



November 22, 2011

Recession? What Recession?

- **U.S. farther away from recession (which was main concern of the summer)**
- **Corporate bond spreads staying wide due to current focus on Europe**
- **Market psychology could gradually change focus again (away from Europe to U.S.) – which would be good for U.S. corporate bonds**

This summer the high yield bond market, which had enjoyed a pretty good record of forecasting the economy in recent years, predicted a recession. Marty Fridson pronounced this as a buying opportunity, since he also noticed that economic forecasters were only forecasting a one-third chance of recession in the coming year. He liked the “chance against no chance” argument – that if the recession came, spreads were already there, and if it didn’t, spreads were free to come in.

Marty turned out to be right and the high-yield market “wrong”. However, spreads are right back close to where they were, due to European deterioration, both in their financial system and their economies. But one thing is clear – statistically, the U.S. is farther away from recession than it was this summer.

Even though the main news was that 3Q GDP was revised down 0.5 percentage points to a 2.0% annual rate of growth, this still handily beats the +0.4% in 1Q11 and the +1.3% annual rate in 2Q11. In addition, there are signs of a decent GDP in 4Q11 (the Fed’s implied forecast is still a 3% annual rate of growth in 4Q11). Separately, a 2%-stronger – than-last-year retail Christmas is forecast by the country’s main retail association.

First-time unemployment claims have fallen dramatically. One could argue some workers are getting discouraged, but you’d have to prove that *more* new “discouraged job-seekers” are dropping out than before. That’s probably not true, since studies show that more job-seekers tend to drop out when the economy is weakening, not strengthening.

Retail sales have been increasing strongly, and leading indicators also rose strongly in October. Consumer confidence is still low, but the indicator is to me softer than the other indicators and could rise a lot once people notice that we’re not really in or nearing a recession after all. Housing starts are rising, not altogether surprising since they were at amazingly low levels. However, they’re at least contributing a tiny amount to growth instead of dragging down growth as they did throughout 2007-2010.

Job growth in the private sector has finally resumed, to the tune of 367,000 jobs added in the last three months. Of course, state & local governments have been shedding jobs at a

rapid rate, but, frankly, isn't that what we want? (Versus the other way around --- private industry getting smaller while government's getting larger, with attendant productivity losses.)

My theory is that markets are seldom "wrong" although occasionally a mania like the dot.com mania is indeed wrong, in retrospect. Currently the market has shifted its focus from the usual one – the U.S. economic outlook – to an unusual focus – the European outlook. It's logical in one sense, since Europe can theoretically go down much more than we can go up. That would swamp out our feeble recovery.

However, let's view it from a different perspective. A market truism is that something cannot continually move the market; eventually the bad news gets fully priced in. Couldn't Europe soon become just another "stuck dial"? – just the way worries over our future deficits have become a kind of "stuck dial." It's not that the worries have gone away, it's that the impact on the market has lessened. This can be true whether the worry is about the potential decline of the U.S. Treasury market through future inflation (the deficits-cause-inflation worry) or the U.S. corporate bond market continuing to decline due to more economic-weakness "contagion" from Europe.

Only a few short months ago we had massive worries that renewed housing weakness could trigger another leg down in the economy. Lower prices, near-zero starts, increasing foreclosures – it all seemed to make sense. What the Cassandras of that time didn't take into account was that housing was assumed to be staying really weak, pretty much way out into the foreseeable future. Therefore when a tiny amount of relative strength in housing actually appeared, housing did a 180-degree turn and actually become a tiny part of the economic strength of the country in terms of contributing to rising GDP.

There's no question Europe is in bad shape, worse than it was two years ago, worse than one year ago, worse than six months ago. Whether it is indeed going to continue to get worse from here is in some doubt, however. At this point so little is expected out of Europe that to me it resembles the outlook for U.S. housing about eight months ago – dismal as far as the eye can see. Or similar to the outlook for deficits in the U.S. – horrible as far out as one can forecast. But my thesis is that markets can shock precisely at the time when they're supposed to be minding the same old indicator.

And don't forget, although it seems relatively unimportant right now given the antics across the Atlantic, our economy is in significantly better shape than it was this past summer. Doesn't that eventually count for something?

Good luck and good investing,

Stephen Smart, CFA
Chicago (630-363-8511) stephen.h.smart@gmail.com
Carolina Capital Markets
Chapel Hill (919-960-0807) smart@bonddog.com
The Smart Bond Guy

“Stephen Smart is an in-house research analyst and former portfolio manager. Recommendations in this report are based on an independent evaluation of particular bonds and do not necessarily represent the views of CCM or its representatives. This is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security. Returns and yields are not guaranteed and may be subject to change. Neither CCM nor its affiliates own or position the recommended security. CCM is an independent, non-positioning fixed income broker/dealer providing execution and research to their clients on a fully compliant and transparent platform. The views expressed in the research report accurately reflect Stephen Smart’s personal views about the subject securities and issuers and no part of his compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report; or to learn more about how to utilize SEC rule 28(e) in acquiring research through CCM, contact a CCM representative at (800) 922-6864.