Double Dip? Don't Think So

July 14, 2010

Dear Clients & Friends,

After a promising start to the year, the market (as measured by the S&P 500 Index) suffered its worst two-month return ending June 2010 since the two-month period ending February 2009, which was during the depths of the financial market meltdown. The market had much to worry about as concerns over the fiscal issues in Southern Europe, the compounding problem of the Gulf Coast oil spill, an impending contentious mid-term election cycle, and the unknown consequences of Congress' financial regulation reform kept investors' fears on the rise and market returns on the decline.

Despite the many external factors weighing on the market, it was perhaps the uneven and somewhat deteriorating economic data, especially in the labor and housing arenas, which turned the stock market recovery into a significant market pullback. The primary question that investors sought an answer to was whether the market was beginning to show signs of a developing "double dip" back into recession or whether the last few months are simply a "soft spot" in an otherwise robust economic recovery and expansion?

The question highlights the longstanding market dilemma of trying to figure out the difference between an economy's changes in direction versus changes in speed. Like a car, the economy can be either in forward (expansion) or reverse (recession). But it can also be increasing its speed (accelerating or improving economic conditions) or reducing speed (decelerating or worsening economic conditions). During the last few months, economic data has indeed seen softness, which begs the question: are we on the verge of reversing (double dip) or just slowing down (soft spot)?

As far as double dip scenarios, the market has limited history to examine. Only during the Great Depression and the severe recessions of the early 1980s were there ever double dip recessionary episodes. Could now be the next? The likelihood is strongly against it. In order for an economic recovery to turn back into a recession, significant negative catalysts are needed to derail economic growth.

While not downplaying the negative effect of the problems in Greece or the Gulf Coast oil spill on global growth, these events are just not big enough to shift the economic gears from forward to reverse—meaning from expansion to recession. During the Great Depression, it took a significant monetary policy mistake—increasing interest rates which slowed down a very fragile economy—to prompt the double dip. During the 1980s, the Federal Reserve again shifted gears early to slow down economic growth, but this time to fend off soaring inflation, as exhibited by 16% mortgage rates and 14% interest rates. The strategy worked, maybe a bit too well, as the deliberate economic slowdown turned into a double dip recession.

But right now, the economic backdrop is far different. Albeit slower than we would all want, the employment picture is improving, consumers are spending, and businesses are once again changing their focus from cutting costs to investing for the future. But more importantly, the Federal Reserve remains firmly committed to maintaining accommodative monetary policies through ultra-low interest rates in order to continue providing this economy with much needed stimulus. As a result, mortgage rates are at all time lows and loans to fuel business growth are under very favorable terms. All in all, the economic canvas on which this market will paint future returns is supportive of sustainable growth and higher asset prices.

With the threat of a double dip virtually off the table, the most likely explanation for the sluggish economy and resulting market pullback is what is commonly referred to as a soft spot or simply put, a reduction in the speed of the recovery. Soft spots occur in every recovery, usually between 6 and 12 months after the end of a recession. At 11 months after the assumed end of the 2007-09 recession, this soft spot is right on cue. Soft spots are triggered not by any threat of a change in direction (*i.e.* double dip), but rather at the inflection point when the economic recovery shifts from the robust growth immediately following the recession to the modest, sustainable growth that fuels longer term economic expansions. Back to the car analogy, soft spots occur when the rapid acceleration on a highway onramp shifts to the sustainable speeds of highway driving.

While the global economy continues to face many obstacles, all of which bring down the speed of this economic recovery, I remain convinced that this economy is facing an economic soft spot and not any threat of a recessionary double dip. The market is always concerned when economic growth speed slows, which makes complete sense. But the recent equity market sell-off has priced in a greater likelihood of a severe change in direction (double dip) rather than the more moderate impacts of a soft spot. As a result, I believe that once the economy emerges from its current transition to slower, but still advancing speeds, asset values will be poised to benefit and investment opportunities taken advantage of at these attractive market levels will likely be rewarded. As always, please contact me with any questions.

Buddy Goldstone