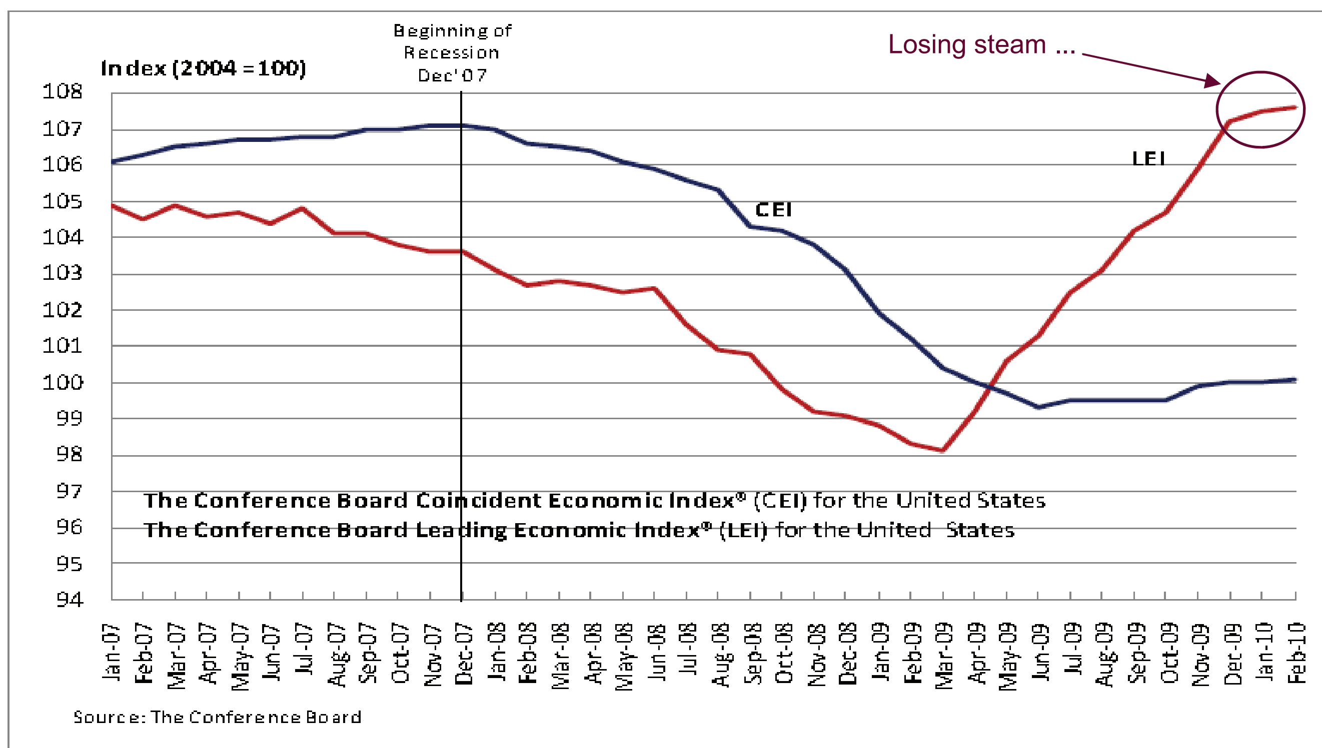
MACROECONOMIC QUICK TAKES

THE RECOVERY CONTINUES ...

March U.S. auto sales jumped 24% versus a year ago while increased factory output in the U.S. and China allowed worldwide manufacturing to expand at its fastest pace in at least six years. According to the Institute for Supply Management, the U.S. manufacturing sector also grew at its fastest pace in over five years. Manufacturing in Europe is also showing strength.

Last quarter, I noted that the Conference Board's Index of Leading Economic Indicators® (LEI) had advanced eight straight months as I illustrated how nicely its rebound coincided with the rebound in equity prices that began last March. The LEI advanced another 1.2% in December while fourth quarter GDP grew at a robust annualized rate of 5.6%.



... BUT IT'S SLOWING

Unfortunately, economists attribute about two-thirds of that 5.6% GDP gain to the inventory restocking that generally takes place after a recession. Therefore, the sustainable the portion of that 5.6% growth rate might be closer to 1.9% per year once non-recurring demand is removed. After the LEI's 1.2% advance in December, it improved only 0.3% in January and 0.1% in February. Whereas the economic recovery certainly appears to be intact, the U.S. faces the ongoing challenge of transforming its long-standing vices of borrowing, spending and importing into more virtuous ones of saving, investing and exporting.

FED SUPPORTS THE MORTGAGE & HOUSING MARKET ...

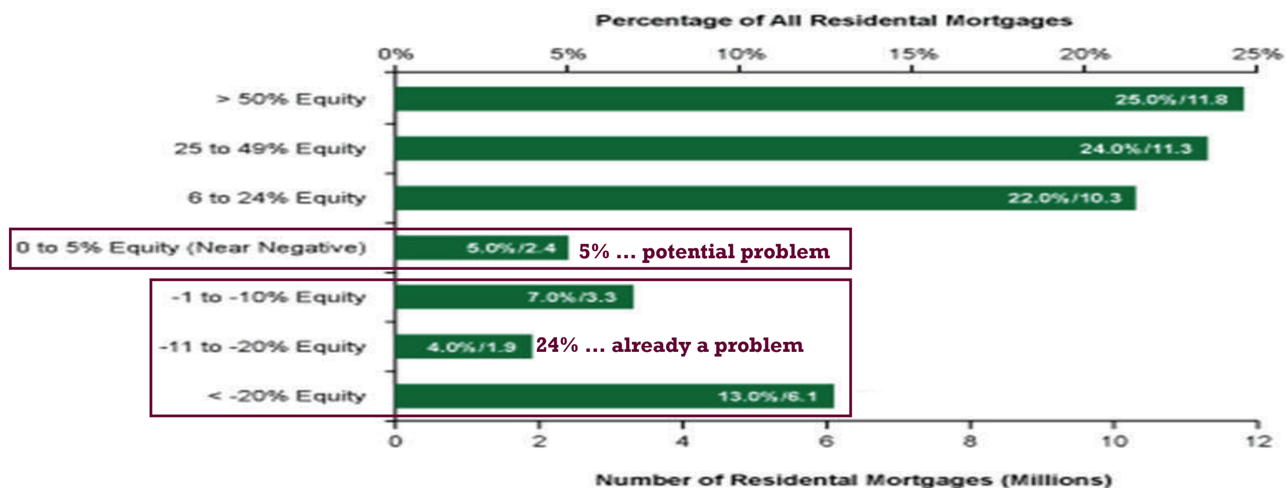
In January of 2009, after it became apparent that the housing market was in a vicious downward spiral of rising defaults and falling prices, the Fed intervened by committing to purchase $500 billion worth of mortgage-backed securities. This move drove mortgage-backed securities' prices higher which helped lenders' balance sheets. It also pushed yields down which made mortgages more affordable. Of course, more affordable mortgages armed home buyers with additional purchasing power which helped support housing demand. Acknowledging the distress of the housing market, the Fed more than doubled the size of this program to $1.25 trillion last March.

Because low interest rates and easy money are asset-bubble ingredients, many have questioned how low mortgage rates could provide the cure to a situation that was, at least in part, caused by those same low rates. Nonetheless, it appears to have worked — at least for now.

... UNTIL RECENTLY

The Fed's support of the mortgage-backed securities market ended with the close of March. The Fed has indicated that it may resume the program if conditions warrant, but that it would only do so as a last resort. For now, the Fed will simply stop buying mortgage-backed securities. However, to the extent the Fed begins liquidating its mortgage-backed securities portfolio, the forces that worked so well to stabilize the mortgage and housing markets would be applied in the opposite direction. This would be less of a issue if the housing market were stable, but the chart below suggests that this is not yet the case.

After stratifying residential mortgages according to the amount of equity owners have in their underlying properties it becomes apparent that almost a quarter of all outstanding residential mortgage loans are inadequately collateralized while another 5% are in danger of falling into this category. (Refer to the boxed areas, below.) In general, loans that are inadequately collateralized have tended to exhibit drastically higher delinquency and foreclosure rates. The fact that almost 30% of all mortgage loans are either marginally or inadequately collateralized suggests that the housing recovery is, at best, fragile.



Source: First American CoreLogic 4th Quarter Survey of Negative Equity. See www.loanperformance.com

COMMERCIAL MORTGAGE STRESS

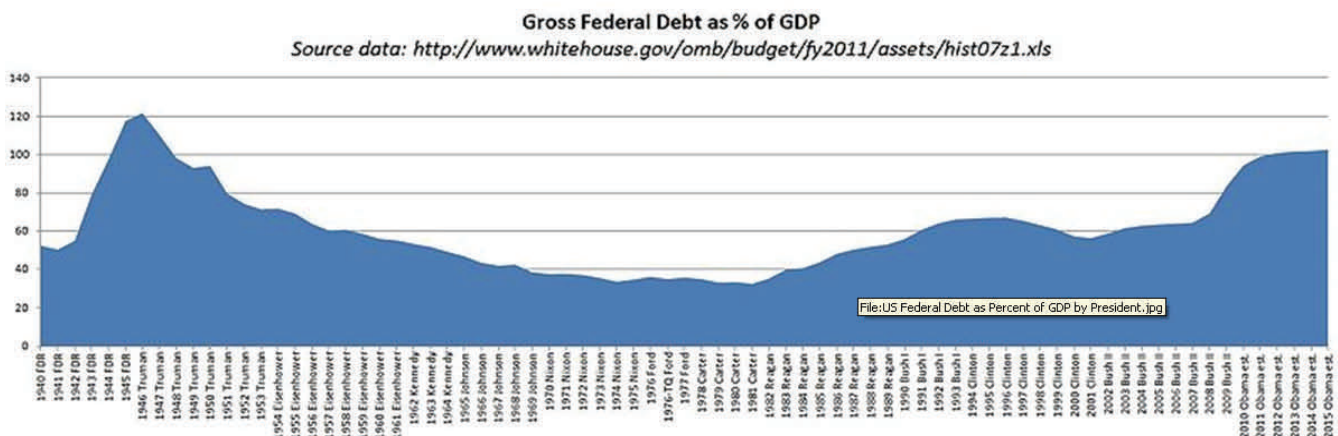
The head of the Congressional Oversight Panel for the Troubled Asset Relief Program predicts that by the end of 2010, half of all commercial-property mortgages in the U.S. will be less than adequately collateralized. Again, borrowers who owe more on their mortgage loans than their properties are worth have little economic incentive to repay their loans. As such, they pose a serious risk to their lenders and to the housing market as a whole. According to this Panel, 2,988 banks have dangerous concentrations in commercial real estate loans, This makes sense because the delinquency rate for loans underlying commercial mortgage-backed securities jumped 5-fold (to more than 6%) by the end of 2009. Vacancies at U.S. strip malls hit an 18-year high in the fourth quarter of 2009 while vacancies for large regional malls reached their highest levels in over a decade. Consequently, it certainly seems plausible that a deteriorating commercial property market could challenge the current recovery.

UNITED STATES' AAA CREDIT RATING AT RISK

Not too long ago, Moodys suggested that the United States may test the boundaries of its triple-A credit rating. Two months later, Timothy Geithner defiantly proclaimed that the U.S. would maintain its AAA status indefinitely. At the time he provided this assurance, the U.S. owed some $12.3 trillion dollars and Congress was on the verge of increasing the federal debt ceiling (out of necessity). The deficit for the current year is expected to total $1.6 trillion and the Office of Management and Budget predicts the U.S. will run deficits through at least 2020. During that span, it estimates the least onerous deficit will be a still staggering $700 billion.

The major credit rating agencies have become increasingly vocal about the possibility of the U.S. losing its AAA status. In March, Moodys suggested that while the U.S.' credit outlook was stable, the so-called "distance to downgrade" had shrunk. Such a downgrade would not only force borrowing costs higher for the government and its citizenry, the assumed increase in taxes that would be necessary to service the higher cost of that debt would further insult economic progress.

The chart below relates total outstanding public debt to the size of the U.S. economy as measured by its output (GDP). As onerous as the U.S.' debt already is, you may be surprised to know that many economists still regard



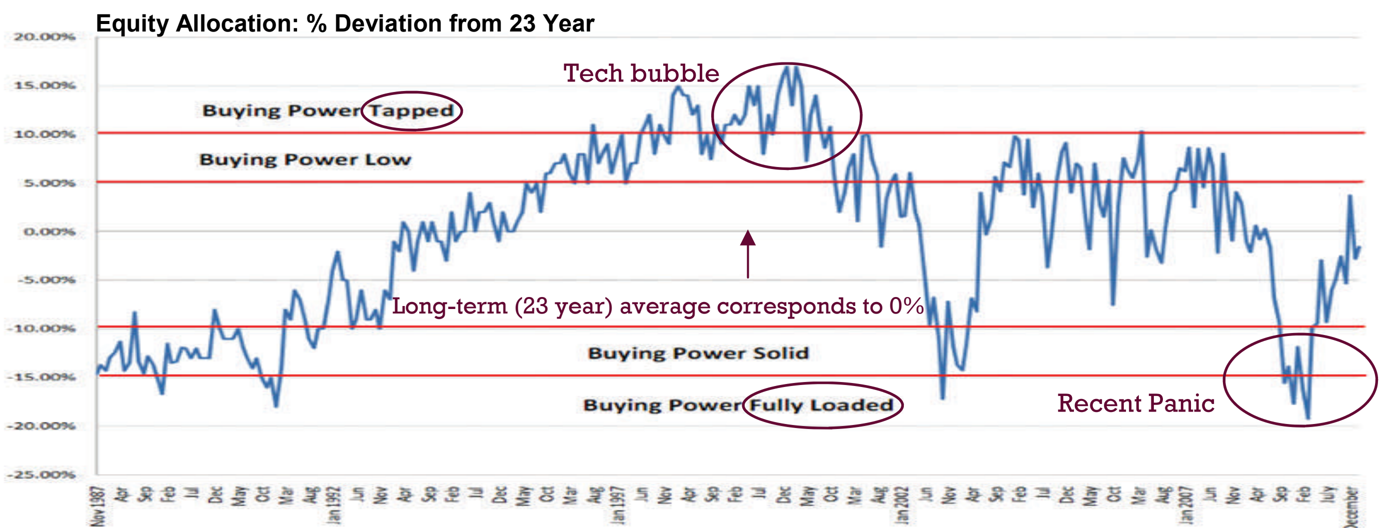
the problem to be manageable — at least for now. Barring a dramatic increase in economic output and tax revenues, the loss of financial flexibility that is sure to follow bodes ill for this nation's ability to run future deficits to pursue any number of worthwhile purposes.

Japan lost its AAA credit rating last May. As the U.S. continues to bump up against ever higher federal debt ceilings, it seems as if the U.S. is likely to follow suit. It's hard to see a silver lining here.

BUYING POWER … NO BETTER THAN NEUTRAL

Although economics and finance can be frustratingly complex, it is fundamentally true that prices rise when cash flows into a market, and fall when cash flows out. In that context, the chart below shows the percentage of wealth Americans have committed to equities at various points in time versus the percentage they have committed, on average, over the past 23 years. If one assumes this average to be "normal," then one might also assume that deviations from this long-term average might tend to revert back to normalcy at some point.

You'll note that this graph clearly shows that buying power became fully "tapped" at the peak of the Tech Bubble and that it became "fully loaded" as investor pessimism peaked last March. For now, this indicator is neutral.



SO, WHAT ARE WE DOING?

While we're certainly pleased that the equities markets have continued to advance, we're not viewing equity valuations as being particularly attractive. Rather than making any drastic changes, however, we've been trimming equity exposures while favoring companies that we regard as being relatively stable. With respect to our fixed income positions, we continue to favor shorter-term instruments over longer-term ones since the shape of the yield curve and the size public debt strongly suggest that rates must rise at some point. And, we continue to favor investment-grade debt over lower-rated issues because the extra yield associated with lower-rated debt no longer seems adequate to compensate for the additional credit risk. In summary, we're maintaining a somewhat more conservative stance while we monitor the health of real estate markets and the actions of the Fed.