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Chicken or the Egg?

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After starting the third quarter with near double-digit gains through July and early August, the market, as measured by the S&P 500 Index, has given up almost half of those returns as optimism around strong earnings has faded into concerns that recent data points are pointing towards an economic slowdown. While it is normal at this stage of the recovery for the rate of improvement in economic conditions to decelerate, the market has become increasingly worried that the global growth story is losing traction and may push the U.S. economy into double-dip recession territory. **The consequence has been increased volatility and a virtual investment-return whiplash as investors seek to determine the market's direction in an economy that appears increasingly directionless.**

The catalyst for the recent pullback was the developing weak employment picture, which subsequently prompted the Federal Reserve Bank (the Fed) to outline a no-win scenario in the Federal Open Market Committee (FOMC) statement on August 10. The interesting part of this unfolding economic puzzle is that it is largely a “**chicken or the egg**” scenario where the potential for a self-fulfilling prophecy is materializing. After all, if we all fear the economy may get worse, our behavior is affected and we may stop spending or sell stocks, which actually increases the odds that it will happen.

Take the employment picture, initial jobless claims (unemployment insurance) increased for the week ending August 7 to 484,000, the highest level of new unemployment claims for any week since February 2010. While that is still a huge

improvement from the worst levels seen during the depths of the recession, the concern is that the improvement in the level of unemployed is stalling and may even begin getting worse. A simple explanation for this level is that companies, which do the hiring, have become more hesitant to add to payrolls because they are now questioning the strength, and maybe even the validity, of this recovery.

But the real paradox comes when we try to figure out why companies feel this way. The likely answer is that because consumer spending has decelerated somewhat, businesses fear the recovery is at risk and thus are not hiring new employees. However, the reason consumer spending is decelerating is because hiring has stalled. Thus, we have a chicken or the egg standoff where businesses want to see spending accelerate before hiring, but consumers do not have the disposable income to spend because of the weak employment situation. The result is an economic stalemate. Investors are rooting for either side—the consumer or business—to gain an edge and be declared the victor as the market needs a winner to fuel the continuation of this economic recovery and avoid a double-dip recession.

Largely as a result of the decelerating rate of economic improvement, the Fed announced in its latest FOMC statement on August 10 that it was downgrading its view of the economy and announced that for the first time in over a year it would put its foot back on the economic accelerator in an attempt to spur economic growth. The plan of action is to buy Treasury Bonds which will serve as an easing monetary policy move that will place additional dollars into the economy, keep mortgage rates low, and drive the yields of conservative Treasury investments to lower levels in an attempt to persuade risk taking by income-seeking investors. Sounds good, right? Well, the market promptly dropped almost 5% in the days following the news.

Not unlike a chicken or the egg dilemma, the Fed was caught in a catch-22. If the Fed elected to do nothing, the market would take the lack of proactive action as a negative. But if the Fed actually did re-engage to offer monetary stimulus, which it did, then the market had to face the reality that this economy still needs the Fed to continue to prop up growth. Ultimately, the market viewed either scenario as a negative which prompted the downside selling pressure we have experienced over the last couple of weeks.

The bottom line is that the market is at a crucial crossroads. Despite the recent move by the Fed, **the economy is attempting to transition from one of stimulus-led growth to one of sustainable growth.** But to make this transition a success, the next catalyst for growth needs to materialize. If the consumer and business continue to play the chicken or the egg game, the likely scenario is decreased growth and an increased chance for a double-dip recession. However, I expect businesses to end the game and to reaccelerate spending in the weeks and months ahead to be the catalyst this market has been waiting for. Evidence is growing that businesses are starting to increase spending on key initiatives like capital expenditures and

advertising—and modest gains in employment will likely be the next area of spending to reemerge.

There is no doubt that economic growth is decelerating, but that is common at this stage of the recovery. After such a remarkable climb from the depths of the worst recession since the Great Depression to a robust recovery in just one year's time, the pace of improvement had to slow down. But I believe that this is merely a soft spot in the midst of what will continue to be a **slow**, but nonetheless moderately advancing economic recovery. While volatile economic data will bring volatile market returns, there are several factors I believe will convert today's market pessimism into tomorrow's potential investment opportunities, such as the Fed's foot firmly on the economic accelerator, record corporate profits, mid term elections, and a consumer that has proven resilient even in the face of adversity. As always, please contact me with any questions.

Sincerely,



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