

October 14, 2009

**MONTHLY SUMMARY FOR SEPTEMBER<sup>1</sup>  
THE SHAPE OF THE RECOVERY**

Pimco and Larry Summers appear to be debating over what type of economic recovery will occur. Is there a “new normal” that includes very high unemployment rates for unlimited periods of time, as Pimco suggests, or a rather brisk rebound in economic growth that eventually restores the economy to the vicinity of full employment (requiring above sustainable growth for a period of time), as Summers argues. To be sure, both have vested interests in the debate. The Pimco scenario will be without much inflation and with relatively low interest rates despite huge growth in government debt (hopefully managed by Pimco funds). The Summers thesis means that revenue growth will allow payment for Obama initiatives without government debt approaching 100% of domestic annual production.

Increasingly, possibly because of rising stock values, Wall Street economists are siding more with Summers, though they continue to buy bonds because those yields are better than money market returns (but will the total returns from bonds continue to be the better investment?). Indeed, many are looking at the inventory liquidations, currently almost 1.5% of GDP, and assuming that production must rebound to stabilize warehouse holdings. If that production advance restores some jobs, as it did in the past, then sales would rise as well, causing more than normal growth in economic activity. Indeed, many are citing the historical record that shows expansion of 3-6% at annual rates soon after foundations for recovery are established. This has become the argument for a V shaped recovery.

The “new norm” of much slower growth is based upon the lower leverage and higher capital costs that many industries must face in the recovery (this is especially true of financial institutions). \$1.6 trillion in capital has been destroyed by the global downturn, which means lending capacity probably is \$15-18 trillion lower than

before the economy swooned. When increasingly stringent regulatory requirements from classifying under-collateralized but performing loans as doubtful, to marking to market REO holdings when the market price is not apparent, to requiring the use of scarce capital to replenish deposit insurance pools are all considered, the possibility that regulatory constraints could cause an economic relapse is not remote. This prospect is one of the reasons that I believe the foundations for recovery will be delayed by more than a year in this recovery. However, I do not subscribe to the “new norm” of 2% growth for as far as the eye can see.

Actually, the “new norm” is the discarded old norm that economists expected following World War II. Using the Keynesian model, they assumed under consumption would persist for an indefinite period of time. Only increased government spending could prevent a return to high unemployment rates after the “boys” came home. That Keynes would not have subscribed to this conclusion is apparent in his “long run” comment (in the long run we are all dead). He wanted to indicate that the long run was not relevant for what he was exploring, not that long run equilibrium could not be achieved. Yet, the Pimco boys appear to be falling into just such an error.

Let us look at the supply side of this economy. To be sure, job losses will slow migration into our country. Unsuccessful job search also will lower the number of people seeking jobs. Thus, the population growth rate and the labor force participation rate both will (are) decline. Instead of growing 1.4%, the labor force may slow to only a 1% rate of growth (though the wealth destruction that will lead to later retirements works in the opposite direction). But we have two imbalances in the labor market. First, unemployment is near 10% and rising. Second, the workweek is the shortest in memory. Certainly, employers will add hours before

<sup>1</sup> The Monthly Summary is prepared by Dr. Donald Ratajczak, PhD., Morgan Keegan's Consulting Economist. Additionally, this report is a transcript of comments made by Dr. Ratajczak and should be read in that context. Additional Information Is Available Upon Request.

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they add workers, as any premature hiring would prove to be much more expensive than merely shaving hours again. Over the next decade, recovery in the workweek might add 0.3 percentage points per year to average labor inputs. Thus, what we lost in jobseekers we will gain in more intensive use of those with jobs.

Now let us look at productivity. Is there any evidence that resource management is less effective (except in the risk management at financial institutions), that labor inputs are less talented, or that innovations are developing at a slower rate? Corporations have been frightened by the loss of liquidity last fall when the commercial paper market disappeared, but except for the financial sector, they have accumulated cash. The after tax profit margins are exceptionally high for this stage of the business cycle for nonfinancial corporations. This means that they probably have the ability and desire to continue seeking innovations. All the evidence suggests that productivity is improving, not decaying. Thus, the three decade steady state growth rate of 2.7% annually appears to persist, and may even have improved.

If that is so, then what will the under consumption expected by the Pimco boys achieve? Clearly, unemployment rates would continue to rise. This would continue to put downward pressure upon wage compensation. At some point, the wealth that exists will begin to buy more goods or the producers will be able to compete more aggressively with the remainder of the world. Unlike the Great Depression, when beggar thy neighbor policies denied access to international markets, exports would soon surge in this environment. Eventually, even consumption would rebound. Not surprisingly, almost every recession since the Great Depression had a subsequent recovery that brought the economy to the "vicinity of full employment." Summers is correct in assuming such an outcome is likely again.

He is not correct, however, in assuming that the foundations for recovery already have been laid. The private sector was able to generate sustainable income growth only in July. The economy expanded in August as well before apparently stalling again in September. In each of those months, income growth has not been sufficient to sustain the prevailing levels of spending. Until the July experience is replicated for several months, the foundations for recovery remain in the future.

In fact, the danger of a relapse as the government stimulus supports are removed remains very real. I believe the inventory rebound is compelling, but the commensurate jump in final sales is not. After the "coupons" have lapsed (the clunker credit already has and the homeowners' credit is scheduled to end after Thanksgiving), what will power the recovery? Moreover, if those "coupons" work as many do, they

have borrowed sales from the future. In the winter, the future is here.

As I said above, if the stimulus is removed while regulatory constraints are tightening, then a full double dip is not only possible, but likely. I certainly do not believe the monetary restraint and tax increases that caused the 1937 recession during a depression are likely, but current regulatory actions effectively are raising the reserve requirements of financial institutions. Is this not similar to the increased reserve requirements that preceded the 1937 decline? And the fear of higher taxes as the Bush cuts expire along with mandatory health insurance purchases could be the equivalent of the social security taxes that caused a jump in the high employment surplus that also contributed to the 1937 dip. While I realize that not many have studied American economic history, the similarities in policy restraint with those in 1937 are greater than the differences.

Now that I have frightened my readers, let me say that corporations outside the financial sector are much better capitalized than in most recovery phases. The inventory imbalance is much larger than normal and growth abroad is improving faster than in the U.S. This allows the ability to use our international customers to re-employ our workers. But this will be a much slower process than many think. Thus, the Summers thesis of 4% growth for several years will not start until 2011. But it will start (assuming our regulators don't strangle the financial sector first).

### **CREDIT MARKETS**

Initial estimates of the just completed fiscal year's deficit are in and they are not as scary as originally expected. The Federal government borrowed \$1.6 trillion to make up the gap between rising expenditures and falling receipts. I mentioned in an earlier commentary that about half a trillion was financed indirectly through the change in household savings. Another quarter trillion came from the reduced household and builder investment in homes. Add to that a quarter trillion change in the net use of funds by the corporate sector (slightly higher cash flow and dramatically lower inventory and capital spending) and a trillion was financed domestically. Remember, the previous deficit was \$454 billion, so no change in the behavior of other investors, whether domestic or international, would be needed to finance the huge deficit.

I point this out to indicate that trillion dollar deficits cannot persist too often without causing some drastic changes in investor behavior. Normally, those "drastic" changes are reflected in a falling currency and/or rising interest rates. The declining currency is readily apparent, although some of that reflects a shift in financing the carry trade from Japan to the U.S. Clearly, the deficit will be lower this fiscal year, though

estimates of a trillion or more continue to surface. This is reinforced by estimates that only a third of the \$787 billion stimulus program has been spent. Remove all the special financing programs, but add that stimulus to the prevailing deficit, and a trillion emerges.

Unfortunately, absorption of that deficit will be much harder than the \$1.6 trillion in the previous year. Households probably will continue to increase savings, but they and their builders no longer are likely to reduce housing investment. At best, the higher household savings will merely finance the gains in home investments. Thus, households change from a major contributor of funds to no further net contribution.

The problem is also substantial for corporations. They almost certainly will be eliminating that inventory liquidation. While cash flow should improve, this is only tens of billions, not enough to compensate for the smaller investment reductions. Thus the net quarter trillion contribution is slashed to less than \$100 billion. Thus, almost a trillion in domestic contributions to finance the deficit is slashed to something less than \$100 billion.

State and local governments will have little capacity to add to any rainy day funds, as receipts lag economic conditions, especially for the local governments (property tax assessments will be plunging throughout the year, even with property values stabilizing).

So, only a \$600-\$700 billion reduction in borrowing by the federal government will be met by nearly a trillion reduction in domestic funds. The rest must come from abroad.

A year ago, that was not a difficult task. International investors wanted liquidity and security. Only the U.S. markets, especially the treasuries, provided that. Now, much of Asia is in rebound and Europe is beginning to stir as well. Parts of Latin America also show significant growth opportunities. In other words, alternatives to the treasuries are springing up. While international savings are more difficult to gauge, they probably will not be surging anytime soon. Thus, with more alternatives and not that much more supply, the dollar based assets in general and the treasuries in particular will be losing favor.

Adding to this pressure will be increases in policy rates in many parts of the world. Australia already has raised rates and Norway is soon to follow. I would be surprised if Euroland did not raise rates by the end of spring. Britain may hold out a bit longer, but they also would be raising rates in the summer. Unless, the Fed raised its policy rates, these changes could place significant pressure upon the dollar.

But, the Fed currently has accepted market risk in its investments as it established markets in vehicles that were struggling for acceptance. I do not fault the Fed for this action, which provided the liquidity and market functions necessary to restore confidence in the financial system. However, I doubt that the Fed will raise policy rates and absorb some of that market risk (possibly even reporting losses) before much of that unusual portfolio is liquidated. We already know that mortgage backed securities will no longer be accumulated after the winter quarter (they probably will be liquidated as market pressures dictate soon thereafter). Already, commercial paper holdings are being reduced. Thus, I believe the Fed will restore a more normal portfolio before they change policy rates, and I expect that restorative process to take all year.

So, the Fed will be reluctant to change policy rates even as other central banks are changing their rates. Not only should this hurt the dollar, but it also should raise longer maturity yields. Thus, the treasury yield curve will become steeper. Of course, the side effects are rising interest margins for lending institutions, which should partially offset the regulatory restraints that still concern me. The long rates should return to normal before the short rates. Remember, normal is inflation adjustment plus bribe for short term funds and that plus market risk insurance for longer maturities. If we assume that 100 basis points are needed to extract savings from those who created wealth and the core rate reflects the expected rate, then next year's equilibrium policy rate should be about 2.5%. The insurance premium for a ten year treasury should be another 100 to 125 basis points for a 3.5-3.75 yield. I am saying that the 3.75% yield will materialize long before policy rates begin to rise.

Furthermore, any hesitancy to remove liquidity during this period of declining currency values almost certainly would add to the core inflation rate. Thus, the equilibrium yield in 2011 could easily be in the 4.5% or higher range for the ten year treasury.

### **EQUITY MARKETS**

In the meantime, the equity markets are benefiting from the narrowing of interest rate spreads. The Baa, which I believe is most relevant for discounting future corporate earnings, is back to a normal rate with the Aaa, although the latter remains about 75 to 100 basis above normal relative to the comparable maturing treasury. Thus, the good news is that the reduced discount rate for evaluating corporate earnings should not rise much in the next year or so.

Of course, the rate plunged once fear of default diminished for most corporations. This is what spawned much of the strong rally in equity values. While everyone talks about the 50% rise in S&P values from their March lows, I have argued that equilibrium

values were rising during the first quarter plunge. Therefore, the declines reflected fear, not economics. As fear diminished, the declines based upon that emotion were reversed. Of more interest is the 18% gain in the S&P since the year began.

A typical bull market has a relatively strong first leg, usually about 30-35% gains in the first 12 to 18 months. For my purposes, I believe the beginning of year values are better at determining the magnitude of gains than the March lows. (By the way, those waiting for those lows to be tested must await another surge in fear. I don't see that happening in this cycle and maybe not for a long time to come.) According to my reckoning, we have another 12-15% rise from current levels before next summer.

What normally ends the first phase of the bull is what I expect will be happening here as well—rates will begin rising (even for my Baa's). The second phase of the bull is more earnings driven and is much less intense. Indeed, only another 10-12% gain in equity values is likely a year from next summer. From there, the issue is whether we establish steady state growth (which adds 7-8% a year to equity values) or do we again drift into excesses requiring another recession. Which one will occur is still unclear and is not important for current market assessments.

The biggest leader in this bull has been the information technology, followed by materials. While technology certainly can maintain leadership the materials almost certainly will not. The dominant loser has been telecommunications services, which are struggling with the impact of new communications technology. The utilities also have struggled, but that is partially because weather changes have dramatically lowered their outputs (along with the intensity of the recession). The strong performance of consumer discretionary stocks is surprising, as the consumer clearly is shifting spending patterns and is not responding to discretionary appeals, unless they are bargains.

What would I expect a year from now? Technology certainly could continue to lead, but materials probably will begin to lag. Energy will be a market performer, which is slightly better than their year to date performance. The Dow stocks, which have lagged, should begin to take some leadership as the falling dollar encourages multinational gains. The REITs will be struggling for at least another year. As for financials, their current 15.4% importance in the S&P is probably where they should be. This suggests market performance for that group in the next year.

As for the 13.5% valuation for healthcare, that depends upon possible reforms. Under prevailing conditions, that concentration of value is low, suggesting better than market performance. However, investors must

understand winners and losers from any government programs before they seek the strong winners that probably will emerge in this group. Until I understand the legislation, I am reluctant to make choices as well.

Nevertheless, I believe the positive trend in stock values persists at this time.

### **MORGAN KEEGAN UNIVERSE**

Bull markets usually initially favor small capital stocks. This is because the flight to safety declines and the search for recovery is more rewarding in the lower capitalized stocks. This market rally has been no exception, though the relative strength of the technology stocks is surprising. More surprising still is the outstanding performance of the MK universe, which is up almost 43% for the year through September.

Technology also is the winner in the MK universe, but the gains are even larger than for their counterparts in the overall market. The worst technology performing segment is system area networks, and they increased more than the MK universe average. Estimates of further decay in their earnings probably prevented even stronger gains there.

Medical technology also was very strong, as most investors believe that is one area that Obamacare may help.

Not only did our energy offerings outperform their benchmark, but they were almost as strong as the technology. Again, we do not see much gain in earnings through next year, so those gains may be hard to replicate.

Our consumer services other than specialty retailing also were strong. Projections of earnings growth certainly aided the restaurants, but earnings are projected to only marginally improve in levels of two years ago for our consumer special situations. Yet, their values grew even faster than the restaurants.

There were declining segments. Regional banks were the worst performers in our universe, despite rebounds for many of the larger banks. The region clearly has real estate problems, but they probably should not be lagging so badly.

Falling earnings undermined transportation leasing. However, they are now priced for problems and I doubt that those problems will become much worse. Airfreight has similar concerns about earnings, and their rebound in volume growth could be more than a year away. The healthcare REITs gained value, but just barely. All real estate assets are suffering, even these more stable earning properties.

The relative weakness in transportation may be a problem. A healthy economy needs to have strength in moving goods and people. Maritime shipping rebounded strongly, suggesting the world economy also is rebounding, and the LTL trucking business was improving because of the compelling value relative to earnings projections. However, all the other segments of transportation underperformed.

The regional banks present a quandary, because finance led the broad market and probably will need to rest. However, our regional banks actually declined. If

they also rest, then little value is being generated in our region of the country.

I personally would look for healthcare once the health reform debate is clarified, though I understand the reluctance now. I also would expect more from transportation, especially the trucking sector. In any event, the 42% gain in the MK universe in the initial three quarters of this year is especially strong and relatively good gains are likely to persist into next year.

Current forecasts for several key economic variables are shown below (they reflect the chain weighted measures of GDP):

	2009				2010				2011	Ann.	Ann.	Ann.	Ann.
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	H1	2008	2009	2010	2011
Real GDP	-6.4	-0.7	2.6	2.2	2.1	2.0	2.7	3.4	3.8	0.4	-2.3	2.2	4.1
GDP Deflator	1.9	0.0	1.4	2.0	2.3	2.5	2.3	2.5	2.7	2.1	1.1	2.0	2.7
Nominal GDP	-4.6	-0.8	4.1	4.3	4.5	4.6	5.2	6.1	6.7	2.6	-1.2	4.4	6.9
CPI-U (annual rate)	-2.4	1.3	3.6	2.8	3.1	2.9	2.6	2.7	2.9	3.8	-0.2	2.7	3.1
91-Day Bills	0.2	0.2	0.2	0.1	0.1	0.1	0.2	0.2	0.9	1.3	0.2	0.1	1.6
Prime Rate	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	4.1	5.1	3.3	3.3	4.6
Federal Funds	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	1.0	1.9	0.2	0.2	1.6
2-Yr Note	0.9	1.0	1.0	1.0	1.0	1.1	1.1	1.5	2.0	1.9	1.0	1.2	2.6
5-Yr Note	1.9	2.2	2.5	2.3	2.4	2.5	2.6	3.0	3.3	2.8	2.2	2.6	3.9
10-Yr Note	2.7	3.3	3.5	3.3	3.5	3.6	3.8	3.9	4.1	3.6	3.2	3.7	4.8
LT-Average	3.6	4.2	4.3	4.1	4.2	4.4	4.5	4.7	4.9	4.3	4.1	4.5	5.6
Aaa	5.3	5.5	5.3	5.2	5.3	5.4	5.5	5.7	5.8	5.6	5.3	5.5	6.4
Baa	8.2	8.0	6.7	6.3	6.3	6.4	6.5	6.6	6.7	7.5	7.3	6.4	7.3
Corporate Profits (\$bil)	976	1031	1082	1113	1151	1185	1222	1276	1369	1171	1051	1209	1397
Operating Profits Adjusted (\$bil)	912	921	953	978	1004	1027	1063	1104	1185	1068	941	1050	1216
S&P 500	809	892	997	1123	1216	1282	1373	1501	1592	1221	955	1343	1556
S&P 500 Equil.*	1042	1079	1333	1454	1493	1503	1532	1567	1657	1356	1227	1524	1547
Value Gap (%)	-22	-17	-25	-23	-19	-15	-10	-4	-4	-10	-22	-12	+1
Dow Jones	7774	8324	9230	10096	10843	11526	12124	12832	13629	11253	8856	11831	13468
Nasdaq	1485	1731	1985	2205	2413	2592	2706	2881	3022	2163	1852	2648	2885
Trade Weighted Dollar	112.0	106.7	102.8	100.9	99.1	98.0	97.3	97.2	98.3	100.7	105.6	97.9	99.1

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