

# Economic outlook and market expectations | Fourth quarter 2011

Perspective on the prospects for the U.S. economy

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The Business Cycle Index presented here is a key component of Russell's preparation of forecasts in contribution to the Blue Chip forecasting panel. The Blue Chip is a group of 50 top economic forecasters who produce two monthly publications: Blue Chip Financial Forecasts and Blue Chip Economic Indicators.

## ECONOMIC ENVIRONMENT:

### Pros:

- Recession fears appear overblown
- Negative shocks, most likely from Europe, needed to tip U.S. economy into recession
- Fiscal tightening not likely to be immediate; future cuts instead

### Cons:

- Europe poses a clear and present danger
- Next projected business cycle peak is pushed out to 2012Q3
- Federal government not on sound fiscal footing for long run

## A recession scare or a Japan scare?

In third quarter 2011, the U.S. economy showed that its growth slowdown was not simply a short-lived result of the high oil prices early in the year and the supply-chain problems that resulted from the March earthquake in Japan. Instead, the slowdown looks to be a more protracted affair: the question is whether this implies a recession or a period of sub-par, but positive, growth (à la Japan)?

An economic rule of thumb is that if the unemployment rate climbs by at least 0.3 percentage points from a recent low point, a recession follows within about six months. Since the unemployment rate hit a low point of 8.8% in March 2011, the U.S. economy hit this inauspicious threshold when the unemployment rate climbed back to 9.1% in May 2011. The only two exceptions in the last 50 years were the low points in November 1966 and January 1986. Nevertheless, current projections of the Business Cycle Index suggest that the probability of a formal recession in the United States is only about 25% in the near term. Additional discussion of this non-recession call appears below. Nevertheless, there is plenty of reason to be disappointed in the performance of the U.S. economy in 2011. Even the Federal Reserve is perplexed with the economy's poor growth and growth prospects as of its September 2011 meeting.

As the protracted nature of the U.S. slowdown and the threat of policy chokepoints in Europe and the U.S. Congress became apparent in July, the Russell 1000<sup>®</sup> Index hit a recent peak on July 22, 2011, and has fallen more than 15 percent from that level (as of October 12, 2011). Investors hope for greater clarity on the policy front in November when the Eurozone members have promised to provide a concrete rescue and bank recapitalization program early in the month; also the Super Committee from the U.S. Congress is scheduled to present its deficit-reduction plan before Thanksgiving.

Forecasts of the Business Cycle Index (BCI)<sup>1</sup> lead us to believe that the cyclical peak in business cycle conditions (the degree to which the economy will experience booming growth) will be the lowest in the 45-year history of the BCI. (See Figure 1.) An important development this year, however, has been that the date of the projected cyclical peak has moved out to August 2012 (as of September 2011 data). Previously, the cyclical peak was projected to

<sup>1</sup> Posted every month at <http://www.russell.com/Helping-Advisors/Markets/BusinessCycleIndex.asp>.

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take place in August 2011 (as of March 2011 data). This shift in the date of the cyclical peak by a full year highlights the magnitude of the growth slowdown since March 2011.

An equally important view at this juncture is the non-recession call stemming from the Business Cycle Index. On September 30, 2011, the influential Economic Cycle Research Institute (owner of the domain name “businesscycle.com,” after all) made an unequivocal call that the U.S. economy was in the process of tipping into recession if it were not in recession already. I beg to differ that a U.S. recession is a ‘done deal,’ even though a U.S. recession is certainly possible, given that a Eurozone recession looks very likely. The key difference in message between my business cycle index and the Economic Cycle Research Institute concerns is whether new negative shocks are needed to drive the U.S. economy into recession or not. I would say that the current trajectory of the U.S. economy, barring further negative shocks, is non-recessionary.

I come to that conclusion based primarily on the fact that the factors I use for my business cycle index to measure the financial market’s concern about the state of the economy are not currently showing acute stress – especially when compared to their values in late 2007 and early 2008. Thus, my current reading of the financial market indicators of the U.S. business cycle is that investors are more concerned about Japan-style economic stagnation right now than about a traditional recession.

### **Labor market stalls and builds from scratch**

The process of job creation essentially collapsed in May 2011 and it has been slow to bounce back. The forecasts in Figure 3 suggest that in the nine months between May 2011 and January 2012, monthly jobs gains will average just over 60,000 jobs per month. This rate of increase is well below the trend rate of growth of the labor force of about 150,000 net entrants per month. As a consequence, the unemployment rate could have risen even more than it did in this period were it not for a drop in the participation rate. The process of getting the unemployment rate decisively below 8.5 percent will likely take us into 2013. The truly disappointing phase of the recovery’s recovery from the job-loss abyss of late 2008 is the anemic job growth experienced thus far in 2011, as seen in Figure 3.

### **Inflation shows a welcome degree of inertia**

Once inflation is in the comfort range, inertia in inflation and inflation expectations is a positive attribute. Only if inflation were too high or low would inertia be a cause for concern. Our view is that, in spite of current headline inflation of 3 percent in third quarter 2011, consumer price inflation is headed toward a trend level of only 1.8 percent (see Figure 4).

The only concern about inflation in the current environment is whether oil prices can remain stable as real GDP growth fluctuates between 2 and 3 percent. A pattern has emerged wherein oil prices accelerate when 3 percent growth is forecast and then decline when 2 percent growth is on the horizon. This oil price behavior has caused the all-items CPI to cycle above and below core CPI inflation. For example, in the most recent monthly CPI data in September 2011, the all-items CPI increased at a 3.6 percent annual clip (largely due to gasoline prices), whereas the CPI ex food and energy increased at only a 0.7 percent rate. The concern is whether oil prices will act to make real GDP growth rates above 3 percent difficult to achieve.

### **Monetary policy: Was Operation Twist meant to be a compromise?**

As market watchers anticipated, the Federal Reserve announced Operation Twist at its September 2011 meeting, such that in the next nine months the Fed will buy \$400 billion in long-term Treasury securities and sell an equal amount of shorter-term Treasuries (with maturities below three years).

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The second change in the Fed's announcement is that the Fed will replace principal repayments on its holdings of Fannie Mae and Freddie Mac mortgage-backed securities (MBS) with fresh purchases of like MBS. Earlier, the reinvestment was all going to Treasuries. Evidently the Fed was aiming to drive down mortgage rates to the lowest possible level in hopes of stimulating the economy. This policy would be considerably more effective, however, if it were combined with measures that President Obama alluded to (but without much follow-up to date) in his jobs speech on September 8, 2011, where government-controlled Fannie Mae and Freddie Mac would be told to refinance borrowers at today's low rates even if they no longer had a full 20 percent equity in their homes at current prices.

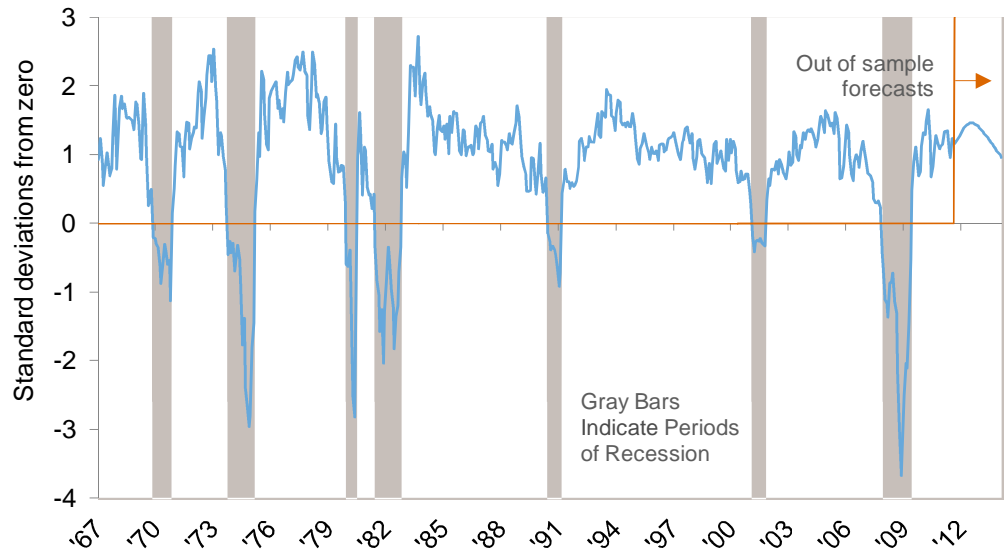
Operation Twist from the early 1960s was widely derided within the Fed in subsequent decades as a weak attempt to influence bond yields by altering the relative market supplies of long-term and short-term securities. I see no reason to alter that conclusion regarding today's attempt at Operation Twist, which might be able to squeeze down the 10-year Treasury yield by 20 basis points for a brief time. Rather than engineer this insignificant decline, I would have thought that another round of Quantitative Easing (QE, the expansion of the Fed's balance sheet through the purchase of bonds) might bring about more confidence about avoiding Japan-style economic stagnation. We want to avoid ongoing expectations of low growth, (too) low inflation and low rates of return. Operation Twist is a one-time shot, whereas QE can be repeated as needed to potentially stay out of a Japan scenario. It would be straightforward, however, to convert Operation Twist into additional QE by cancelling the asset sale side of the equation.

Nevertheless, one awkward feature of Operation Twist is that one has to claim that the aim is to lower long-term interest rates, so the definition of success can be problematic. With Quantitative Easing, in contrast, it is entirely fair to say that the objective of the policy is to avoid Japan-style deflation and economic stagnation, so a rise in long-term rates would be a sign of success.

### **First Fed rate hike in 2014 or beyond?**

The other big announcement from the Fed in the third quarter of 2011 was the August policy statement that the Fed would hold the federal funds rate near zero until at least the middle of 2013. This unprecedented commitment made clear what people already knew: the U.S. economy will need the support of accommodative monetary policy for as far into the future as the eye can see.

Figure 1: U.S. Business Cycle Index



Data as of October 2011

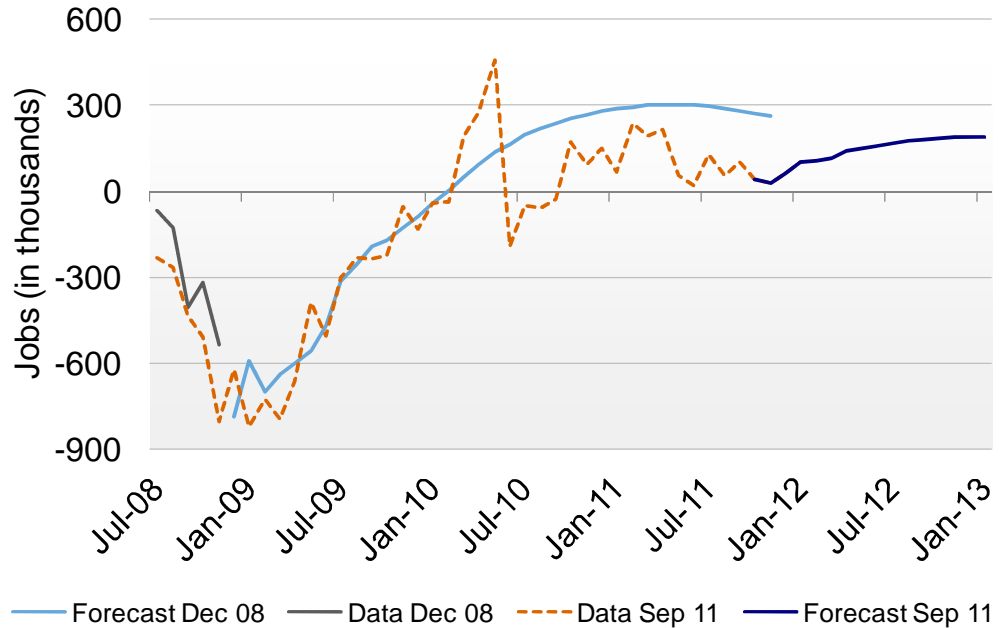
Out of sample forecasts were calculated by simulating the time-series model into the future.

The value shown is the median of the simulated value for the month.

Source: Recession data from National Bureau of Economic Research

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

Figure 2: Non-farm payroll employment changes



Data and forecasts as of December 2008 and actual data through September 2011

Source: Actual employment data from St. Louis Fed's FRED database

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Historical data is not indicative of future results.

Figure 3: Forecasts for nonfarm payroll employment changes

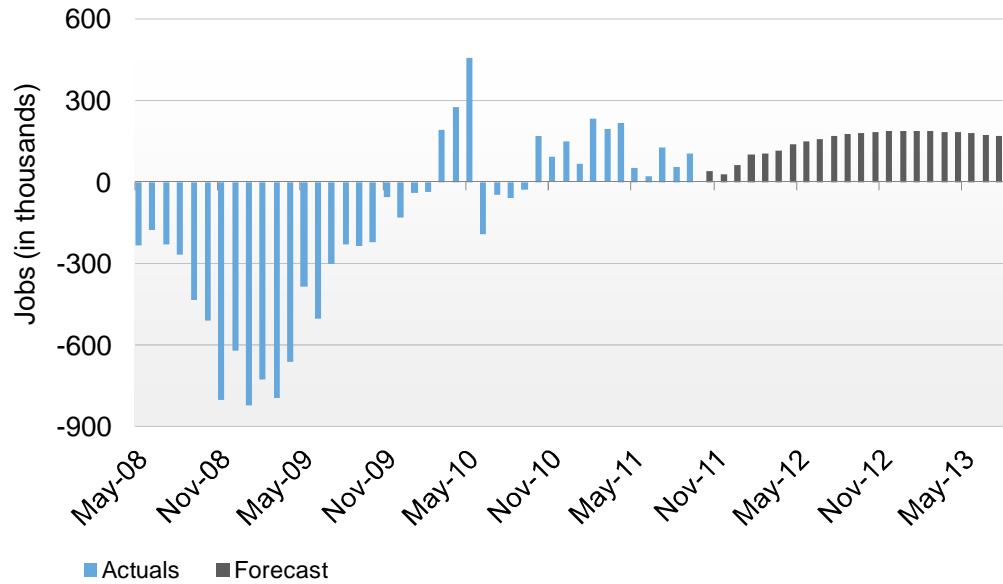
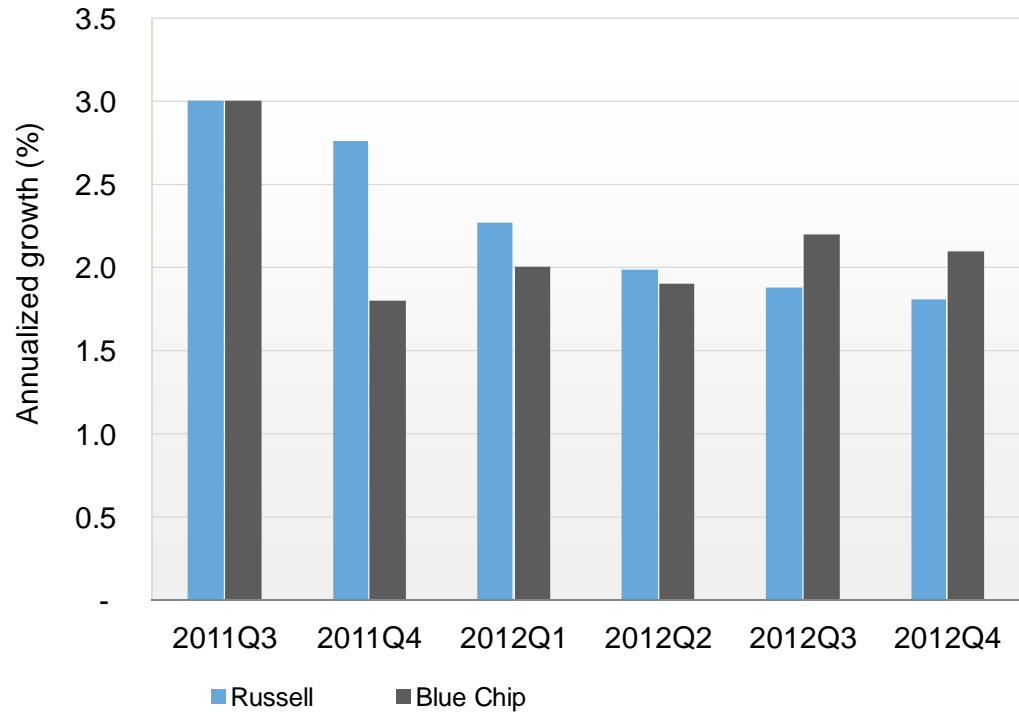


Figure 5: Forecasts for CPI Inflation: Blue Chip consensus and Russell's forecast



Source: Blue Chip Financial Forecasts, October 2011 issue

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## Perspectives on the prospects for the global economy

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The European Union is attempting, as of October 19, 2011, to put together a definitive rescue fund to recapitalize banks and to have funds on hand if needed for below-market lending to peripheral Eurozone members. The EU is aiming to create this fund prior to the G20 summit in early November.

### GLOBAL ECONOMIC ENVIRONMENT:

#### Pros:

- Policymakers can be counted on to avoid the worst outcomes?
- More cohesive European monetary policy now that growth rates diverge less across Europe?
- Soft landing in China?

#### Cons:

- Europe has not put forth a solid plan for weathering a Greek default
- Export-oriented emerging-market economies are not finding strong demand in the U.S. and Europe
- Asian economies must adapt to higher real exchange rates in future
- Will oil price increases stymie impetus towards fast growth?

### All Europe, all the time

Paul LaMonica of CNN Money.com reflects the pervasiveness of crisis fatigue regarding European finances:

“Europe is the only thing that matters right now to investors. And as long as rumors rule the day, (The EFSF will reportedly be 2 trillion euros! France may get downgraded! Unnamed sources say troika members mulling gyros instead of moussaka for lunch!) it’s impossible to know where the overall market is heading, let alone bank stocks.”<sup>2</sup>

Accordingly, market commentators are discussing a binary outcome. Either Europe will blow up or it won’t, and the financial consequences would be dramatically different in these two scenarios. This fall, stock markets across the developed world have had unusually long streaks in which daily returns are at least one percent in absolute value. The reason is that small changes in market perceptions of the probabilities of these binary outcomes make a big difference in stock market valuations. Hence, nuances in policymaker statements take on outsized importance.

### Which Bear Stearns/Lehman analogy is apropos?

Right now, many pundits are asking whether the situation in Europe will go down as a Bear Stearns event (a manageable unwinding) or a Lehman event (an all-out financial panic). Instead, consider Bear Stearns in March 2008 and then Lehman in September 2008 as the beginning and end of a timeline. The clock started ticking when Bear Stearns was taken over by Chase. The question was whether policymakers could line up the tools and resources and whether large financial institutions would collaborate by the time an institution larger than Bear Stearns ran into similar trouble. In September 2008, the answer was “no” because policymakers had frittered away six months without acquiring the necessary tools and resources to dismantle a systemically-important player like Lehman Brothers; at the same time, the other large financial institutions declined to take joint action to prevent a calamity in the financial markets.

For Europe, the timeline started with the first Greek bailout in May 2010 and the inception of the European Financial Stability Fund. The question has been whether policymakers in Europe will gather sufficient resources to enable banks and peripheral sovereign borrowers to weather the inevitable Greek default. For banks to weather a Greek default, recapitalization will have to take place, in a manner similar to the Troubled Asset Relief Program (TARP) injections in the United States in October 2008. Under TARP, even banks that did not feel that they needed additional capital were forced to sell preferred stock to the governments to enhance confidence in the system as whole.

To prevent contagion to other sovereign borrowers in the Eurozone, such as Portugal, Spain, Ireland and Italy, the rescue fund must be able to provide either lending at below-market

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<sup>2</sup> La Monica, P. (2011, October 19). “Big Banks: Everyone hates our debt. Yay, us!” *CNN Money*. Retrieved from: <http://money.cnn.com/2011/10/19/markets/thebuzz/>.

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rates or public loan guarantees that induce private investors to continue to buy bonds from these borrower countries. Indeed, the genesis of the current crisis was that, in the aftermath of the 2008 financial crisis, bond investors began to differentiate among sovereign European borrowers and charge punishing interest rates.

### **A shot across the bow**

Many commentators have been asking where the bond market vigilantes are vis-à-vis the United States, given that bond yields remain relatively low, even following the downgrade of U.S. government debt. The answer might be that they have already begun to attack unsustainable social welfare states by concentrating their initial salvos on the peripheral European Economic and Monetary Union (EMU) countries. It is the common currency that has made these economies the most vulnerable to bond market vigilantes.

### **Eurozone headed for recession?**

At the beginning of 2011, business cycle conditions in the Eurozone—based largely on Germany's torrid growth in the first quarter—were more robust than in the United States. This was true in spite of recessionary conditions in the hardest hit corners of the Eurozone, such as Greece and Portugal. During 2011, business cycle conditions have deteriorated in core Europe, especially Germany, in dramatic fashion. Recession in the peripheral countries has been in the cards from the beginning of 2011, although the Eurozone economy as a whole was not expected to fall into recession. Current forecasts, however, suggest that the Eurozone will be on the very edge of recession entering 2012. Forecasts of the Eurozone business cycle index (see Figures 6 and 7) are projected to dip just below zero at the end of 2011. At the same time, Russell forecasts of real GDP growth for the Eurozone (see Figure 8) remain just above zero. Thus, it is not clear whether the Eurozone as a whole will be in recession or not going into 2012. It looks like a close call for the business cycle dating committee in Europe.

The only silver lining to the slowdown in Germany is that, with less divergence in economic fortunes across the Eurozone, it might be easier for the European Central Bank to find a coherent monetary policy. Quantitative Easing might look much more palatable to Germany now that their economy has slowed nearly to stall speed.

At the same time, inflation in the Eurozone is expected to fall nearly to zero, which is not surprising, given that the policy course of the peripheral countries is to try to deflate their way to more competitive real exchange rates. (See Figure 9.)

### **China's soft landing**

Current Blue Chip consensus forecasts indicate that China's myriad measures to contain inflation are working in the short run, with inflation projected to be a bit over 5 percent in 2011 and under 4 percent in 2012. At the same time, real GDP growth is expected to be at or slightly below 9 percent in both years. Thus, congratulations are being offered to Chinese policymakers for achieving a soft landing, with achievement of inflation control without much deleterious effect on growth.

Nevertheless, two stubborn facts still stare China in the face. First, the record of emerging market economies maturing gracefully from torrid 8-10 percent growth rates to 5 percent growth rates is not good. The East Asian crisis of 1997-98 is a case in point of how tumultuous this transition can be. The fact that China's share of GDP dedicated to fixed capital investment is at or above 50 percent does not bode well for the proposition that China's growth can decelerate smoothly without any capital and/or debt overhang. Second, China's long-term inflation control is going to have to involve a faster rate of exchange-rate adjustment than we have witnessed so far. In the long run, however, only exchange rate appreciation will keep China's inflation rate under control; loan-quota decrees and reserve-requirement increases will not.

Figure 6: Eurozone and U.S. business cycle indices (1970-2012)

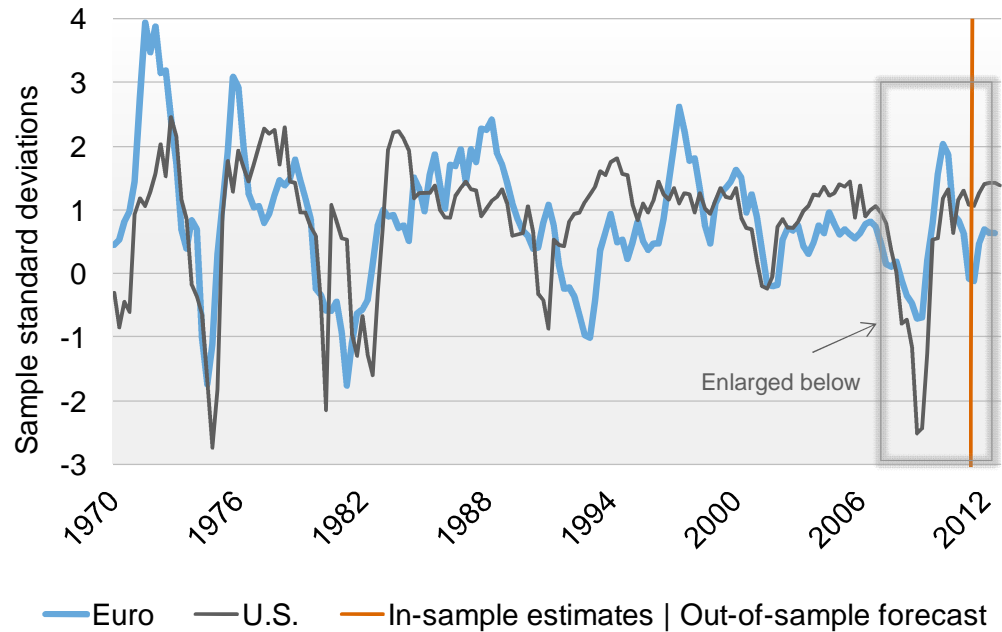
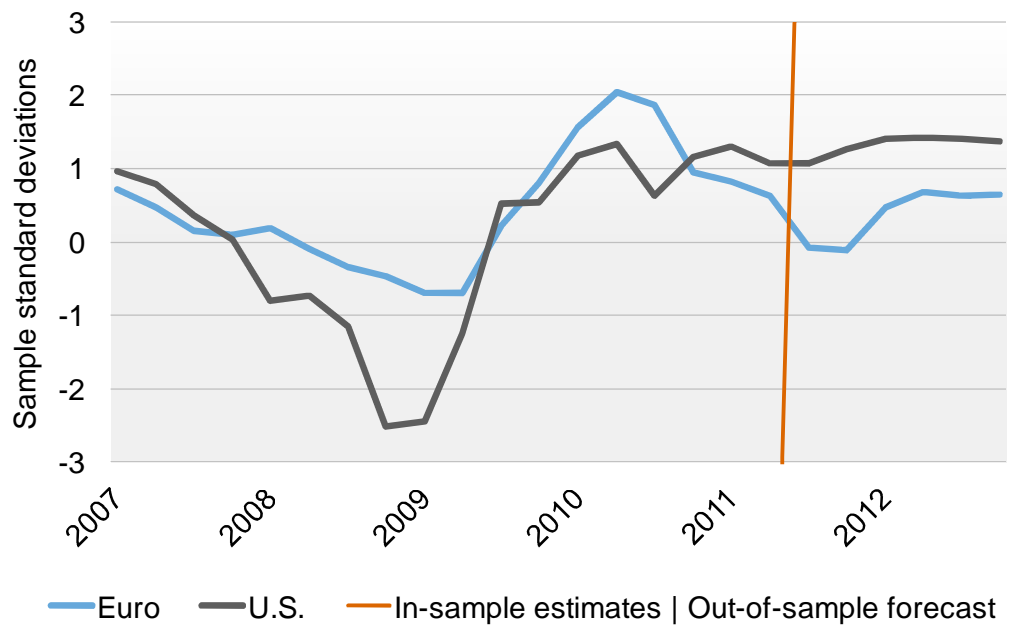


Figure 7: Eurozone and U.S. business cycle indices (2007-2012)



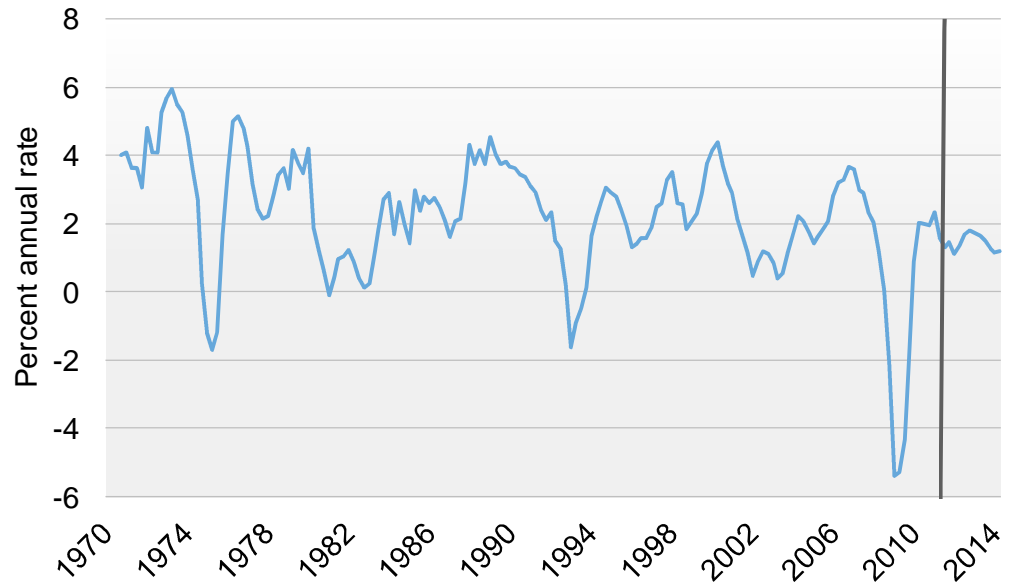
Values shown for the in-sample estimates and out-of-sample forecasts are the median of the simulated values for the quarter. Out-of-sample forecasts were calculated by simulating the time-series model into the future.

Source: U.S. recession data from National Bureau of Economic Research. Europe recession data from the Centre for Economic Policy Research. Recession for Europe in 2002 is based on research completed by Mike Dueker, Ph.D., Russell Investments: <http://research.stlouisfed.org/wp/more/2008-001>

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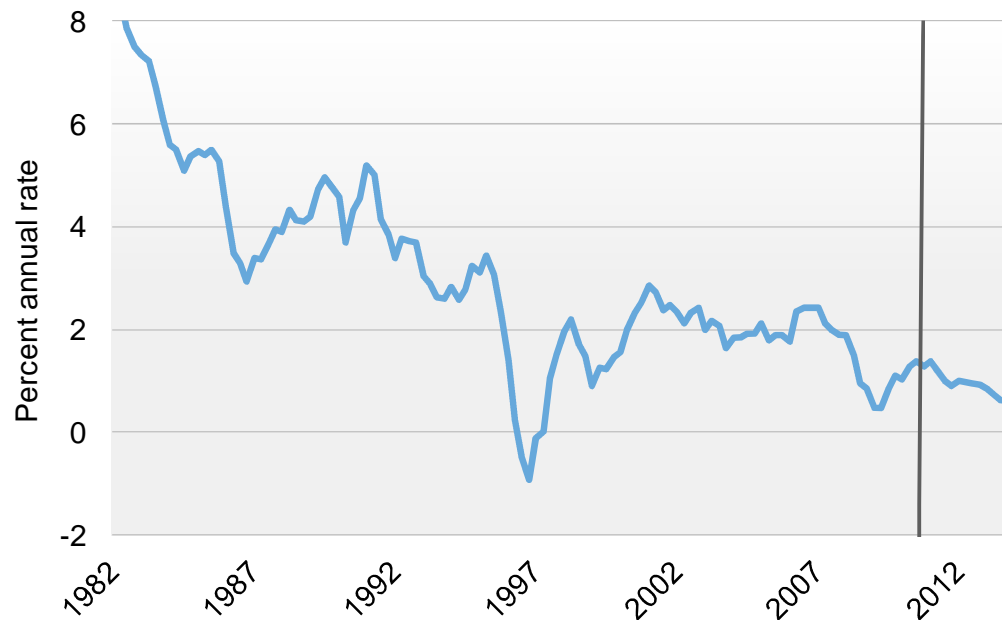
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Figure 8: Eurozone GDP growth (4-qtr. growth) and forecasts



Source: Factset: European data through September 30, 2011, Russell calculations: forecasts through September 30, 2014

Figure 9: Eurozone CPI inflation (4-qtr average) and forecasts



Source: Factset: European data through September 30, 2011, Russell calculations: forecasts through September 30, 2014

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