



Editor: Daniel Zhao

Danyang.Zhao@stern.nyu.edu

IAG Insider Team

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A Summer of Discontent

As the calendar rolls into October and we all complete our (gradual) shift back to a world of mundane activities involving sleep-inducing reading assignments, group projects with freeriders, and presentations stuffed with generous portions of premium-grade hogwash, the summer of 2009 is now forever history.

Perhaps it's all for the better. After all by any standard – whether political, economic, and pop cultural, this year's summer has to be one of the duller in recent memory. For all the talks of financial and banking regulatory overhauls, Congress (unsurprisingly) managed to get nothing done. For all rhetoric labeling healthcare reform either as *the* panacea for all of the nation's ills or as the last straw in the complete communization of America, it too has suddenly been put on the backburner. For all talks of a partisan political maelstrom in Congress, Sonya Sotomayor got her confirmation and Helicopter Ben was granted a second term. Throughout summer, Tim Geithner mainly concentrated on strong-arming the Swiss into spilling the beans and giving up the names of tax evaders, apparently failing to notice the irony of it all. The Iranians predictably stole an election, the Japanese finally decided to give their government the finger – after a 50-year wait. Meanwhile, President Obama's approval ratings remained as stable and elevated as the Kanye West Idiocy Index. There were positively no good movies. Even *Brüno* – by far the summer's least P.C. movie – failed to live up to its predecessor and didn't sufficiently offend enough people. The most exciting car introduced all summer was a family sedan – as interpreted by Porsche; if you're still looking for evidence that the world is indeed going mad, this is it. It started raining in New York in June, and didn't stop all summer (disclosure: your editor punched the big, red "eject" button immediately upon finishing his last final exam and escaped home to sunny Los Angeles). In fact,

the summer of 2009 will be remembered in popular culture mostly for what it cruelly took away. Michael Jackson, Farrah Fawcett, Ted Kennedy, and Ed McMahon are no longer with us; we are all made poorer by this fact.

It appears that the only exception to the general sense of malaise is on Wall Street. All summer long, equities were able to stay on the one-way autobahn that they have been on since March and left in their dust any doubters brazen enough to question the economic recovery (including yours truly). A mere 12 months since the chaos surrounding Lehman's collapse and the subsequent trillion-dollar bailouts, the terrors of the bear market are rapidly becoming a distant memory in the minds of many traders and analysts. With the market advancing to a new high every month since the March bottom, the S&P 500 is now sitting almost 60% above its March lows. Bulls – long thought to be an endangered species – are not only out of hiding but appear in full control. Bullish commentators gleefully point to numerous alleged "green shoots" in the US economy to justify such a run-up in equities. For instance, they eagerly highlight the "better-than-expected" economic data. To the bull's credit there are numerous signs that the residential housing market has indeed stabilized, if not bottomed. Further, a majority of companies reported earnings that have topped Wall Street's expectations (though the alarming majority did so through cost cutting, not top-line growth). Lastly, the economy has likely returned to growth; we will likely see a positive GDP for the 3rd and 4th quarter. As a

Taking it to the next level.

result, lately investment bank analysts have been falling over themselves to upgrade year-end targets for equities and even US GDP growth figures. In short, the market is rather confident that the US economy will enjoy a relatively quick recovery – just like every other recession we've had since WWII – and that the happy days of the 1990s will come back in short order. Essentially, the market is betting that there will be a "V"-shaped recovery bringing the economy back to rapid growth.

So where exactly were these analysts in a few months ago when the S&P was below 700? Just as your editor asserted that equities are undervalued from February to the end of last semester, he will now go on record saying that the market is a state of irrational sugar high and that equity valuations have gotten well ahead of economic fundamentals. A "V"-shaped recovery will simply not occur, instead we are looking at a "U" (if not "W") shaped recovery that will be accompanied by many quarters of very slow economic growth. Despite the cheerleaders on CNBC proclaiming the latest lunacies such as the possibilities of a "jobless recovery" (isn't that an oxymoron), a meaningful recovery requires the following four pillars: consumers (70% of the US economy), housing (what got us into this mess in the first place), manufacturing (or what's left of it in this country), and the labor market. With the sole *possible* exception of housing, none of these four pillars has shown any signs of recovery. Unlike previous post-WWII recessions, this is not a typical inventory-cycle induced recession but rather its root cause is unsustainable levels of debt accumulated over a decade by consumers, businesses, and government drunken on easy credit. Despite the best efforts of the Bernanke & Co to flood the economy with liquidity, I fully expect a long and painful period of detox (debt deleveraging) for the country characterized by weak consumer spending, increased savings rate, elevated unemployment, and anemic economic growth.

The rapid stabilization seen in the financial market and the broader economy and "green shoot" since March are a direct result of the extreme measures

taken by the Federal Reserve and massive fiscal stimulus programs. However, the concept of "less bad" is very different. The fact is the economy continues to shed jobs at a rapid pace. Just today, we have learned that the economy lost 263,000 jobs in August with the unemployment rate ticking up to 9.8%. The risk for the next two or three quarters will be the "double-dip" recession scenario playing out. With the federal fiscal deficit and national debt reaching stratospheric levels, the government's fiscal programs are likely to be slowly scaled down and eventually withdrawn. It is almost impossible for private consumption to pick up the slack, threatening to kill off the nascent recovery. Further, the Federal Reserve will be forced to raise interest rates in 2010 (we will explore this topic further in subsequent newsletters) to protect the value of the dollar. Delighted bulls point to the fact that most mega-banks have returned to profitability. However, this "profitability" is precisely because of the unprecedented monetary policy and massive taxpayer bailouts. With federal funds rates at effectively zero, banks are borrowing from depositors at next to nothing and lending them out to borrowers at high interest rates. The rich margin on loans is now more than offsetting the rising defaults and bad loans associated with higher unemployment rates. In this environment, even *bankers* can figure out how to make a profit. When interest rates rise, this will no longer be the case. Elevated unemployment and commercial real estate loans will be the twin dark clouds hanging over bank profitability for years to come.

Equities indeed have a long way to go (down) to reflect this scenario. Is this enough bad news for a Friday night on the third week of school? Have a great weekend and I look forward to a great school year with everyone at IAG.