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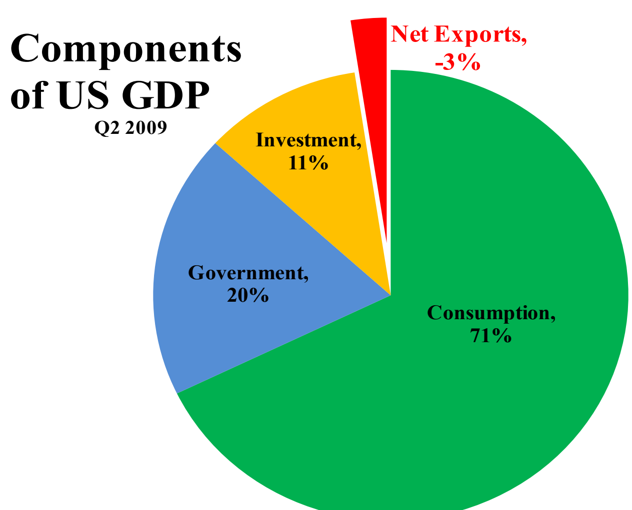
The New Normal Cannot Be the New Normal

We believe that financial markets are approaching an important milestone. Following Lehman Brothers' collapse and the subsequent financial crisis, financial markets fell to levels that anticipated global economic depression. We have consistently argued that the Federal Reserve's unprecedented monetary stimulus would prevent a depression and that financial markets would ultimately reverse these extraordinary declines. Most fixed income and commodity asset classes have already recovered to pre-Lehman levels, and equity markets are within 5 to 10%. We believe that the Fed must create approximately $500 billion in additional monetary reserves by March 2010 in order to complete its credit easing program, a forecast supported by the Fed's printing of $65 billion during the week ended 10/22/2009. We think that this flood of liquidity will help push the S&P 500 back to its pre-Lehman trading range of roughly 1140 to 1250. Once all major markets have returned to pre-Lehman levels, significant market gains will likely be more difficult and will depend in large part upon the sustainable level of economic growth in the US, in our view.

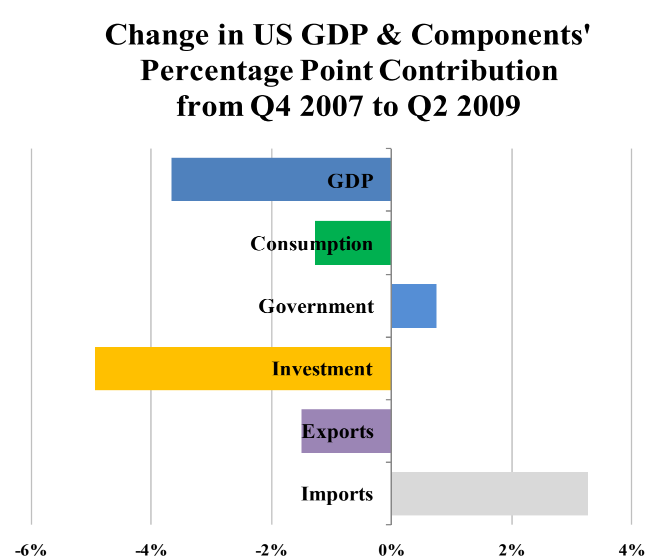
In assessing the sustainable growth potential for the US, we regard the extraordinary government stimulus efforts being applied to the economy as a temporary bridge across a severe decline in private-sector economic activity. Based upon the currently announced stimulus efforts, that bridge will cease to exist in the next six to nine months. Given the forward-looking nature of financial markets, we must begin to ask what sources of economic growth are likely to emerge on the other side of the bridge. We conclude that **sustainable growth from domestic sources will likely range between 1% and 2% once the impact of the current stimulus fades. In our view, such anemic economic growth (often described as the 'New Normal') will be insufficient to reduce unemployment from current elevated levels and will not be politically acceptable. Thus, we believe that US policymakers will be forced to seek additional growth by encouraging exports through a weaker dollar, especially versus the Chinese Yuan.**

Parsing the US Economy

The US economy produced about $12.9 trillion in goods and services on an annualized basis as of June 2009, down about 4% from $13.4 trillion prior to entering recession at the end of 2007. US household consumption represents about 71% of total GDP. A 'normal' recession typically ends when consumer confidence improves to the point that household spending starts to increase. Renewed consumer spending prompts businesses to increase investment in inventories and production capacity, which leads to additional employment gains and consumption. Thus, the initial burst of consumption generally creates a positively reinforcing cycle of economic growth. Current economic conditions, however, make kick-starting such a consumption cycle difficult.

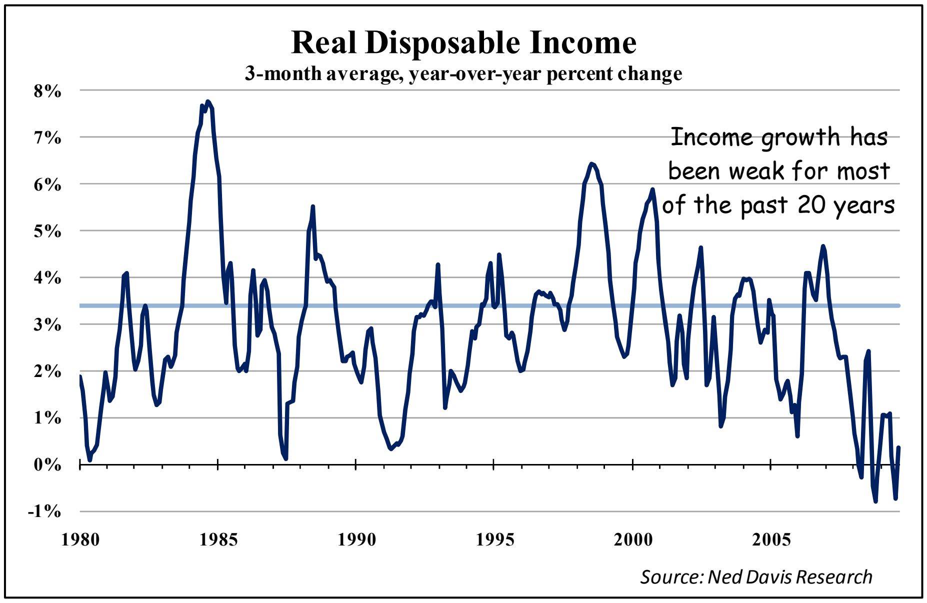


Source: Federal Reserve, Riverfront Investment Group
Note: Percentages do not add to 100% due to rounding



Consumption (71% of GDP)

US consumers entered into the recession with unprecedented levels of debt and a savings rate close to zero. Since many big-ticket purchases (e.g. cars, flat-screen TVs, luxury vacations) require either incurring additional debt or dipping into savings, we do not expect the typical end-of-recession surge in consumption spending. Rather, we believe that consumer spending will remain subdued until savings rates have returned to their long-term average of about 8%. Even after this is achieved, we believe that consumers will remain debt adverse and sustainable gains in consumer spending will be limited to gains in household income. Government stimulus programs such as 'cash for clunkers' can only provide a temporary boost to consumer spending, in our view.



As shown in the chart, the pace of consumer income growth has been below average for most of the last decade, and with the exception of the late-1990s tech bubble, income growth has been weak for the past 20 years. Likely causes of this persistently weak income growth include the fall of the Berlin Wall, as well as China's and India's integration into the global workforce. This rapid expansion of the global labor supply inevitably put downward pressure on incomes.

The abundant labor supply that has depressed income growth for the past decade has been exacerbated by the high current level of US unemployment. This suggests that income growth may remain at the anemic 1% pace of the past two years even as the US economy emerges from recession. A more optimistic assumption would be for income growth to accelerate to 2.5%, the rate for most of the past decade. We cannot imagine a scenario in which income growth could accelerate to 3.4%, its long-term average. Limited income growth combined with a reluctance to engage in sustained borrowing suggests that consumption's long-term contribution to GDP will average from 1.0 to 2.5 percentage points, much weaker than consumption growth in prior economic recoveries.

Government (20% of GDP)

Government spending has been the one area of domestic economic growth since the beginning of the recession. Government stimulus spending and tax cuts accelerated in the third quarter of 2009 and will continue to increase into the first quarter of 2010. Although stimulus spending will remain high into 2011, the level of spending starts to decline by mid-2010. Since spending increases are necessary for the government to positively contribute to GDP, it will begin subtracting from overall economic growth by the second half of 2010 without another stimulus package.

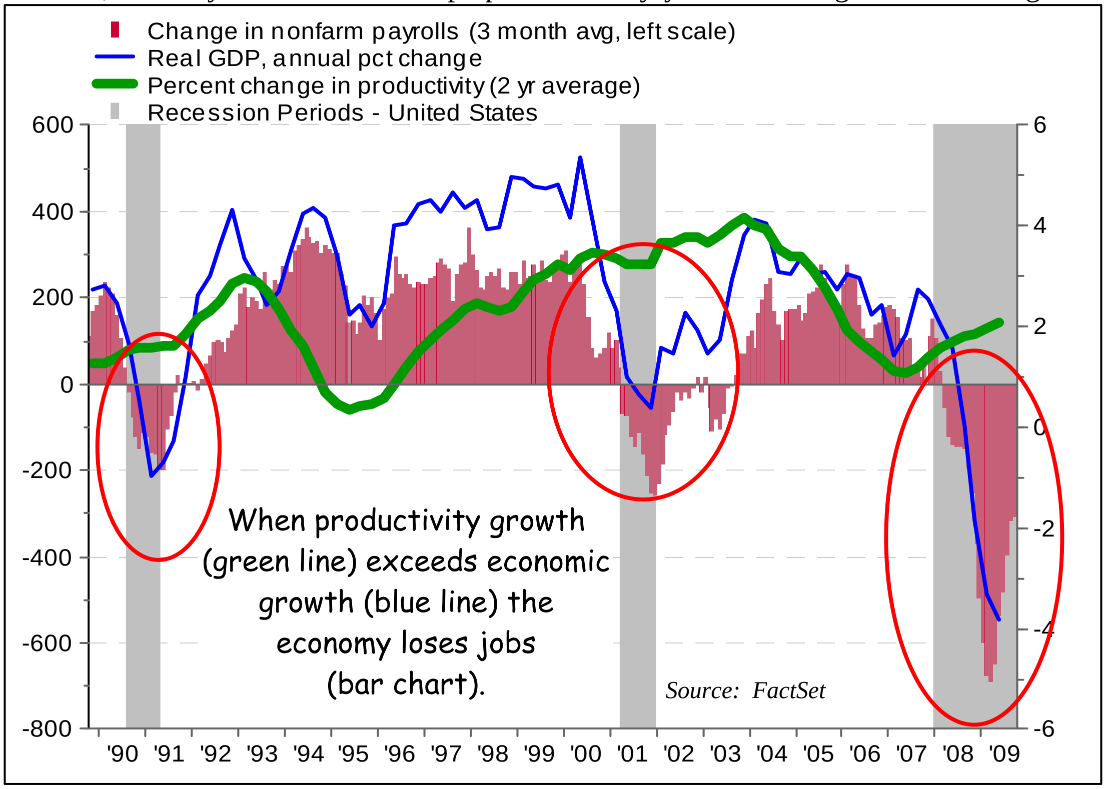
Given that President Obama's stimulus package is set to fade during the run up to the 2010 elections, we believe the probability of an additional stimulus package is quite high. We think that the current stimulus plan has been financed without significant increases in interest rates because the Fed's aggressive purchases of government bonds have effectively "monetized" the debt. For any additional stimulus package to be effective and not just 'crowd out' private demand by pushing up interest rates, we believe that the Fed would have to continue buying government bonds beyond its current $1.7 trillion target. Even with the Fed's support, an additional government stimulus package can only delay the inevitable, in our view. Current deficits are unsustainable in the long run. Spending will ultimately have to decrease, taxes will have to be raised, and the government's contribution to growth will subtract between 0.5 and 1.0 percentage points from GDP for many years to come.

Investment (11% of GDP)
Recessions are typically characterized by sharp drops in investment spending because a weaker economy reduces the need for additional housing, production capacity, or inventories. This recession has been marked by an unprecedented $600 billion decline in investment expenditures. The recent housing and commercial real estate bubble has led to overbuilding, and working through the excess supply of homes, office buildings and shopping centers will likely depress construction investment for years to come. With companies having aggressively cut inventories by $171 billion in response to a potential depression, some of the decline in inventory investment could be reversed over the next several quarters. However, such swings in inventories are short term and do not contribute to sustainable economic growth, in our view.

With real estate investing depressed and inventories only providing a short-term boost to growth, the sole remaining source of sustainable growth from investments is in software and equipment. These expenditures plummeted in the wake of Lehman's failure, as the near collapse of global financial markets made it difficult to obtain financing and prompted companies to conserve cash. With financial markets largely recovered and US companies relying on cost cutting to drive earnings, we believe that software and equipment investments that improve productivity will accelerate. Thus, we believe that investment spending will settle into a long-term contribution to GDP of approximately 0.5 percentage points. By contrast, investment spending contributed an average of about 1.5 percentage points annually to GDP for several years during the recovery from the 1982 recession.

The New Normal *Cannot* Be the New Normal

Combining all of our assumptions into a forecast for GDP, we arrive at a sustainable rate of growth from *domestic* sources (consumption, government, and investment) of between 1.0 and 2.0%. This level of potential growth has been labeled by market commentators as the new normal, and they warn investors to prepare for many years of slow growth. Although our constraints on GDP support a new normal forecast, the impact of such a forecast on unemployment makes it difficult for us to believe that US policymakers will passively accept this outcome.



For unemployment to decline, GDP not only has to grow, but it has to grow faster than productivity. Productivity measures the aggregate increase in output per worker. As shown in the chart, when productivity rises faster than growth in GDP, companies can meet customer demand with fewer workers, and unemployment rises. As illustrated by the so-called jobless recovery of the early 2000s, even a growing economy will experience rising unemployment if its rate of growth is less than the growth in productivity. Assuming US productivity growth remains close to 2%, then new normal assumptions for GDP suggest unemployment is unlikely to decline and may actually increase since productivity typically rises as the economy emerges from recession.

The prospect of sustained unemployment of 10% or higher is unlikely to be acceptable to US citizens. Government policymakers will be under severe pressure to deliver more economic growth than the new normal in order to reduce painfully high levels of unemployment. We believe that policymakers have few options for generating higher growth from domestic sources and will therefore focus on increasing exports.

Breaking Out of the New Normal — Rising Exports

Since the beginning of the recession, an improving balance of trade (exports minus imports) has added $200 billion to US GDP (about 1.5 percentage points). Despite this improvement, the US trade deficit remains about $400 billion and further reductions in the trade deficit offer the potential for significant incremental economic growth. To date, the improvement in the trade balance has been driven by imports falling faster than exports and is a function of collapsing consumer demand in the US. Further gains from falling imports may be limited, since a large percentage of the current trade deficit consists of oil and low-end manufacturing without significant domestic US competition. Thus, further gains in the trade balance need to be driven by rising exports, in our view.

After 30 years of persistent trade deficits the prospect of an export driven U.S. economy may strike some as farfetched. However, the U.S. remains the world's largest manufacturer and its third largest exporter (behind Germany and China), so an export driven growth strategy is at least theoretically possible. To quote Sherlock Holmes, "once you have eliminated the impossible what is left, no matter how improbable, must be true." We believe that the level of unemployment suggested by the "New Normal" will be impossible for U.S. policymakers to accept. Therefore, no matter how improbable, the U.S. must pursue incremental economic growth through rising exports.

The most powerful lever policymakers have for encouraging exports is the value of the dollar and the most important currency that needs to adjust its value relative to the dollar is the Chinese Yuan. The value of the Yuan is tightly controlled by the Chinese government, so any increase in its value versus the dollar will require Chinese cooperation. In a subsequent report, we evaluate the likelihood that China will cooperate in a dollar devaluation policy and the potential market implications if they do not.

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