Perspective on the Latest Market Events

Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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Investors have effectively transitioned from "wishful thinking" to "show me," assessing the economic data releases in order to determine the sustainability of any signs of recovery. The data continue to present some inconsistencies, and investors seem a bit reluctant to conclude that the slowdown in the rate of deterioration in the global economy is an all-clear signal. There are signs of relative strength, such as the increase in durable goods orders and the data on personal income, which both came in higher than expectations. There are also areas of concern, primarily on the employment front, where initial weekly jobless claims remain well above 600,000.

As a result, global equity markets continue to be range bound, unable to breach the 2009 high points reached in mid-June. Further, the flight-from-risk trade paid off handsomely last week, with the U.S. Treasury enjoying the best week in three months. There was robust demand even from foreign central banks for three government debt auctions, and the 10-year note rallied, with the yield falling to 3.53% from a high of almost 4% earlier this month. Risk aversion played out in the gold market as well, with the metal reaching a two-week high.

The Federal Open Market Committee minutes released at midweek reflected a Federal Reserve that continues to see improvement in the economy and is less concerned about deflation at this point. The clear resolve articulated to keep the Fed funds rate low for an "extended period" had an immediate impact on Fed funds futures, which had been pricing in a 75% chance of a rise in rates by the end of the year and now view that probability at 37%. Neither is the Fed concerned about inflation, citing the global slack in capacity as an important governor of that outcome.

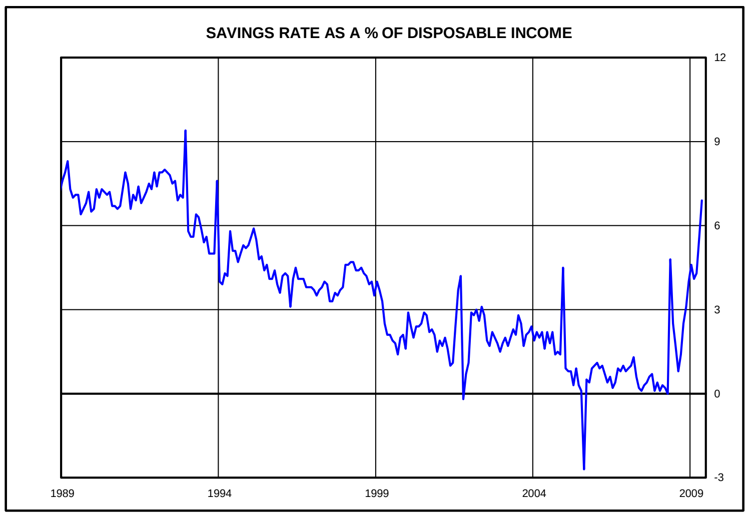
The most interesting piece of data released last week was related to U.S. personal income and spending. We are at the beginning stages of being able to assess the success of certain parts of the fiscal stimulus package – those aimed directly at consumers in the form of tax rebates and transfer payments. With the May personal income number jumping 1.4%, far above expectations, it is clear that the stimulus is getting into the hands of the consumer. The more interesting piece of data, however, was on personal savings. This rate came in at a 15-year high of 6.9% in May, up from the April rate of 5.6%. Could it be that consumers are not spending this stimulus and are, instead, saving these funds?

There have been many studies aimed at predicting what consumers do with direct governmental stimulus. A joint study released by University of Chicago and Northwestern University concluded that the 2008 stimulus package did provide a lift to spending, and the highest effect was in the week the consumer received the check. Another study based on the 2001 stimulus similarly concluded that the spending is front-end loaded, with consumers spending about one-third of the funds within the first month. These studies do not appear to be predictive in the current environment.

If, indeed, consumers are changing their behavior and using the stimulus to repair their damaged balance sheets, this may have a dramatic impact on both the pace and composition of economic growth going forward. This is the Keynesian "Paradox of Thrift," whereby each consumer's savings is beneficial to the individual but harmful to overall economic growth. The saving feedback loop is powerful, with an increase in saving/decrease in consumption reflected in further cutbacks in manufacturing and other economic activity and further reductions in the workforce. The long-term impact may, in fact, be a net negative for the overall economy. This can be mitigated, however, if this savings sits on the balance sheets of banks in the form of deposits, as this provides funds that banks can subsequently lend to individuals and businesses. However, with the deleveraging trend continuing, and given the newly stringent lending standards and the capital concerns on the part of banks, loan activity remains anemic.

With consumption representing 70% of our economy, a more prudent and frugal consumer may result in a prolonged economic recovery period. This change in consumer behavior is potentially painful during the short term, but ultimately it is necessary to repair the damage done to household balance sheets during the era of extreme leverage and inflated asset prices. Many economists are calling this period the "new normal." We contend, however, that this *is* actually normal. The following chart on historical household savings rates supports the idea that what we are witnessing is more a reversion to the mean.

After rising consistently throughout the post-WWII period and hovering generally at levels exceeding 10% in the mid 1980s, it wasn't until the early- to mid-1990s that the personal savings rate began to fall in earnest, which coincides with the bull market in equities. The next bull market – in residential real estate – actually drove the savings rate into negative territory. The current rate of 6.9% is beginning to reach a more normalized long-term mean but clearly has room to increase. Given the uncertainties in the employment picture, and the asset value destruction that households have experienced, we believe that it is likely this rate may increase.



Source: Bloomberg and the Bureau of Economic Analysis.

Katherine Ellis Nixon holds designations as a Chartered Financial Analyst and Certified Investment Management Analyst.