



# Dr. Krosby

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## On the Other Hand

It doesn't matter which side you take in the debate on the economy and the markets, there will always be a package of data and corporate guidance to substantiate your position. Moreover, there will be a chorus of economists and professional pundits armed with an arsenal of charts to validate and lend credence to your assertions. For technical analysts of the markets who follow price movements and patterns, there's much of the same divergence, although the near-mystical emphasis of their predictions – the “Death Cross versus the Golden Cross”; the “Hindenburg Omen”; and the “Elliott Wave Principle” to name a few – leads ultimately to the same conclusion: the economy has decelerated and markets are re-pricing in an effort to determine how corporate profits will be affected.

As investors look ahead to the end of 2010, and peer into 2011, the overriding concern remains whether the soft patch develops into something more pernicious and destabilizing, and, by extension, does the Federal Reserve, despite assurances to the contrary, have the ability to mitigate downside risks. On the fiscal front, the White House, as it faces the wrath of disaffected voters, is introducing an infrastructure stimulus package and a package of corporate investment tax breaks it hopes will turn the economic tide and voter sentiment.

Until the trend clearly asserts itself in that “Gestalt” moment when uncertainty gives way to clear direction, markets will lurch from headline to headline and back again. Risk on, risk off. In the meantime, opportunities present themselves, only to be dismissed because of fear and lack of confidence.

### From Uncertainty to Unusual Uncertainty

The chairman of the Federal Reserve, Ben Bernanke, has expressed concern about the challenging economic environment. In numerous speeches he has highlighted unemployment, the housing market, lost savings, and weak credit expansion as hampering prospects for a more robust recovery. During his July semi-annual Congressional testimony, he concluded that the economy is fragile and the outlook continues to remain “unusually uncertain.”

While hoping to reassure markets that the Federal Reserve is prepared to implement measures to staunch a further downdraft in the economy, Chairman Bernanke, at the Federal Reserve Bank of Kansas City's annual conference in Jackson Hole, Wyoming, was careful in outlining the Fed's options, but held back details on the all important “when” and “if” of their plans. Certainly, data on employment will constitute the weight of the Fed's consideration. More than likely, the option most favored is to continue the purchase of assets, particularly Treasuries and mortgage-backed securities, or “quantitative easing.”

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The policy of quantitative easing (or “printing of money”) is controversial. A September 4, 2010, article in *The Economist*, appropriately headlined “War Footing,” discusses why. First and foremost is that by buying government debt, the Fed inches central bankers ever closer into fiscal policy: “They can justify such ‘quantitative easing’ (QE) on monetary grounds since they have already lowered short-term interest rates to, or close to, zero. But they worry it is a slippery slope from QE to monetising government deficits and thence, inevitably, to inflation.”

The Federal Reserve has since the end of 2008 purchased \$1.75 trillion of Treasuries and mortgage-backed debt, pushing interest rates down dramatically. Would a new round of QE in fact, make a difference, or would it be nothing more than pushing on the proverbial string? Mortgage rates in the U.S. are low by any historical measure, yet the housing market remains weak and demand for loans, in general, remains weak while the economy tries to gain traction. As private sector deleveraging continues and asset prices fall, it is proving difficult to induce significant demand, especially while employment concerns remain paramount.

The aura of uncertainty pervades small business and large business alike. In a recent statement from the National Federation of Independent Business, the prospect of new hiring was doused by the claim that “Weak sales and uncertainty about the future continue to hold back any commitments to growth, hiring or capital spending.” The CEO of Caterpillar discussed his company’s plans for domestic hiring in a television interview and remarked that it would hire “guardedly into the second half because there is a lot of uncertainty.” During the Cisco Systems call with analysts, the words “uncertain” and “unclear” were mentioned nineteen times. The company’s CEO said that there is “unusual uncertainty,” and while not predicting a double-dip recession, he acknowledged that they were getting “mixed signals” from their global customer base.

### **Mixed Signals Across the Board**

To be sure, the pattern of pulling out of a recession with strong growth followed by a soft patch is normal. Typically, the cooling off period is just that, with another cycle of growth building momentum. Moreover, there have been four quarters of GDP recovery coupled with eight months of job growth. In examining leading indicators, analysts look for “pronounced, pervasive and persistent” trends, and with data continuing to be mixed the call on a double-dip recession is difficult. A “double dip” is a recession which materializes before an economy has healed completely from the initial downturn. The widely followed ECRI index has “flat lined” after deteriorating and projecting the current weakness. Still, the proprietary indicators used by ECRI do not see a re-acceleration in the immediate future, but neither do they suggest recession.

**a)** Corporate balance sheets are strong as low interest rates have allowed companies to refinance and cost cutting has helped keep operating margins healthy. Federal Reserve data indicate that nonfinancial companies hold \$1.84 trillion in cash and assorted liquid assets. Estimates are that globally, the 1,000 largest companies, not including financial services, have nearly \$3 trillion in assets. Mergers and acquisitions are staging a comeback as cross-border deals continue to generate front page stories. Smaller deals in technology, health care and consumer companies have also started to pick up. While many of these deals, if completed, will lead to job losses, they also help markets set a floor on prices and inject sorely needed optimism and confidence among investors.

**b)** Although private sector jobs are being created, the recovery is slow. Whereas other post-recession recoveries had particular sectors paving the way toward recovery, including technology after 1982, and most recently housing and construction following the technology crash in 2001, there isn’t one major growth area today spurring job growth. Manufacturing is helping, but most recently, job momentum has been tapering off. The unemployment rate used by economists is the Labor Department’s “U-6” classification, which includes people who have stopped looking for jobs and those who take part-time positions because they can’t find full-

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time ones. This number now stands at 16.7 percent. In addition, the contraction in the diffusion index, which covers the breadth of hiring, suggests that the economy continues to slow. And although we are adding jobs, the U.S. needs more than 100,000 new jobs a month to keep pace with workforce growth. At turning points in the economy, however, job generation can be missed by analysts, only to be recognized later in the upturn. Layoff announcements have continued to ease.

c) The housing market continues to show signs of modest improvement, with prices higher in a number of key regions and pending home sales trending higher. Stabilization, albeit at depressed levels, may be forming. Economists attribute most of the gains, however, to the final weeks of the tax credit allowance. Also, there's growing concern that a backlog of foreclosures will come to market, making it difficult for homeowners to compete with a growing inventory of foreclosed properties. A mind-set that is troubling to policymakers is that potential buyers are holding off purchases because they are waiting for lower prices. This is the hallmark of deflationary trends: don't buy it today because tomorrow it will be cheaper. Refinancing activity continues to improve as the lower rates help credit-worthy consumers repair their personal balance sheets. Karl Case of the S+P/Case-Shiller home-price index commented in an interview following the latest data on prices:

“There's an awful lot of positive stuff here in our numbers today... It generally takes four or five years to stabilize the whole housing market. We're into about four now.” Case also warned of the effects of the shadow inventory on the market, but added that nationally, housing prices are almost thirty percent lower than the July 2006 peak, but up six percent from the low set in April 2009. “It's down from the peak an average of something on the order of thirty percent. If you take a thirty-year fixed mortgage in the low 4s, you take a monthly payment down by roughly half. It's the best affordable housing program we've ever had in this country.”

d) As retailers look ahead to the all-important holiday season, it was encouraging that consumers – aided by discounts and tax holiday promotions – picked up the pace of spending, however cautiously, during the back to school season. At the higher end, consumer spending increased more markedly, while paycheck-to-paycheck consumers continued to be more careful in their spending. With taxes poised to rise for upper income consumers, uncertainty is setting in as to how this may affect their spending patterns. With overall consumer spending responsible for two-thirds of GDP, it is often overlooked that the top 5 percent of earners account for almost 37 percent of consumer spending. The bottom 80 percent account for 39.5 percent. Analysts remain cautious that tax hikes for the wealthy, continued deleveraging, and weak employment figures will continue to hinder spending as engine of growth.

e) For an economy dependent on consumer spending, consumer restraint and tightening of lending standards has unleashed seven continuous quarters of contracting household debt. A recent New York Times article, “Paralyzed by Debt,” breaks down the figures: mortgage debt is down \$462 billion from its late 2008 peak; bank-card borrowing, which peaked at the beginning of 2009, is down \$126 billion; vehicle loans are down \$122 billion; home-equity lines are down \$77 billion.

### **Awaiting the Data**

As prescriptions abound as to how we can re-accelerate growth, the economy sluggishly continues to expand. If another recession can be averted, markets can still offer attractive returns as investors look globally for opportunities. Strong companies with solid balance sheets should thrive in this environment. The fixed income market, as well, appreciates the positives of modest growth rates. Until we reach that point in the road where we can safely put away one hand, we're forced to offer explanations on both sides of the equation. The next few months should provide clarity both on the macro-economic backdrop as well as the political landscape. Markets struggle for a clear outlook, and as “unusual uncertainty” gives way to mere “uncertainty,” investors will continue to search for guidance. In the end, the data will provide.

Dr. Quincy Crosby's sources of information include Barron's, Bloomberg.com, *Bloomberg BusinessWeek*, *The Economist*, ECRI, *The Financial Times*, Goldman Sachs, *Investor's Business Daily*, *ISI*, *Moody's Analytics*, Morgan Stanley, The National Federation of Independent Business, *The New York Times*, S&P/Case Shiller, UBS, *The Wall Street Journal*, Yahoo Finance.

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