SLOW AS IT GOES
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The major economic unknown, about which answers have been provided by most economists as well as Wall Street, is the sustainability of the current economic recovery. They say yes, it is sustainable and we say we doubt it. To be honest, we felt the slow quarters of 2Q10 and 3Q10 were the prelude to a double-dip recession. It might well have been, but the Fed moved in with QE2 and the world changed. It seems as if faith in the Fed's omnipotence reigns supreme. Still the lingering question remains, how can you solve an over-indebtedness problem by using more debt? The answer is that you can't. Thus, in effect, the can is being kicked down the road again, which indicates more trouble ahead. Van Hoisington has termed this current period a growth recession. A growth recession is one where positive real growth occurs while unemployment remains high. He is exactly right as that perfectly describes the economy since 6/30/09.

Debt however, as mentioned previously, marches on. For the third quarter ended 9/30/10, domestic non-financial debt increased 4.2%, consumer debt declined 1.7%, business debt was up 1.7%, while state and local debt was up 5.2% and federal debt advanced 16.0%. As we look forward, we expect consumer debt to continue to decline even though it appears the fourth quarter may have seen a slight increase. We also believe the debt window may be closing on state and local governments, and the pressure is on to reduce federal government spending (thus reducing their debt). With debt trends developing as they are, what is one to expect real GDP to do over the next year? In other words, where is growth to come from? Will it be exports? Exports have advanced rather nicely as the dollar has depreciated somewhat, but will it continue as Europe (our largest market) is undergoing its own debt problems? What capital spending there is appears to be in the tech area which adds to unemployment and lower wage rates. Will they offset each other somewhat?

Will it be housing? No way. It is bouncing along the bottom and, until the millions of houses yet to be sold leave the huge shadow backlog, we can't expect much there. Commercial real estate is dead in the water with little to no demand. We already mentioned the consumer, who is spending, but those numbers are not increasing very fast and unemployment compensation may have seen its last increase. All in all, it is just difficult to paint a real rosy picture. Maybe we can maintain a 1-2% real GDP, but that will not suffice to propel economic activity and lower unemployment in any way.

The blue chip economists are predicting 3-4% real growth, but how good is their record? Note the chart below.

Adapted from James Montier