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How is the Economy Doing at this point?

The stock market ended slightly down this past Friday, making it 4 days in a row of declines last week. Is this a bad sign or just business as usual? When will the recession be ending?

Even though the stock market lost 2.3% last week, the S&P 500 is still up over 25% from its March lows. So we have to keep that in mind when things get turbulent. Speaking of turbulence, it's been rare lately — the VIX (Volatility Index) has been under 30 for the last two weeks and only yesterday did it rise again above 30. Last fall when investors were in panic mode, the VIX was regularly above 70 and even 80.

Economists are starting to agree that the recession may end in August, but that the recovery back to where the economy was in early 2007 may take several years. At a recession's end, news typically turns mixed, as it has recently. Corporate borrowing costs, for instance, have fallen significantly, as measured by the TED Spread. Surveys of businesses and households show increased confidence. The labor market is even showing very tentative signs of improvement.

On the negative side, however, last week's government report on retail sales showed that in April sales fell unexpectedly, lowering hopes that consumer spending is recovering. And remember, consumer spending represents 70% of the economy. In addition, the housing market remains distressed, with house prices continuing to fall in most major markets.

Looking at financial markets, they seem to be pointing toward recovery. Investors are, as mentioned, out of panic mode. A recent rally in corporate bonds sent their yields lower. Treasury prices have slipped, pushing their yields higher; this could be a sign of investor willingness to take more risk, which would be a very positive signal.

Adding to the mood of optimism is a positive report on manufacturing, from the Institute for Supply Management. The April survey found signs that the slowdown in U.S. manufacturing has eased somewhat. More purchasing managers said that orders had picked up than said they were still falling, a good sign.

A very good measure of the recession having crested is the report of new claims for unemployment benefits. Even though Chrysler workers were being laid off in droves, this monthly number was 630,500 as of May 9; that's still quite high but down from early April's peak of 658,750. It will be very interesting in early June to see if this downward trend continues.

It's possible for a recovery to begin taking hold even if jobs are slow to return, since unemployment is what's known as a "lagging indicator." What is key is that households begin to feel confident enough to increase spending in anticipation of better times.

Keep in mind, though, that there is still plenty that could go wrong in the economy to forestall the recovery. A continuing drop in housing prices, for instance, is not a good sign. That's correlated, by the way, to a rise in foreclosures, now that the federal government's moratorium on foreclosures has lapsed. As well, new housing starts remain 50% below last year's figure.

Many economists are not jumping on the optimism bandwagon; Martin Feldstein, from Harvard, said that "there's a grabbing for good news, and when you dig down a little, the news isn't good." Others feel that the bank capital situation is not positive enough to warrant a recovery mindset in investors.

It's my view that we're going to have to see a leveling off in foreclosures before consumers will begin to feel like opening their wallets. Hopefully the administration's foreclosure abatement programs will take hold soon and have an effect.

Meantime, I have begun rebalancing investment portfolios again, now that we're not looking over the abyss anymore. Sure, the current rally may end up being what's called a "bear market rally," meaning that, as in the period from November 2008 until February 2009, markets rose only to drop to new lows around March 9th.

In the end, though, the only way to participate in a lasting rally, which this could be a part of, is to be in the markets at a level of exposure you feel comfortable with. Please call or email if you'd like to discuss our strategy for your portfolio in this regard.