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The “double dip” chant

Key points:

- There is a point to all the fuss over the anemic state of the housing market; its condition reflects weakness in other parts of the economy.
- The U.S. Commerce Department meaningfully lowered its estimate of second quarter U.S. economic growth, from 2.4% to 1.6% on a real, or inflation-adjusted, annualized basis. The data continue to support our outlook for low economic growth.
- Investors probably should expect real interest rates to remain very low and financial market returns to be modest for the near future.

The media certainly has been appreciative of the slew of data released over the last week about the U.S. housing market and its financing. On Tuesday, the National Association of Realtors® announced a dismal 27% decline in the sale of existing homes from June to July. Yesterday, the Mortgage Bankers Association reported that the rates of mortgage delinquencies and home foreclosures declined in the second quarter, though only slightly. Beneath the headline reductions in troubled mortgages lurked an increase in loans 30 days past due. Hundreds of articles have been written about all of this, filling the papers, blogs, and airwaves with the resounding chant of “double dip.” Both reports reinforce the weakness in residential real estate, but also offer windows into household finances and balance sheets.

Lenders’ standards have risen

The question has been asked, with interest rates so low and housing so cheap, why do home sales continue to plunge? The answer appears to reflect the difference between the quality of household balance sheets that banks now require in order to lend and the actual state of most household balance sheets. Current household balance sheets, while smaller in terms of liabilities than they were 18 months ago, are still too weak to support the kind of housing sales we saw three years ago, and they are too damaged to support credit creation from other sources, such as home equity loans and credit cards, thereby impacting spending on other fronts.

Businesses waiting for an upturn in demand

Consumers do not account for all economic activity, of course, but their spending restraint has led to excess capacity within the business sector. Companies are hesitant to borrow and expand, though in aggregate they are in a much better position to do so than consumers. Businesses have been much more aggressive in their balance sheet restructuring, eliminating more than \$2.3 trillion of debt between the start of 2009 and the end of the first quarter or 8.4% of their peak outstanding debt level. By reducing staff, trimming inventories, and otherwise restructuring, companies have managed to deliver relatively strong profits in recent quarters. Until demand picks up, however, there is unlikely to be any material change in business spending.

Tepid U.S. economic growth continues

The result is that overall economic growth rates are left without the support of increasing leverage. Households are either unwilling to take on additional debt to consume, or they are unable, or both. They have been sobered by their balance sheets as well as their income statements, with little aggregate increase in real incomes and many realizing decreases in income. Household spending restraint combined with reduced business leverage naturally lead to subdued year-over-year changes in gross domestic product (GDP), especially relative to the last strong economic expansion, when low interest rates and tame inflation encouraged outsized leverage. In this context, today's updated GDP number of 1.6% for the second quarter of 2010—the second of three estimates from the U.S. Commerce Department—makes sense to us. This matches our expectations of an economy with more than enough baggage—most notably, its unemployment rate—and a consumer and business environment that is less hospitable than the early to middle portion of the aughts. We continue to expect weak economic growth, despite the increasing number of surveys suggesting a contraction in GDP. And with expectations of some expansion in the production of goods and services, we still believe in equity exposure as a means of enabling investors to participate in that growth.

One driver of market returns: Real interest rates

The biggest impact on investors of these turning economic gears is the current low level of real interest rates—that is, nominal interest rates adjusted to reflect changes in the prices of goods and services. In order to support the cost of debt and to encourage additional leverage, the Federal Reserve has orchestrated the lowest level of nominal interest rates on record. These low levels also affect real interest rates. Real rates should affect the pricing of most financial assets. Under a building block approach to projecting financial market returns, one starts with real interest rates and adds the expected rate of inflation to find an expected return on the safest assets, which we think of as U.S. Treasury bills. As you consider the risks of various financial instruments, you layer on premiums, or additional required rates of return, on the assumption that investors will not bear additional risks unless they can reasonably expect compensation for doing so. When we start with an extremely low real interest rate, we tend to end with low rates of expected total returns on all investable assets. The low level of real interest rates has impacted both our expectations of future returns and the market's pricing of various asset classes. We think investors should maintain their moderate return expectations for investment portfolios, given historically tiny real rates.

Markets remain changeable, we remain on watch for opportunities

These low returns are part of the reason we've spent so much time talking about risk and the amount of risk we have in each of our model asset allocation strategies. Today, investors are receiving little additional compensation for the incremental risk, relative to the risk of Treasury bills, they are taking in many asset classes. Modest returns reflect both low real rates and elevated levels of financial market volatility. The dearth of compensation for risk-taking is the reason we continue to be slightly defensive in our recommendations. However, markets change, often quickly. Real rates have nowhere to go but up, and volatility could moderate if investors find some comforting news. We continue, therefore, to evaluate all investment opportunities and could well look to increase our exposure to risky assets, if we think investors will begin to be paid more to do so. In the meantime, we are here to answer your questions.

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