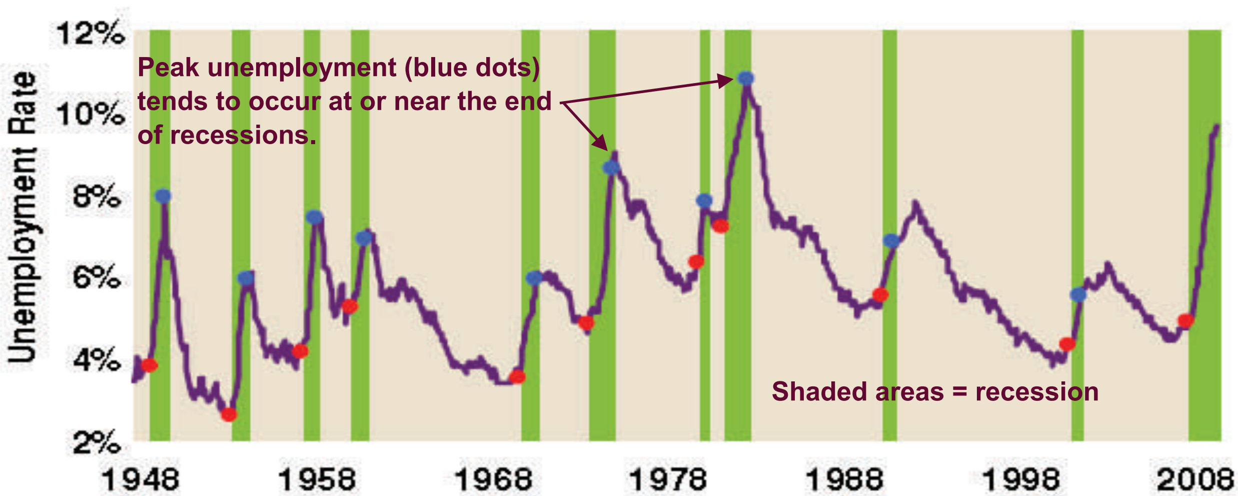
CONSUMER EXPECTATIONS RISE DRAMATICALLY

The chart that follows captures the historical relationship between consumers' expectations regarding business conditions and actual changes in gross domestic product (GDP). If you look closely, you'll find that consumers' expectations (depicted by the purple line) have tended to slightly lead actual changes in GDP (the orange line). Of note here is the sharp improvement in consumer expectations that has recently occurred. If history holds true, an up tick in GDP should be forthcoming.



PEAK UNEMPLOYMENT NOW IN SIGHT — A GOOD SIGN

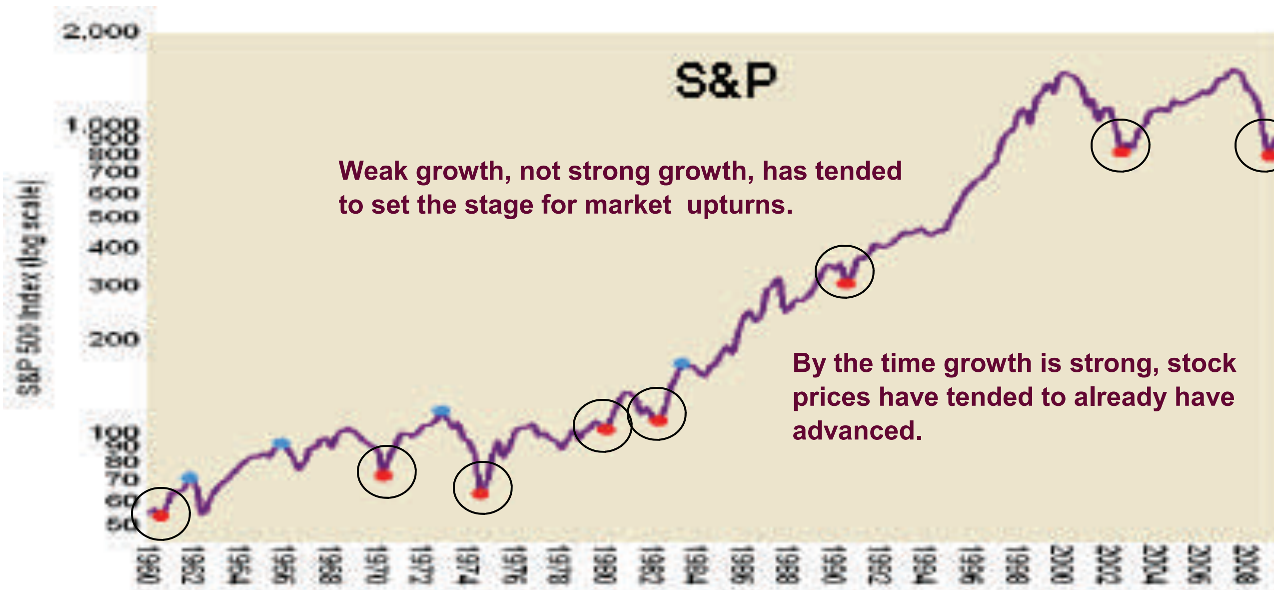
Despite the fact that the general rate of unemployment has long been considered a lagging indicator of future economic activity (versus a predictive one), political spin doctors and the talking finance heads continue to question how a recovery could occur in the face of rising unemployment. Somewhat analogous to the manner in which July is typically the hottest month even though the summer solstice (peak sunlight) occurs one month prior, recoveries typically begin while unemployment is still rising simply because it takes a while for the general increase in demand to flow through to the job market. The fact that economists are now predicting that the unemployment might soon peak is a positive signal.

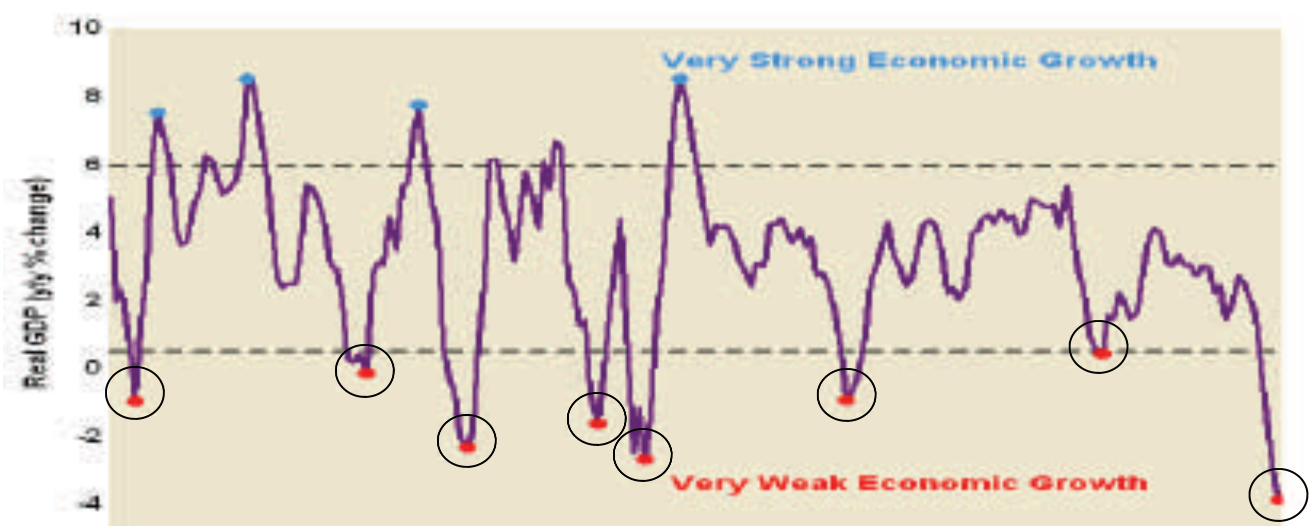


Consequently, if you're inclined to rely on the general rate of unemployment as a general proxy for the overall investment climate, be careful to interpret that data in the proper context.

WAITING FOR HIGHER GROWTH TO RETURN BEFORE INVESTING IN EQUITIES?

If you look at the two charts that appear immediately below, you may be surprised to learn that equity values have tended to advance more sharply during times of <u>tepid</u> economic growth than they have during more robust times. As illogical as this relationship may at first seem, it actually makes sense.





During periods of strong economic growth, the Federal Reserve has tended to become more vigilant in its effort to stave off inflation and this vigilance has typically translated into less accommodative monetary policies, a shrinking of the nation's money supply, and less favorable business conditions. During times of relative economic stagnation, the process has often worked in reverse.

Whereas it might be emotionally satisfying to be invested in equities only during times of relative prosperity, the historical record clearly suggests that it makes more sense to ignore the overall investment climate and to instead focus on the changes that are likely to impact that climate. When the country is mired in the depths of despair, subtle improvements can be difficult to sense. Yet, these subtle clues are exactly what investors began reacting to back in March.

REACT TO CHANGE — NOT TO EMOTION

While it may be tempting to make investment decisions in the context of current market sentiment, more relevant investment signals are generally found by assessing various data in an effort to determine how that sentiment might change — for it is change that drives the markets.

Thank you for allowing me to share with you some of the data we consider as we manage the portfolios that have been entrusted to us. And thank you for allowing us to help you remove emotion from the investment process.

— Glenn Wessel