



December 7, 2007

Joseph V. Battipaglia, 973-549-4050  
Market Strategist, Private Client Group

Kevin R. Caron, 973-549-4051  
Portfolio Manager, Private Client Group

Chad A. Morganlander, 973-549-4052  
Portfolio Manager, Private Client Group

---

### **NBER President Raises Recession Concerns**

The National Bureau of Economic Research (NBER) is a private, nonprofit, nonpartisan research organization dedicated to promoting a greater understanding of how the economy works. Their Business Cycle Dating Committee is considered the authoritative source for determining when economic expansions begin and end.

That is why the comments made by the President of NBER, Dr. Martin Feldstein, in an editorial in The Wall Street Journal this week caught our attention. In the first two paragraphs of the article, he made the following statements:

- 1) He sees "virtually no rise in real GDP in the current quarter";
- 2) Almost "every economic indicator" since October has "deteriorated";
- 3) He places a 50% probability of a recession emerging in 2008; and
- 4) It "could be deeper and longer than the recessions of the recent past."

These statements are strong words from a man who has dedicated much of his career to tracking the economy's cycle. Given Dr. Feldstein's concerns, we decided to look more closely at the NBER's process to glean an understanding of what they look at when determining turning points in the economy and then try to follow their process using current data.

### **NBER's Perspective**

The NBER [website](#) discusses criteria for recessions, and they specifically reject the use of gross domestic product as the sole basis for determining recessions. Instead, they consider a much broader set of data. The committee defines a recession as a "significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."

## **Market's Perspective**

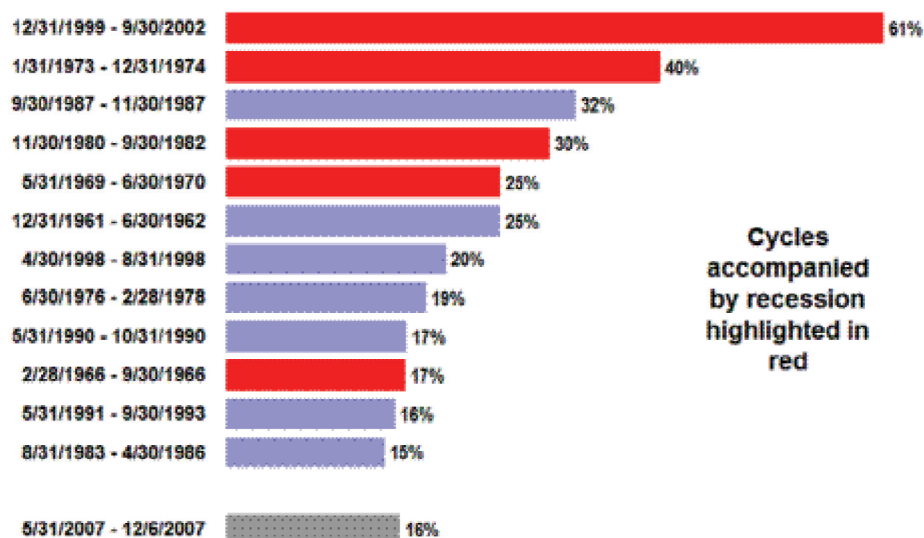
Before we tackle the specifics of the NBER's definition, we need to remember that we are not economists, but investors. Therefore, we must tie the effect of a changing economy to the investment decision by considering first how stocks and bonds perform should the economy transition from expansion to contraction, as is Dr. Feldstein's concern. We also recognize that market behavior, especially the interaction between stock and bond markets, often anticipates changes in the economy before it is apparent in the data. It is true that markets can be mistaken at times, but as the charts below show, there is a strong tendency for recessions to emerge during market cycles led by bonds (when bond returns are higher than equity returns, which has been the case since July) and for recessions not to emerge when led by equities.

Looking back to the early 1960s, we see twelve distinct periods where bonds clearly outperformed stocks. Sometimes these market cycles were accurate in predicting recessions, and other times they turned out to be false starts. It is worth noting that the average outperformance by long-term Treasury bonds was in the range of 15-20% if no recession emerged. Since this year's bond market outperformance is in that range, those who do not expect further deterioration in the economy should consider selling bonds and buying stocks. However, in those instances where recessions did emerge, the underperformance of bonds compared to stocks tended to be in the 20-40% or more range and would usually last for a year or more. Thus, if an investor is concerned about further deterioration in the economy, it seems advisable to hold off on purchasing equities.

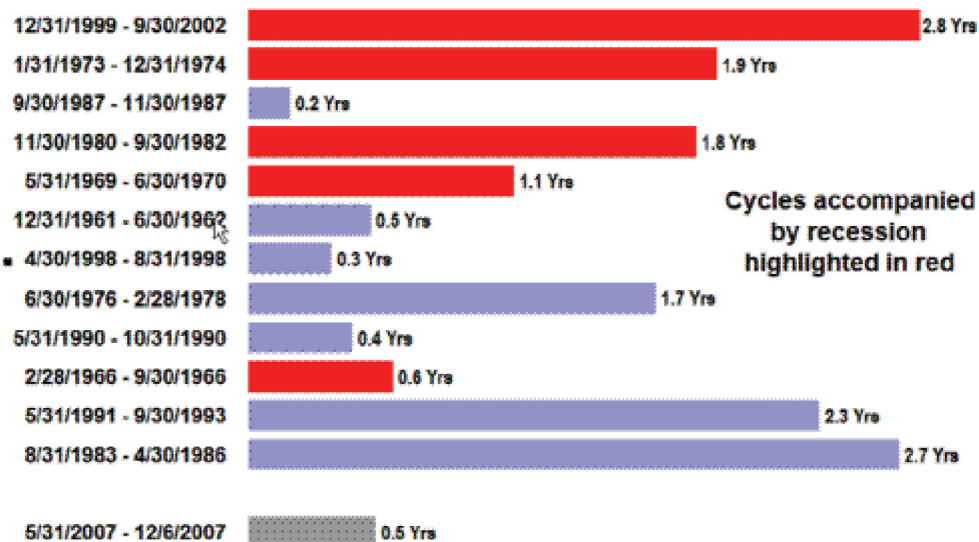
Because this issue is critically important to the tactical asset allocation decision and because the economy's health is more at issue today than it has been in several years, it is worth delving deeper into the NBER's perspective on what constitutes a recession. Let's now return our discussion to the NBER's definition of recession to see if the current data supports or conflicts with our assessment that the recession in housing and other parts of the economy is likely to spread further.

---

## Outperformance Of Bonds During Bond-Led Markets



## Duration Of Bond-Led Markets



Source: NBER, Morningstar, and Stifel, Nicolaus & Company, Incorporated

## Drilling Down on The Data (As NBER Would See It)

*A significant decline spread across the economy...*

The NBER needs to see a significant decline in activity spread across the economy.

We believe we have seen a significant decline in activity that affects the largest household asset (36% of net worth), is the largest category of indebtedness (\$10.1 trillion versus \$5.3 trillion in mortgage debt in '01), and largest portion of household budgets (33% of spending). The cresting of the home ownership rates that began in late '04 spread to a downturn for credit starting in early '06, and now credit availability is fading for many borrowers. All other categories of consumer spending pale in comparison in relation to shelter. Other major consumer categories like food, healthcare, entertainment, apparel, personal care, and education combined account for less than 22% of annual household expenditures according to the Federal Reserves' latest [\*Consumer Expenditures Survey\*](#).

As for another large category of spending, vehicle sales have softened from the 17.5 million annualized unit sales pace of a couple of years back and now have slipped to 16 million annualized units. Similarly, average quarterly growth rate in aggregate final sales throughout the economy to domestic purchasers has fallen to levels that are not generally supportive with a sustainable expansion in output. The measure is a broad measure of business and consumer demand within the economy, and this measure has slipped to less than 2% average year-over-year growth for the first three quarters of 2007. Lastly, reports of rising delinquencies and defaults can also be seen in consumer areas including student loans, automobile credit, and credit card receivables.

Taken together, we believe that this evidence suggests that the ongoing troubles for the economy that originated with housing and mortgage debt is not isolated to immaterial parts of the economy, but rather have begun to spread to a broader category of activities, and thus, the slowdown in activity fits the NBER's recession definition, as it is both "significant" and "wide spread."

### ***Employment***

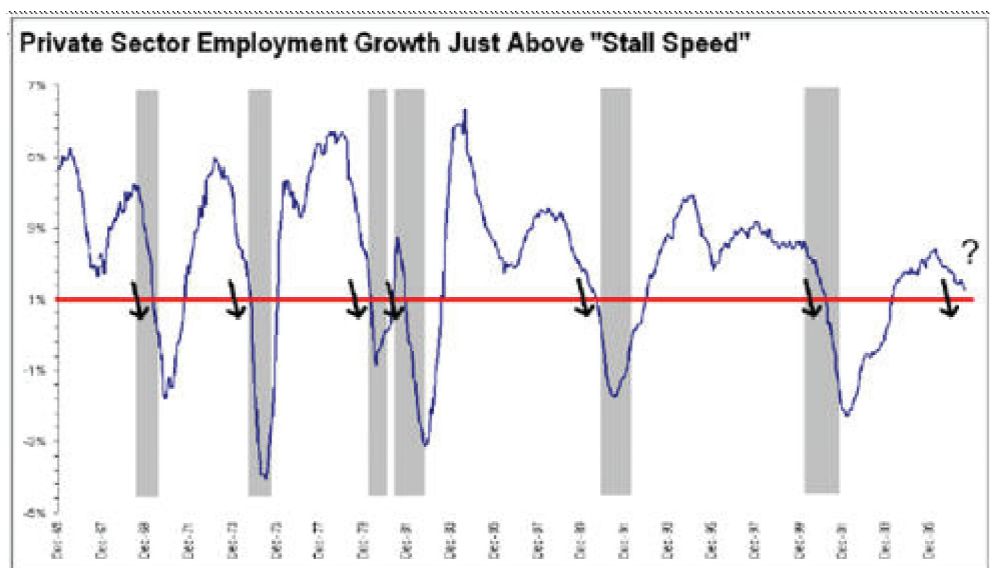
Perhaps it could be said that homes and autos, while they account for a large portion of household expenditures, do not account for nearly as large a portion of income and jobs and, therefore, fail to affect the rest of the economy, which is performing well. One way to test this is to look at the percentage of industries who are expanding employment. As of October, 62% of private, non-farm industries are reporting an increase in payrolls compared to a year ago. This percentage is down from 67.6% in July 2006, but any reading above 50% is generally considered to be expanding.

This perspective of stability is questionable, however, when we look at growth in private sector employment. The reason to look at the employment situation excluding the effect of government hiring is to assess the response of businesses to a changing outlook on the economy. By doing so, we sense more quickly changes without the distortions caused by bureaucratic government hiring decisions. Today, growth in private sector employment has slowed to

below 1%. In the past, growth below 1% was below the minimum "stall speed" below which there is a strong tendency for recessions to take hold (see graph below). While the focus on private sector payroll growth may not be NBER's primary focus, we believe it is an accurate measure for changes in business conditions.

Lastly, the overall unemployment rate has risen to 4.7% from 4.4% in October 2006. While the NBER considers the employment situation the key factor in determining recessions, they are often slow to the draw in spotting deterioration in employment, as was the case in the last recession where the unemployment rate had been rising for a year before the NBER declared the start of the 2001 recession.

While employment is the most important indicator for measuring recessions, we need to look more closely at a wider array of data to get a more complete picture.



Source: Bureau of Labor Statistics, NBER, Stifel, Nicolaus & Company, Incorporated

### ***Real Income***

The NBER looks at personal income after inflation and transfer payments. On this front, there is good news to report. Specifically, there has yet to be a measurable falloff in real income, that is, incomes adjusted for inflation, despite the sluggishness in demand for homes and automobiles we discussed earlier. Importantly, we note that each of the past three recessions were accompanied by a drop-off in growth in aggregate real income. Through November, aggregate real income growth measured 3.6% higher than the year prior – making this the fifth consecutive year of real income growth in the United States. It is worth noting that recessions can occur when real income growth is

positive, as the starts of recession are measured from the point at which the economy began to demonstrate a decline in economic activity – starts of recessions are never defined as being the low reading. This is precisely what makes this kind of forecasting so difficult without the passage of time or an overwhelming confluence of corroborating evidence.

### ***Industrial Production***

The NBER has been de-emphasizing the role of manufacturing in its assessment of the economy, as manufacturing activities have declined relative to service activities. That said, the data on industrial production remains positive, but activity has moderated somewhat over the past year. The Federal Reserve's industrial production index has slowed from a 4% growth rate a year ago to 2% today, and capacity utilization remains stable. A broader view of production that takes into account housing construction might tell a different story, as housing starts are down some 50% from peak levels in 2005 but not considered part of "manufacturing." Taken together, the combination of stronger export markets, weak manufacturing data, and depressed levels of residential construction suggests that industrial production is, for now, still expanding but has decelerated to a very tepid pace that borders on contraction.

### ***Wholesale and Retail Sales***

There has been evidence of a moderation in retail sales, as the largest retailers are reporting monthly same store sales growth in the area of 6-8% compared to last year. During 2006, it was more common to see growth rates in the 8-10% range. These sales figures do not include housing, but do include automobiles, food, and fuel. Thus, if we choose to ignore housing for the moment, the remaining portions of consumer spending seem to be demonstrating some forward momentum, albeit at a more modest pace. It is also somewhat unclear to what extent the progress is being driven by increased units versus higher prices for food and fuel.

Moving one step down the sales chain, we see that sales to wholesalers by manufacturers are still positive. Here, too, we see a deceleration in sales when we strip out the distortions created by higher fuel prices and the distorting effects caused by a surge in ethanol production and related effects on farm activity. Specifically, the quarterly growth rate in wholesale sales has decelerated from an 8-12% annualized quarterly rate of growth in 2005-2006 to under 4% based on the most recent quarterly change in wholesale sales excluding farm goods and fuel. If we include farm goods and fuel, we see very little change in the rate of wholesale growth.

We expect to see demand slow prospectively for the aggregate wholesale sales number, as inventories have risen sharply for farm products. An analysis of the inventory data shows that about half of the overall growth in national inventories can be tied directly to the increase in farm products held by wholesalers. With farm inventories a multiple of what would be considered "normal," we would expect the growth rate in sales by farm manufacturers to

wholesalers to slow. In addition, the still low inventory to sales ratio is suggestive of good balance in the supply and demand situation at the wholesale level. Remember, however, that a substantial amount of production and supply to the wholesalers originates now outside of our borders. This trend accelerated sharply after year 2000 and greatly reduces the informational value of the traditional inventory-to-sales ratio, because the inventory will likely be undercounted since much of it now is domiciled overseas.

### ***Real GDP***

Forecasters go out of their way to say that changes in GDP are not always sufficient in defining a recession. For one, the measures are only available on a quarterly basis, which prohibits more specific and timely analysis of the economy. GDP also is subject to substantial revisions from the originally reported numbers, and it often takes years for a complete picture of the economy to emerge in the fully revised data. For example, on July 31, 2002, the Bureau of Economic Analysis released revised figures for GDP that showed three quarters of negative growth in 2001-quarters 1, 2, and 3 – where previously the data had shown only quarter 3 as negative. This revision shows one danger in relying on a simple rule of thumb, such as two consecutive quarters of negative growth, or relying on GDP data alone in characterizing the economy as expanding or contracting. In addition, within the complexity of the National Income and Product Accounting system, it is easy to miss the demand trends within the United States. This is important, because without the U.S. consumer fully on board, it is difficult for the world's output to grow. By focusing on purchases made by U.S. consumers and businesses within the final sales component of GDP, we see that demand has been running in the 1-2% range in recent quarters and well below average. The same thing is also reflected in falling demand for imports, where we see declining unit growth rate for non-OPEC imports, and this trend is partly responsible for why the trade balance is reversing, which is, in turn, additive to GDP but still indicative of weakness rather than an improvement in our competitive and improving export position in the world (other than a weak dollar).

Moreover, it is insufficient for a forecaster to argue that just because the growth in real GDP is positive that the economy is prospering. In fact, due to the ever-growing workforce, it is necessary for the economy to increase output by \$350 billion a year (or at least 3%) to keep everyone employed and keep wages growing. The last time that real GDP was up by more than 3% on a year-over-year basis was in the second quarter of 2006, which goes a long way to explaining why the unemployment rate began rising in the fall of 2006.

### ***Conclusion***

Only the NBER's recession dating committee can decide when they might declare a recession under their definition. Clearly, the economy has changed from past cycles and no two periods are perfect comparisons. Nonetheless, we are not at all surprised that prominent economists are now beginning to voice concern over the ongoing downturn in housing and credit. The market's recent

rally in anticipation of further rate cuts and in response to the President's plan to ease some of the pressure in sub-prime mortgages will likely be short-lived, unfortunately, if these measures prove to be insufficient in boosting the economy.

In parting, we should note that Dr. Feldstein's solution to keep the economy afloat in 2008 requires more than rate cuts – it requires fiscal stimulus as well. Unfortunately, we see this suggestion as nothing more than a "paper tiger," and we do not believe that there is enough political momentum behind tax cuts at this time to make this a reality. Hence, we expect that monetary policy will remain the tool of choice for managing the economy through this period.

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High yield bonds have greater credit risk than higher quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | [www.stifel.com](http://www.stifel.com)