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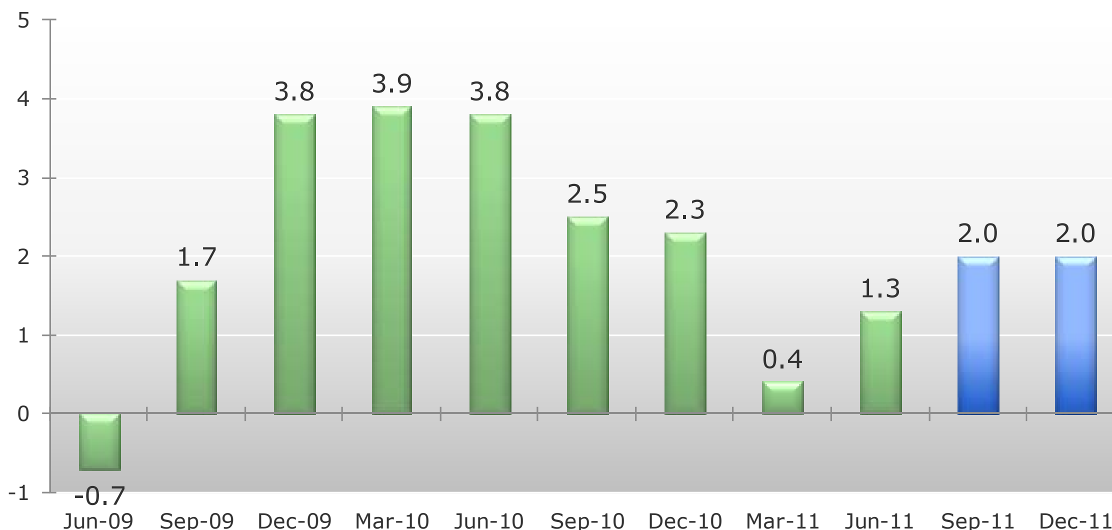
QUICK MARKET UPDATE

U.S. Recession Looming?

Chris Haverland, CFA®, Senior Investment Research Analyst *October 14, 2011*

A deluge of mixed economic data in the last few months has led to increased speculation that the U.S. could dip into another recession. The U.S. economic soft patch that started in the summer has lingered into the fall with little evidence of a meaningful turnaround. Indeed, the loss of momentum in the economic recovery prompted us to downgrade our 2011 GDP growth forecast below 2.0 percent, with the expectation for minimal improvement in 2012. Despite the disappointing outlook, we believe the odds of a recession are below 50 percent and likely falling given recent employment and manufacturing reports that continue to suggest modest economic growth.

The National Bureau of Economic Research (NBER)—the official arbiter of recessions—declared the end of the "Great Recession" in June of 2009. NBER's decision confirmed the end of one of the worst recessions in U.S. history, asserting that any future downturns in the economy would be considered a new recession, not a continuation (double-dip) of the previous one. The financial crisis led to the longest contraction since the Great Depression, lasting 18 months. Since 1945, recessions on average have lasted only 11 months, while expansions have had durations of nearly five years. The current expansion is slightly over two years old, which would be considered brief, based on post-Depression history.



Source: Bloomberg, October 2011

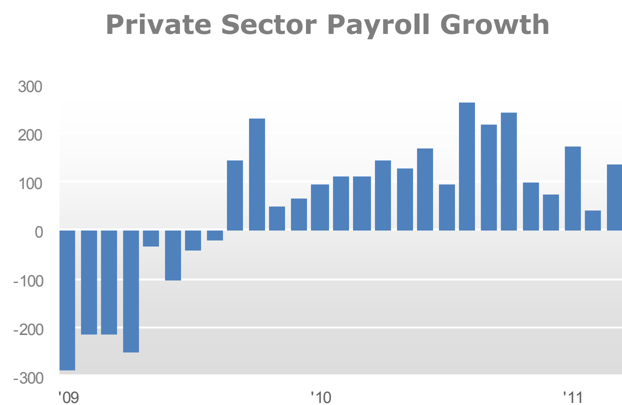
The NBER has a Business Cycle Dating Committee, which provides the generally accepted dates that recessions begin and end. The NBER defines a recession as:

A significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. A recession begins just after the economy reaches a peak of activity and ends as the economy reaches its trough. Between trough and peak, the economy is in an expansion. Expansion is the normal state of the economy; most recessions are brief and they have been rare in recent decades.[1]

Based on the NBER methodology, it is hard to say whether we are currently in recession or heading toward a recession. Clearly, the employment situation remains troubling and has held back the economic recovery. However, real income, industrial production and sales have all shown resiliency during the recent slowdown. Let's take a closer look at each measure:

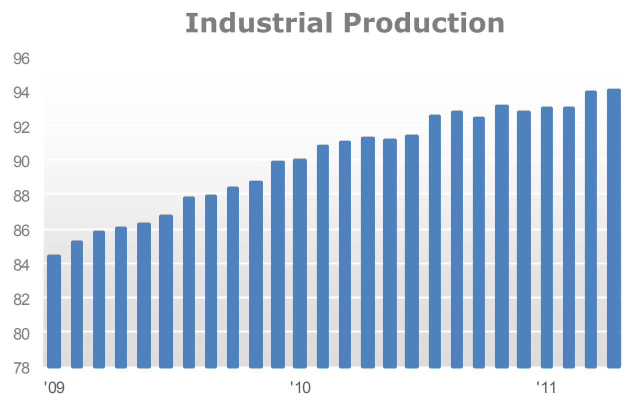
Employment

Data from the Labor Department indicated positive job growth in September, despite continued government cuts. The private sector has led the way, adding more than 2.5 million jobs to the U.S. economy since the start of 2010. The unemployment rate remains a problem, but job growth has not turned negative and weekly jobless claims have held steady around 400,000.



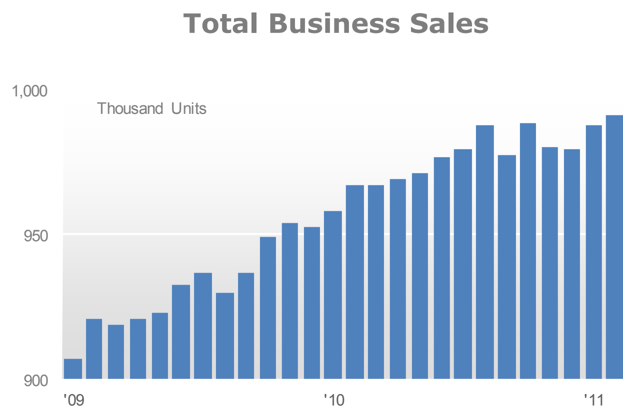
Industrial Production

Manufacturing was one of the first facets of the economy to turn positive coming out of the financial crisis. Industrial production has improved dramatically in the last two years and has shown no signs of weakening during the recent economic soft patch. Capacity utilization has also risen, reaching the highest levels since 2008. There has been a slowdown in the ISM indices, but both services and manufacturing activity continue to expand.



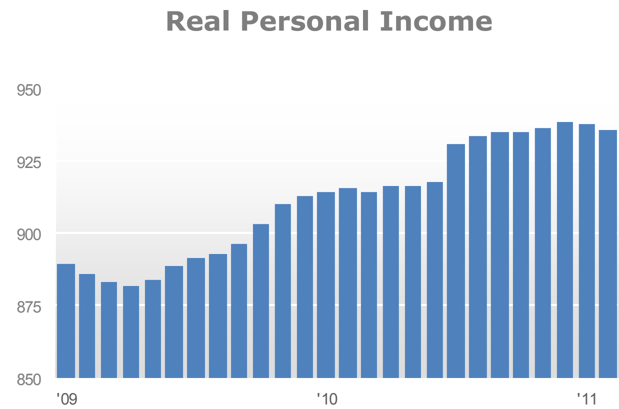
[1] Hall, Robert, Martin Feldstein, Jeffrey Frankel, Robert Gordon, Christina Romer, David Romer, and Victor Zarnowitz. *The NBER's Business-Cycle Dating Procedure*. October 21, 2003.

Total Business Sales



One way to look at the health of an economy is to aggregate all sales from manufacturers, wholesalers and retailers. Total business sales have been steadily trending higher throughout the recovery period and haven't shown a sustainable setback during the recent slowdown. In fact, back-to-school sales came in better-than-expected and tend to correlate highly with holiday sales. Meanwhile, a resurgent auto sector has buoyed overall retail sales in the second half of the year.

Real Personal Income



Inflation-adjusted personal income has yet to reach 2008 highs, but has improved during the recovery. With unemployment above 9.0 percent, there is limited upward pressure on wages. The poor employment environment coupled with higher consumer inflation has caused real personal income to stall recently. Wages may not get a boost from a vibrant jobs market for some time. However, inflation appears to be peaking, which likely will put more money in the consumer's pocket.

Conclusion

Although the current economic data are weak, they are not pointing to a near-term recession. As we have noted in previous publications, we expect a slow growth environment for some time, but the evidence does not support another recession just yet. We acknowledge the U.S. economy remains very fragile and could tip into negative territory if a significant shock were to occur. Historically, recessions are caused by structural imbalances or monetary policy mistakes. The U.S. Federal Reserve Bank and central banks around the world are likely to be accommodative for the next two years, so it would take a major event in Europe, a hard landing in China or a worsening employment situation in the U.S. to push the economy back into recession.

Recent reports on leading economic indicators, private sector job growth, retail sales, construction spending and business spending all support the case for modest near-term economic growth. Moreover, our Points of Data Economic Index has shown moderate improvement in the last month. At the same time, we have no "housing bubble" that needs to burst, corporate balance sheets are in pristine condition and monetary policymakers are likely willing to do whatever it takes to spur economic growth. Despite the potential to avert a recession, we do not want to be overly optimistic given the uncertain landscape and continue to believe a well-diversified portfolio comprised of our four asset group model (stocks, bonds, real assets and complementary strategies) is the optimal approach to weather economic uncertainty.

Data for this QMU sourced from Bloomberg unless otherwise noted.

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