

The Recession is Probably Over... Now What?

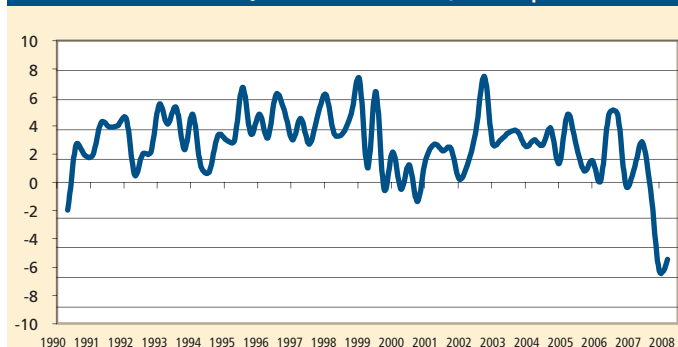
By Mark Luschini, Chief Investment Strategist



As the economy moves from recession to expansion, a fair amount of debate exists about what the contour of the widely anticipated recovery will look like. Clearly, the lowest point of the recession seems to have already passed. A primary measure of the health of our country's economy is gross domestic product ("GDP"). It represents the total dollar value of all goods and services produced and is usually measured on a yearly basis. In the U.S., that dollar amount is approximately \$14 trillion. This is a significant sum, even after falling for four consecutive quarters for the first time since 1947.

On July 31st, the government released its report on GDP for the second quarter of this year. The figure of minus 1.0 percent (an annual rate) improved upon the 6.4 percent decline in the opening three months of 2009, and the 5.4 percent we saw in the final quarter of 2008. Many expect that the draw down in inventories, due to businesses' reluctance to stock pile in the face of weakening demand, will need to be rebuilt and therefore make a meaningful contribution to GDP during the third quarter. So much so, in fact, that preliminary estimates for GDP of positive 1 percent, risk understating the final figures if other components of GDP (such as construction, government spending or personal consumption) show just a sliver of improvement. (Chart A plots GDP growth for the last 20 years). While the historical trend line in real growth is roughly 3 percent, since 1945 the average annualized growth rate in GDP in the first two quarters of recovery post-recession is a robust 7 percent.

Chart A: U.S. Calendar Quarter GDP Growth, 1990 – present

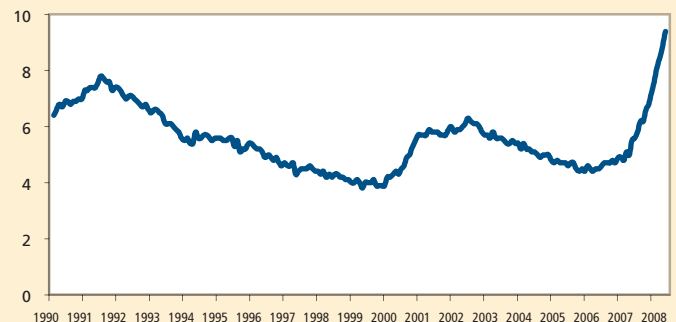


(Source: Bloomberg)

The liquidation-to-rebuild inventory cycle is usually marked by a ramp up in activity back to the point where there is enough inertia to sustain the advance and allow for artificial interventions (like the Federal Reserve lowering interest rates) to be pulled away without fear of relapse. Policymakers can do so comfortably knowing that this process generally leads to hiring and improved confidence, which in turn entices spending to help further stoke economic growth.

History suggests, however, that rebounds from recessions induced by financial crises are often (though not always) on the tepid side. We suspect this recovery may conform to that playbook. High unemployment (the magnitude of which is shown in Chart B), slipping conditions in the commercial real estate market, soft housing prices, household wealth impairment, increased savings, and the poor state of public finances, are widely-acknowledged dampers on vigorous growth. Even when the economy turns positive, it will likely "feel bad" for many. For the unemployment rate to fall, the amount of jobs created must exceed the increase in the labor force. If economic activity remains subdued, that is unlikely to happen for some time and the unemployment rate will probably continue to rise from June's figure of 9.5 percent to 10 percent or more; thus inviting the concern of this being a jobless recovery.

Chart B: U.S. Unemployment Rate, 1990 – present



(Source: Bloomberg)

Currently in place are several dynamics that do support the beginnings of a sustained expansion. Credit markets and quantitative easing policies are providing liquidity, bringing much needed breathing room to the capital markets. Along these lines, central bank policy rates around the world should remain low, making cheap funds available for qualified borrowers. In addition, aggressive cost cutting among employers has outstripped the contraction in output, which is constructive for corporate earnings, and could suggest that the pace of job liquidation will soon moderate (reports of fewer workers filing claims for unemployment insurance for the first time are hinting at such a development).

(Continued on page 4. *The Recession is Probably Over*)



Spring Forward —No Fall Back

By Gregory M. Drachusak, Market Strategist

For a time during July it appeared that the S&P 500 might remain entrapped within a prolonged trading range. Three quarters of the way through the month, however, the S&P finally cracked resistance at the top of the range and moved to a new recovery high. While there were several significant events last month, in our view, breaking the shackles of the trading range was the most significant.

July marked the S&P 500's fifth-straight monthly gain. However, in one sense, posting a fifth consecutive monthly gain was not all that surprising. More often than not, once the S&P 500 rises for four straight months, a fifth monthly gain follows. This year's consecutive monthly gains, from March through July, marked the 20th time that the S&P 500 had a five month (or longer) monthly gain following the 28 periods in which the Index rose in four straight months.

Keeping this winning streak going, however, now becomes increasingly difficult. Since 1950, six or more consecutive monthly gains have happened only 14 times. Extending a streak has been even more difficult when it has involved the month of August. The six consecutive monthly gains that have included August happened only five times (winning streaks that included September, which on average is the market's weakest month, have happened only twice). In addition, August was the halting point for the winning streaks in 1954, 1964, 1995 and 1997.

The last time the S&P 500 posted five-straight monthly gains was three years ago. In that particular situation, the S&P rose for eight consecutive months from June 2006 through January 2007. If the market extends the current winning streak through January 2010 as it did in the 2006–07 period, it would match the longest monthly winning streak on record, which ran from March 1958 through January 1959.

2009 Index Performance

2009 Market Data		Prior Close	Last	Change	% Daily	% Yearly	% Jan	% Feb	% Mar	% Apr	% May	% June	% July	1st Quarter	2nd Quarter	3rd Quarter
DJ Industries	.DJIA	9154.46	9171.61	17.15	0.19	4.50	(8.84)	(11.72)	7.73	20.54	4.07	(0.63)	8.58	(13.30)	11.01	8.58
S&P 500	SPX	986.75	987.48	0.73	0.07	9.33	(8.57)	(10.99)	8.54	23.76	5.31	0.02	7.41	(11.67)	15.22	7.41
NASDAQ Comp	COMP	1984.30	1978.50	(5.80)	(0.29)	25.46	(6.38)	(6.68)	10.94	29.43	3.32	3.42	7.82	(3.07)	20.05	7.82
SOX Index	SOX	301.05	301.74	0.69	0.23	42.22	(1.84)	(5.11)	13.89	31.51	7.86	(3.01)	14.66	8.14	14.69	14.66
Biotech Index	BTK	878.18	870.25	(7.93)	(0.90)	34.47	(1.95)	(6.01)	7.55	35.67	1.83	7.47	24.83	(0.88)	8.69	24.83
DJ Transports	.TRANS	3570.30	3579.99	9.69	0.27	1.21	(16.16)	(15.73)	7.40	33.38	1.85	1.00	10.68	(24.12)	20.51	10.68
DJ Utilities	.UTIL	373.65	369.47	(4.18)	(1.12)	(0.35)	(0.29)	(12.37)	1.67	12.17	2.03	4.93	3.26	(11.16)	8.63	3.26
Volatility Index	VIX	25.40	25.92	0.52	2.05	(35.20)	12.10	3.37	(4.77)	(41.28)	(20.77)	(8.89)	(1.63)	10.35	(40.30)	(1.63)
S&P Midcap 400	MID	627.39	628.05	0.66	0.11	16.68	(7.36)	(9.87)	9.75	27.33	2.56	0.46	8.63	(8.36)	17.21	8.63
S&P 100	.OEX	460.06	460.26	0.20	0.04	6.66	(9.33)	(11.01)	8.37	21.97	5.31	0.49	7.12	(12.56)	13.86	7.12
Gold ETF	GLD	91.62	93.35	1.73	1.89	7.89	5.54	1.45	(2.54)	3.40	10.23	(5.22)	2.38	4.35	1.00	2.38
Russell 1000 Index	.RUI	539.53	539.88	.035	0.06	10.68	(8.29)	(10.67)	8.52	24.49	5.27	0.06	7.49	(11.09)	15.82	7.49
Russell 2000 Index	.RUT	557.71	556.71	(1.09)	(0.20)	11.46	(11.20)	(12.29)	8.67	31.69	2.88	1.34	9.53	(15.36)	20.23	9.53

(Source: Standard & Poor's)

Instead of worrying about the next 31 days, however, we think it is far more important to focus on the potential for the next several quarters.

The market's biases during the extension of the move up from the March low were clearly centered on economically sensitive areas at the relative expense of defensive sectors like Staples, Utilities, Telecom and Health-care. (Chart C on page 3, illustrates this well).

In large measure, recent sector activity brought back to the forefront many of the same market-leading sectors that drove the S&P 500 to its previous peak. While it may be natural for a market discounting an upward turn in the economy to center its attention on cyclical areas, a secular bull market coming off a protracted downturn often changes leadership. The lack of a change like this is one reason why we still reserve judgment on whether the market is capable of establishing a new secular bull market or whether this is only a potentially vigorous cyclical market upturn. The difference between these two types of market improvement is significant.

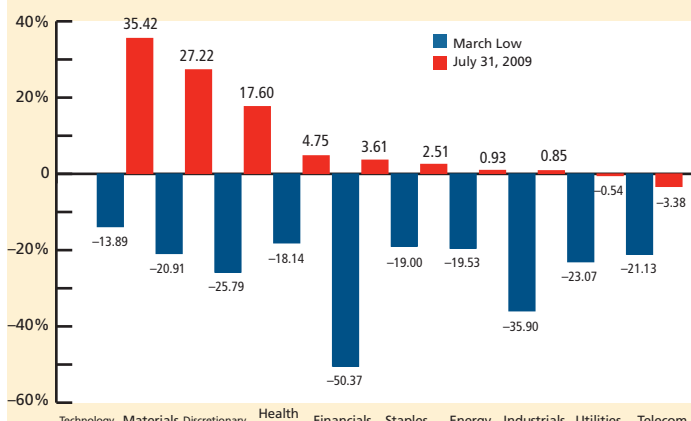
The nature of the recent market rebound prompted the question of how much of the rise was attributable to short-covering. We found it to be particularly interesting that the most recent short-interest data released late in July showed that many groups and sectors experienced a rise in short interest. This happened before the S&P broke the top end of the trading range. The post-breakout upside had to worry those holding short positions. This month's first release of short interest data will answer the question of how much artificial influence short covering had.

As noted in our *Market View Daily* publication, we think the market has not seen its high for this cycle, even though the S&P 500 has moved up significantly from its March low.

At the same time markets do not go straight up.

As the S&P 500 approached 1000 in late July, sentiment among many money managers seemed to shift toward acknowledging the potential for an interim correction. A technical overbought condition was cited as one of the main reasons to consider the potential for a temporary setback. Strong markets, however, can remain in an overbought condition for an extended period.

Chart C: Sector Changes March low through July 31



(Source: Standard & Poor's and Janney Montgomery Scott)

We, however, would not rule out the potential for an interim pullback, but we do not see one as being deep. The 950 level of the S&P 500, which was a technical breakout point, would be expected to offer an initial level of support. Focusing on a possible correction, however, could divert attention from the more relevant issue of where the market might head whether a correction develops or not.

On this score, we continue to think that the S&P 500 index can move toward 1100, and we would not rule out the potential to reach 1200.

Prior periods offer some guidance when seeking a potential upside market target. Since the 1930's, the S&P 500 has faced 14 major bear markets. Each one was followed by substantial bounces off the lows. Subsequent corrections were followed in all 14 instances by a second leg upward. The smallest post-correction gains were 18 percent in 1966 and 1987. The average gain was 36 percent.

Assuming that the S&P 500 slipped back to 950 and then embarked upon a second move higher, matching the average results of a second leg up would take the index to 1292. The lowest post-correction gain was 18 percent. If this is all we see after a move to 950, the S&P still would be able to make it to 1121.

For many people, August is the last chance to round out the summer with some rest and relaxation. Don't rest too much though, or you might fail to position your portfolio for what could be the best part of the recovery from this spring's crisis-induced decline. ■

Falling from the Clouds

By Guy LeBas, Chief Fixed Income Strategist



"Brighter once amidst the host of Angels, than that star the stars among." —Dante

The idea of fallen angels may have found its origin in *Paradise Lost*, but the veritable ratings agencies Moody's and S&P appropriated the concept in the 1990s to refer to a corporate bond issuer that's fallen from an investment grade to a high yield credit rating. In other words, the term refers to an issuer that's been downgraded below BBB-. A distinct negative implication is inherent in these fallen angels for a range of reasons. Arguably, the most significant is the fact that many holders are restricted from owning high yield credits. This means that when an angel does descend from its lofty perch into the depths of sub-investment grade, that descent is often accompanied by forced selling from insurance companies, mutual funds, money managers, and the like.

Between 2000 and 2009, S&P has downgraded a total of 504 entities from investment grade to below investment grade, which resulted in about \$1.65 trillion in bonds and loans crossing over to high yield. (See Chart D on page 4). A plurality of these downgrades were actually the result of a relatively few entities crossing the critical threshold (namely GM, GMAC, and Ford in 2005 and Lehman, Sallie Mae, and CIT more recently). However, another substantial portion has been the result of private equity and LBO deals adding debt to firms' balance sheets. While these two categories are responsible for the bulk of fallen angel downgrades over the last decade, we're more interested in the firms that have been cut to sub-investment grade as the result of either incremental debt issuance or economically-driven revenue declines. These are what could best be described as "classic" fallen angels, as opposed to those with "blow up" potential.

We can draw a few big-picture conclusions from analyzing fallen angels over the past decade. First of all, the markets are predicting downgrades in the current environment more effectively than in prior market environments. Evidence for this conclusion comes most evidently from weakening in bond prices that preceded many of the 2009 ratings downgrades. Investors are acting preemptively with increasing consistency, which is arguably an outgrowth of increased investor risk aversion. With so many debt fund managers showing weak performance in the last 12 months, a portfolio manager who takes a modest loss at the first sign of problems is far less likely to lose her job than a portfolio manager who takes a gamble and risks a larger loss later on.

(Continues on page 4, *Falling From the Clouds*)

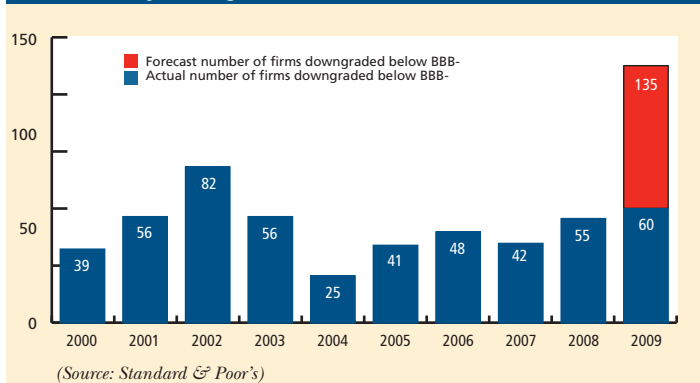
(Falling From the Clouds, Continued from page 3.)

Our second major observation from the changing nature of the markets' response to downgrades is that the ratings agencies are more focused on readily-evident problems than long term, conceptual business model concerns. This observation suggests that a ratings agency pushing an angel over the brink may well ignore some of the (potentially) significant long term forces that could benefit an industry or issuer. One example of this issue lies in some of the lodging names that have been downgraded in recent months. Though consumer and business spending is pressuring revenues at these firms, property liquidity has improved and lower construction expenditures in the coming months and years suggest we'll see at least a few positive signs for the sector that outlast the current downturn.

The third observation that we can take from the market's treatment of fallen angels is perhaps the most obvious one: entities that are downgraded because of ratings agencies' perceptions of liquidity risk will almost certainly feel the wrath of mass debt selling. To bring back the old phrase, "fundamentals hurt, balance sheets maim, but liquidity kills." Along with everything that has happened in the past 12 months, downgrades to below investment grade based on expectations of deteriorating liquidity suggest deeper problems to ensue.

The corollary to our third observation is that downgrades, which are based on revenue declines or marginal additional debt, are not inherently a terrible thing. In fact, in many cases, we prefer the credit quality of fallen angels that fall under this category to the credit profiles of tried and true high yield issuers. In many cases, the management teams of fallen angels have a vested interest in returning to investment grade as a method of reducing their costs of capital. With the spread between BBB and BB bonds trending at around 300 basis points, that one notch of downgrade can be particularly expensive. Firms that have operated in high yield space for an extended period have a business model which incorporates the effects of this higher cost debt issuance. On the other hand, firms that are just making the transition typically don't have this benefit, which therefore encourages management to try and reduce debt issuance cost by improving their credit rating over time. Estimating the cost of falling from investment grade to sub-investment grade isn't a straightforward exercise. Particularly since, as we've noted, the market anticipates many such crossovers well ahead of time. The simplest way to understand the relationship is to examine the spread between BBB and BB rated debt, which, while much tighter than we saw in March, remains wide by historical standards. While this spread isn't meant to indicate the cost of an individual firm tumbling from the clouds, it does provide a relative point of reference for the potential impact on capital costs. ■

Chart D: Entity Downgrades in 2000 – 2009



(The Recession is Probably Over, Continued from page 1.)

Exports of U.S. goods are showing signs of stability as a result of economic rebounds overseas, particularly in East Asia. And lastly, over the next year or so, the maximum outlays of the fiscal stimulus (about \$400 billion has been earmarked to be spent in fiscal 2010 versus \$185 billion in fiscal 2009) will infiltrate the economy.

Parts of President Obama's fiscal stimulus package have worked to blunt the decline in consumer spending that has been lost to the aforementioned headwinds that are sapping the economy. Lower taxes for certain wage earners and other benefits helped to preserve the decline in consumption but further job cuts and anemic wage growth threaten to overcome the positive interference of the stimulus; especially as its benefits begin to fade. Without a pick up in consumer spending, any inventory led bounce in growth will stall. Therefore, the fragility of this recovery rests on the stabilization of the labor market which offers households a source of predictable income growth. ■

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