

July 2010

Third Quarter 2010 Economic Commentary

Overshooting to the Downside

It's been interesting to watch the markets set up for alternating scenarios through this downturn. Several times during the last 22 months since Lehman went under, fears of inflation have swept in like waves on the beach. Just as quickly the water receded from the shore, leaving only sand and shells in the form of low market rates and a confused stock market.

The second quarter of 2010 reflected the outdraft of the first quarter's crashing wave in the form of heightened concerns about price pressures worldwide. To be sure, we did have a few rate increases across the globe recently, but they were focused on commodity-driven economies that are seeing growing demand for their undiversified product sets.

Back in the real world, a brewing debt crisis in Europe has taken center stage with Greece playing the lead role in what everyone believes is surely a tragedy to come. Who would have thought that a country so small could create so much (potential) damage? Well, such is the interconnectedness of our global financial system.

In the U.S., the Federal Reserve has held rates steady at its target range of 0–0.25 percent since December 2008, and retains language in its near-monthly statement that it will continue to do so for an “extended period” (our thoughts on the meaning of this phrase laid out in [last quarter's piece](#)).

But recently — and prior to the Grecian fumble — there were small but significant signs brewing that a rate increase could be on the way. Most obvious, but perhaps most overlooked, was the structure of the Federal Open Market Committee statement itself.

The lone dissenting voter on the FOMC has been Kansas City's Federal Reserve Bank President Thomas Hoenig, who has been against the “extended period” language since his current voting term began this past January. (Don't ask me to explain the rules regarding FOMC voting terms — they are more complicated than the World Cup playoff structure).

At each meeting date, Hoenig's explanation for dissenting has been given greater play until Europe took center stage recently. In the much-watched statement, Hoenig's dissent began with just 39 words in January and expanded consistently during the year to 64 words in both April and June.

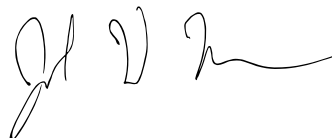
After overshooting to the upside and projecting rate increases far too soon, it could be the markets are now overshooting to the downside as yields compress to record lows even as the economy continues to create jobs and spending continues to grow.

All Too Often, There's a “But”

But for consistent strong growth to appear in the U.S., consumers' fears need to be allayed on two fronts: employment and housing.

The current anemic private sector job growth — averaging just 99,000 jobs per month since turning positive in January — is not making anyone feel good enough to head to the malls just yet. We will need consistent growth well north of 200,000 per month before significant headway is made on the 8 million jobs lost in 2008 and 2009.

More likely, resolution will be found on the housing side first as the government determines where it will play in this crucial sector of the economy, allowing the free market private sector to allocate capital based on risk and return, hopefully beginning in 2011. The longer this can is kicked down the street, the longer we'll see consumers holed up in their homes — with the shades drawn tightly.

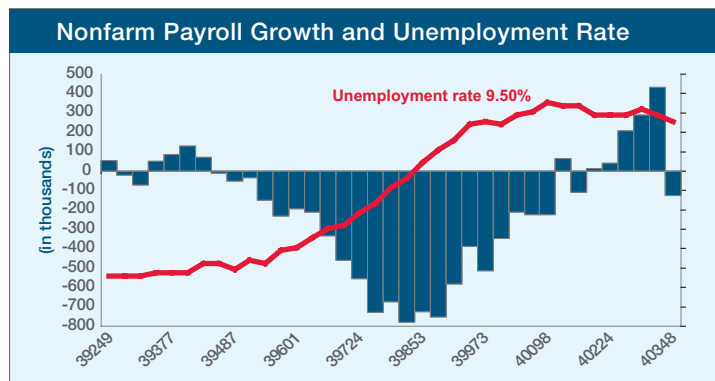


Joe Morgan, CFA

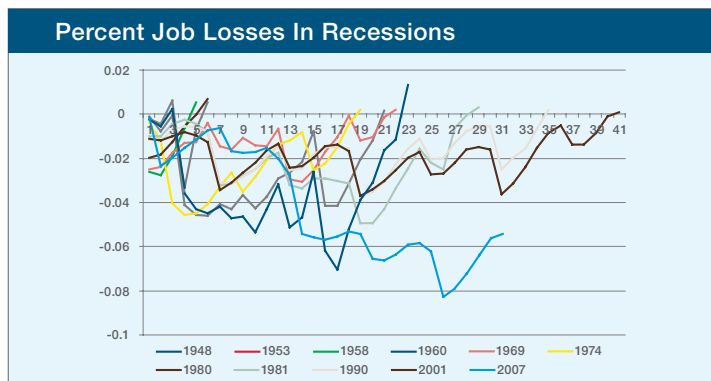
Chief Investment Officer
SVB Asset Management

Charting the Course

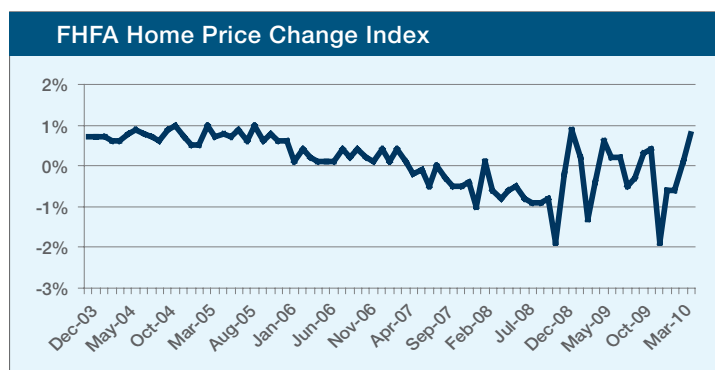
Consumers continue to be concerned on two fronts: employment and wealth. Though job losses have stabilized (even after considering temporary census worker hirings), we still have some 8 million extra people out of work. In addition, the value of their largest asset is fluctuating greatly with no feelings of stability yet on the horizon. The combination of these two factors is keeping consumers on the sidelines with final demand spending coming primarily from the government sector.



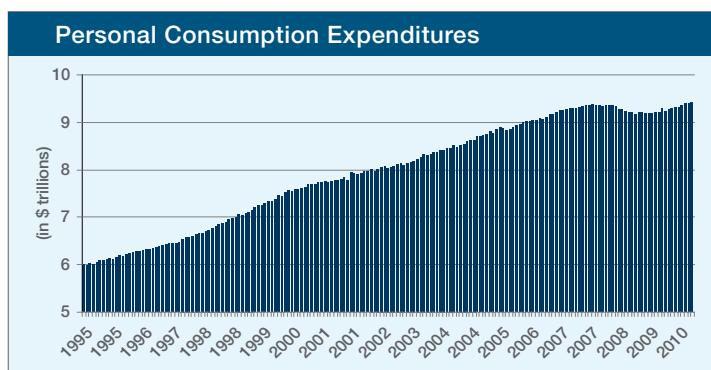
Though job growth has turned positive, deep losses since January 2008 make for a steep hill to climb before getting back to "normal." Future job gains remain in question as final demand growth continues to be questionable.



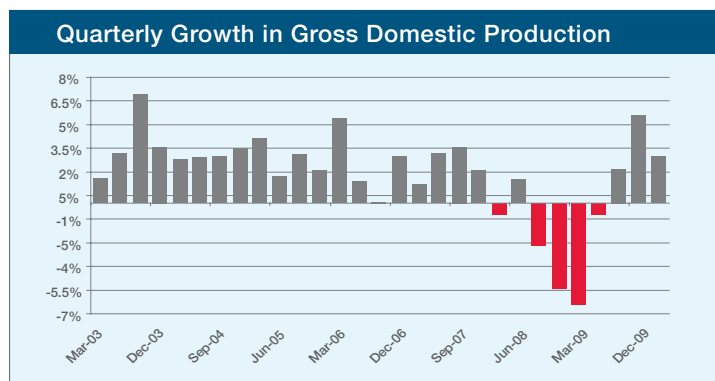
The worst negative employment change in the WWII era is trending up, primarily driven by census payrolls.



Volatile home prices do not lead to a stable consumer. Recent volatility has been caused by both the crisis and the government's various and changing programs for this sector.

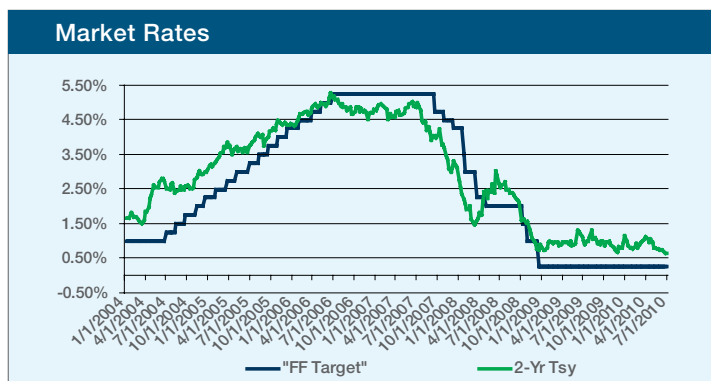


The American economy has become used to a resilient consumer most evident by the continued growth in spending through 9-11. However, this time it's very different with consumption off-pace by some \$600 billion.



GDP has bounced back strongly in 2009 with government spending more than picking up the slack created by consumers. Government spending in the short run can help smooth out the bottom, but by itself, it cannot launch a new era of overall economic growth.

Source: Bloomberg and SVB Asset Management



Market interest rates grind lower as European debt fears wipe out considerations of potential future interest rate increases. This trend could reverse course in the coming months if signs of consumer activity continue to emerge.

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