FirstMerit Monthly Commentary
The Great Debate
October 7, 2009

The format for this commentary is an economic debate between an Optimist and a Pessimist. The Investment Team discusses these issues on a regular basis and we thought it would be enlightening to our clients to read both sides of the argument. Thanks to portfolio managers Mark Shupe (Optimist) and Jeff Onuska (Pessimist) for generating the arguments. After the debate, I'll close by answering a question about the markets and our investment strategies.

Opening Statements

Optimist: America's economic engine is powered by over 200 million participants determined to succeed. Our wealth of natural resources and open economic system has consistently delivered health, security, and growth. This is not the first severe recession we have experienced and current data indicates that we are in the early stages of a V-shaped recovery. The normal positive feedback loop from government to businesses to consumers will develop and result in a sustainable economic expansion.

Pessimist: The impact of the forced deleveraging of consumers, investors and the financial system will be a drag on global economic growth for years to come. We are worried that the V-shape will turn out to be the first half of a "W". The New Deal in the 1930s and Japan in the 1990s -2000s are vivid examples of huge government stimulus spending that did not ignite economic growth. One of the long-term effects of current US stimulus spending may be a depreciating currency. If the government printing presses break down under the weight of soaring deficits and debts, a W will emerge.

Moderator: What is the likely impact of government actions?

Pessimist: While there is an obvious positive effect on the economy from the government stimulus, the key question is sustainability. Cash for clunkers, moratoriums on foreclosures and first time homeowner incentives are all temporary. Deleveraging, de-globalization and reregulation will cause slower global economic growth. The downside to increased regulation such as new capital requirements and compensation oversight will be slower growth. The number of mortgage lenders has been reduced dramatically and the appetite to lend has been curtailed. The deeply indebted consumer will be forced to replace "shop until you drop" with "save to the grave."

Optimist: Given global monetary and fiscal stimulus, there is plenty of money available for an economic recovery. Growth will be driven by the pent-up demand for goods and services resulting from the severity of the recession. It is important that Federal Reserve tighten monetary policy in time to stem inflationary momentum. However this does not have to mean the end of the recovery - our economy has recovered from other brutal recessions with higher fed funds rates than we have now, most recently in 1981-82. Tightening will mean more long-term economic stability. The recent backlash on Main Street against increased government intervention should impact the growth of regulation.

Moderator: What's your outlook for the consumer?

Optimist: Consumer spending depends on employment. Initial and continuing jobless claims are down substantially from where they were earlier this year so this will not be a jobless recovery like the ones that began in 1991 and in 2001. Those were soft recoveries with GDP growth of less than 3%. The common wisdom is that higher rates of savings will impede economic growth, however if you believe that our current economic opportunity is in productivity gains (which have been remarkable lately) then increased consumer savings and reduced debt will mean substantial buying power in the future!

Pessimist: As consumer debt levels reached all time highs in 2008, savings rates reached all time lows. The savings rates have since rebounded at the expense of consumer spending. The home equity piggy bank has been broken, government retirement programs are suspect and higher taxes seem inevitable. In addition, it is estimated that there is a 7 million unit overhang in the housing market and delinquencies are still rising. To reach 5% unemployment we will have to create 14 million jobs in the next five years, which means we would need to create 250,000 jobs per month from 2010 to 2014. In a new era of cost cutting and productivity gains, this seems highly unlikely.

Moderator: What is the outlook for corporate growth?

Pessimist: Corporate revenue comparisons for Q2 2009 were significantly negative. The consumer is on the ropes, so GDP growth for 2010 will be led by government spending. Corporate budget constraints will limit new hiring, capital expenditures and anything but modest inventory restocking.

Optimist: New orders for durable goods declined 2.4% in August, but the entire decline is attributable to aircraft, which is the most volatile segment. Continued earnings growth, normalized bank lending terms, and development of new markets will ultimately lead to increased business investment in inventories and equipment, not to mention increased hiring.

Moderator: What is your rebuttal to the opposing view?

Pessimist: Unfortunately, a “normal positive feedback loop” will not develop in 2010. The fragile economic recovery relies heavily on government stimulus spending, but as the money runs out, a sustained rebound will be elusive. Many Americans are out of work, and their ranks continue to increase which puts them in poor position to pay off the mounds of debt accumulated during the boom times. The negative feedback loop is thus likely to re-emerge.

Optimist: Many of the points made by our esteemed Pessimist are already or will soon become history. Improvement in residential housing inventories, employment and consumer spending will not be quick, but none of these is necessary for the current growth trend to continue. Regarding deleveraging, consumer demand and borrowing do not drive long-term productive capacity. If de-globalization means protectionism, most of the rest of the developed economies seem to be headed in the right direction and hopefully the US Administration will end its protectionist rhetoric and plans. Some re-regulation is required, but we think political gridlock will limit that damage.

Moderator: And in conclusion?

Optimist: Our economy has impressive positive momentum behind it and there is compelling value in the market prices of many of our publicly traded companies. The forces at work are the ones that have always worked; the productivity and invention of individuals and organizations that produce. So long as the trend is toward focusing more on the requirements of production, we have a bright future. In the short run, the argument for a “V-shaped recovery” is intact.

Pessimist: Less than 12 months ago, we were on the brink of financial Armageddon. We have made substantial progress towards stabilization of the global economic system, but the progress is due to unprecedented and massive global government intervention. It remains to be seen whether or not the engine of private sector growth has been reignited. Trees don't grow to the skies and massive governmental and personal debt levels take years to pare down. Let's hope the green shoots survive the coming winter!

Moderator: Thank you, gentlemen. The shorter term Optimist perspective seems to be playing out, but it may be months before it is obvious which longer term outlook proves correct. While we believe the risk of Depression has been averted, the Pessimist has a strong point about the impact of de-leveraging. At this time our focus is on the fact that 8 of the 10 signals on our Expansion Signals Checklist are now switched on. In our opinion, the severe recession is clearly over. However, the debate over the sustainability of the nascent recovery is clearly not over.

With regard to the financial markets, the S&P has now racked up seven consecutive positive months and international and smaller domestic stocks have led the rally. Corporate bonds are beating US Treasury bonds. This is the normal pattern as we exit a recession. The S&P 500 gained 60% between March and September. It is now up 19% year to date and +15.6% this quarter. Most equity indexes returned 13% to 20%+ in Q3. Value beat growth and Midcap Value was the best of all at +23.6%. While Emerging Markets were up a mere 21% for the quarter, the year-to-date return is now a spectacular 64%!

So the question I received was: given the power of the rally over the past 7 months, is it too greedy to expect the normal seasonal pattern of good fourth gains topped off by a yearend Santa Claus rally? First, yes that is rather greedy. Recall that in March we were fending off questions that boiled down to: Are we experiencing the Apocalypse now or is it going to arrive later? Secondly, the Market Meter has gone from -3 in March to +4 this month, but the Wall of Worry remains high and wide and cash on the sidelines is very high. If the Bears throw in the towel there is plenty of fuel for a melt-UP in stocks.

While we are not going so far as to predict such an event, we will keep client accounts fully invested in equities until the Meter indicates the currently very favorable risk/reward in stocks is changing. We continue to believe Santa Claus is more likely to be seen than the Grinch!

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