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A Recession Ends, But What's Next?

KEY POINTS

- GDP report indicates that the recession has ended.
- Fed will start to remove stabilizers from fixed income markets.
- As long-term interest rates begin to rise, we maintain our modest allocation to high-yield bonds and continue to exhibit a preference for shorter maturities among tax-exempt securities.
- The value of the dollar will be part of our decision-making for managing risky asset classes.

After rising almost 7%, mainly in response to positive earnings announcements, the stock market had drifted down over the last couple of weeks until yesterday (October 29), when the government announced a surprising 3.5% increase in Gross Domestic Product (GDP). It has become apparent that the recession ended sometime in the third quarter. However, it is less clear whether this bounce in activity will be sustained by the resumption of private sector credit creation. Such an evolution is needed to support consumer spending and business investment, as the effects of government stimulus diminishes.

Making Fixed Income Decisions

We are keeping a sharp eye on the fixed income markets for a real-time perspective on this. As October draws to a close, the **Federal Reserve's program of "quantitative easing"** (i.e., buying bonds) is beginning to wind down. So far, the short end of the yield curve has not increased much over the last month, suggesting that the markets are not yet discounting a more aggressive tightening of monetary policy through traditional measures, such as the Fed raising its target rate. However, the 10-year Treasury bond yield has increased around 20 basis points (0.20%) to end the month at 3.5%. Corporate bond spreads have come in a lot, especially in the investment-grade segment, and we recently reduced our tactical exposure to them. We are comfortable maintaining our allocations to the lower-quality segment, as we believe spread compression in this arena may have further to run, as the economic recovery continues.

Municipal yields have increased more dramatically than corporate during the month. For AAA-rated securities, 3-year yields have risen about 14 basis points (0.14%), 5- to 15-year yields have risen 33–50 basis points (0.33% to 0.50%), and 20- to 30-year yields have risen about 30 basis points (0.30%). This increase in yields supports our view that the markets were overvalued, and we continue to avoid the longer end as we anticipate further corrections. The short end (i.e. inside 3 years) is being supported by investors continuing to look for the safety of short-term maturities, but wanting more yield than **what's available** from money market funds. The outflow of cash from tax-exempt money market funds last week was \$2.85 billion, a consistent trend. In contrast, municipal bond funds gained \$606 million.

Evaluating the Role of the Dollar

The decline in the dollar has generated conversations about a collapse of the greenback. The dollar has been in a secular decline since the end of 2001. Due to a flight to quality, it staged a comeback during the financial crisis. In our view, its recent sharp decline is largely explained by the dollar seeking the level it had attained before the crisis, as the panic born from recessionary fears has abated.

As the dollar falls, imports become more expensive, adding to inflationary pressures. Goods made in the U.S. become more competitive in the global economy, which adds a tailwind to recovery. The Fed has two mandates, price stability (which means keeping inflation under control) and minimizing cyclical fluctuations in unemployment. If the dollar breaks through the lows it reached in early 2007, markets will probably begin to price in a more aggressive end to the Fed's zero-interest-rate policy.

Despite all the talk from the Treasury about its belief in a strong dollar policy, a competitive devaluation of the currency and moderate inflation can be part of the solution to a credit crisis. BCA Research points out that over one-third of U.S. corporate profits are derived from abroad, so a declining dollar can help to fuel corporate profits. For countries like the U.S. that are struggling to recover and still flirting with deflation, equity market strength often depends on cheapening currencies. Only countries with strong economies and no deflationary threat are likely to have strong stock markets and a strong currency. Today, Australia and Canada are good examples of that.

The danger of relying on currency markets to reflate asset markets and strengthen the recovery is that inflation expectations can quickly spin out of control. When it comes to the decision to press the brake pedal on our allocations to risky asset classes more decisively, one of the things we are watching closely is the glide path of the dollar and any accompanying increase in interest rate expectations. A sharp increase can provoke a sharp correction, after the impressive rally we have had.

Looking Past the Latest GDP

The third quarter GDP number was helped by consumer spending on autos and homes, to the tune of about 1.5%, which was driven in part by government programs. The good news is that housing and autos are not likely to be the drag that they have been in the past, as excess inventories have been absorbed to a great degree. While the economy often rebounds sharply after deep recessions, its growth can be less sharp after a financial crisis because credit often remains tight. As pleasant as the news about GDP was, it was only a data point and much remains to be seen.

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