April 20, 2009

First Quarter 2009 Economic Commentary

Thoughts From the Desk

The first quarter was filled with hope and not a little optimism from investors even though consumers continued to pare back their purchases. The consumers are now worried about two things: first, the value of their homes, which has been a concern for several quarters now, and second, the stability of their jobs, which has come to the fore in recent months. Until either (or hopefully, both) of these concerns begin to dissipate, consumers will remain on the sidelines.

For its part, the stock market seems to have bottomed, although it is possible we could reach new lows before beginning a new steady upward trend. The massive amount of capital sitting on the sidelines (including approximately $2 trillion in money funds that is normally invested elsewhere) could drive swift and violent rallies that could leave the impression a market recovery is on the way. Throw out your old definition of a big market movement and realize investors now wield much larger influence than in the past.

Turning to the economy, we have yet to see anyone inside the Beltway stand up and provide a five- or seven-point plan to get the economy back on the road to recovery. Instead their focus seems aligned with the news cycle, putting out fires as they occur as opposed to thinking comprehensively regarding the problems we face. Until investors and consumers alike can see this path back toward economic prosperity, expect the economy to languish and confidence to remain negligible.

There has been much debate as to whether the current recession is as bad as, say, the early 1970s or perhaps even the 1930s eras; however, we realize that every downturn is different and requires differing solutions as well. Today, it seems the government is attempting to convince investors that almost everything has a government guarantee, so why not invest? Unfortunately, other actions taken by the government are sending the signal that "excessive profits" may be confiscated in one manner or other, which sends exactly the opposite message.

Meanwhile, time has not been on our side. Mounting job losses in the fourth and first quarters will lead to a continued downturn in the housing sector further affecting consumer confidence. Because job losses have accelerated to an almost unbelievable pace, we expect to see many more negative headlines on this critical segment of the economy in 2009.

On the positive side, if someone inside the Beltway can convince institutional investors that it is safe to go back in the water, we could see massive capital flows into the risk markets like we've never seen before. In addition, we remain hopeful that later in the year some banks will be able to "write up" their mortgage investments given the extreme conservatism that has been applied to portfolio holdings to date. Should we begin seeing these types of headlines, consumer and investor confidence could swing toward the positive and get the economy rolling again later this year or early next. While that is not currently our projection, it is certainly a welcome possibility.

Economic Data

By the old definition of a recession — that is, two consecutive quarters of negative growth — the economy officially became recessionary in the fourth quarter of 2008. Under the new definition — that is, whatever the National Bureau of Economic Research (NBER) labels a recession — we have been in recession since December 2007. In either case, the economy continues to trend downward or at least tread water awaiting a boost in activity to bring about positive growth. Unfortunately, few signs exist that point toward a recovery anytime soon.

Even so, the housing market has reported some positive figures including a boost in mortgage refinancings and a slight recovery in existing home sales. Unfortunately, even housing starts recent increase from a 477,000 annual pace to 583,000 leaves total housing stock on a declining trend for the first time since reliable data has been accumulated in the mid-1950s. Consumers will not get back on track until they have some faith their home value has found solid ground and we are not convinced this has occurred.

In fact, given 65 percent of the 5.1 million jobs lost in this recession have occurred in just the last five months, we reckon the housing market could get worse from here. Thinking back to the record pace of foreclosures in 2008, we recall their cause being funky mortgage structures or shady lenders (and borrowers!) as opposed to loss of incomes. It is difficult to see a recovery in the housing market as people continue to lose their incomes at just an impressive rate.

As global trade slows and valid fears of future inflationary pressures arise, it's easy to see consumers and investors putting off their normal activity in the short run. However, at some point pent up demand from both sectors will have to be let out at least in small doses which could cause many "head fakes" in the data looking forward. Instead of focusing on month-to-month data points, it is important to find a plan that will lead us toward recovery. Unfortunately, no such plan has been communicated from inside the Beltway, as politicians continue instead to focus on "the next thing" as opposed to an overall solution.

Monetary Policy

Monetary policy has taken a dramatic shift as the Fed continues to wipe the dust off so many contingency plans and, we believe, invent new ones on the fly. The trillions of dollars being printed and shoved into the economy in the form of current and future government spending is building a tremendous backlog of potential inflation.

Think of San Francisco's famous cable cars which simply grab onto the cable running beneath the streets in order to float along the roadway. Today, consumers and investors have unhinged themselves from the economy and sit idle in the middle of the street. The government's solution is to increase the speed of the cable hoping in some fashion that the car will lurch forward.

When consumers and investors finally engage their grip on the cable, the swift jerking motion caused by the cable moving at too-rapid speed will create damage and panic among the passengers. This is the hyperinflationary scenario feared at the Fed.

One of the problems with this analogy is that money-spenders do not fully grip the economy all at once, but begin to spend gradually as they gain confidence in the coming recovery. This allows the Fed (along with the Treasury, Congress and the Administration, but certainly lead by the Fed) to begin reigning in some of the prior stimulus programs in order to guard against the jerking motion of a too-engaged economy.

It remains to be seen whether Ben Bernanke can politically navigate the waters of a recovering economy, pulling in this stimulus at just the right pace to keep inflation in check. Indeed, even if he does have the omnipotent foresight to identify the most appropriate pace of the cable, it remains to be seen how politically skilled he will be in instituting such stimulus reductions which will surely be viewed as anti-populist.

We hope to be facing such problems some time in 2010 as consumers and investors alike don't seem much interested in gripping the cable anytime soon.

Market Action

Corporate debt issuance dominated headlines in the fixed income world as over $115 billion of government-guaranteed debt hit the street along with more than $212 billion highly rated, non-government guaranteed debt. Unfortunately, the gap continues to grow between the "haves" and the "have nots."

According to the Barclay's indices, investment grade corporate debt yielded 7.5 percent at the end of the quarter, while high yield debt (those issues rated "BB" or worse) yielded 17.7 percent. Issuers of debt in the first quarter included mainly the higher quality corporations such as Cisco, Hewlett Packard, and Roche Holdings.

These themes carried over into the secondary markets as only the top-tier issuers traded actively and others languished on the sidelines with little liquidity to be enjoyed.

All of this is a symptom of the dichotomy facing the markets today: too much cash on the sidelines and too much fear in those who control that cash. Today, over $4 trillion sits in money market funds vs. a more typical allocation of just $2 trillion. That extra $2 trillion is looking for an excuse to get involved, but at the same time its current location indicates how fearful the decision makers are.

If some impetus can be found to direct investments back into the risk markets, the absolute size of the lake held back by the damn of fear will wreak havoc on investors who remain sidelined. Volatility will remain high or even rise from today's lofty levels as massive amounts of cash move back into the markets, but only into the best of investment opportunities.

SVB Asset Management Market Strategy

Our investment strategy for SVB Asset Management clients has changed little in the first quarter. We remain focused on liquidity, holding some 60 – 70 percent of our individual portfolios in money market funds. Lately, we have been reducing this allocation in favor of longer term Treasuries and government agency securities as we believe interest rates will hold steady for the foreseeable future.

Our non-government guaranteed corporate allocation remains very small at around 10 percent depending on issuer availability. Today, our credit team is comfortable with only about 20 issuers that actively trade in the marketplace. Given the team's incredibly skilled results — including not one dollar of lost principal or lost liquidity in this cycle — along with our view of a continued deterioration in the overall economy, we are comfortable remaining almost entirely on the sidelines until the fog begins to lift.

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