Economic and Market Outlook:
A Recovery in Three Gears

In September, the National Bureau of Economic Research (NBER) announced that the recession which started in December 2007 had ended in June 2009. Recessions are measured from peak to trough, or in other words, from the best month to the worst month and, by this definition, it’s hard to argue with the NBER’s decision. But this is a recovery in three gears: mediocre in economic growth, miserably slow in job creation, but fast in terms of a profit rebound. A balanced approach to investing in this environment requires a balanced understanding of the nature of the recovery.

Economic Growth: Sub-Par but Double-Dip Not Likely

In the first year of this recovery, real GDP grew by 3%, well short of the 5% growth seen on average in the first year of recoveries over the past half century. Part of the blame for this slow rebound stems from the financial crisis at the center of the recession. Households who saw the value of their homes and 401K plans plunge have been slow to buy new homes or new vehicles. Equally important, the banking industry, having absorbed huge losses itself and been vilified for its role in the housing bubble, has been reluctant to lend.

While some have worried that these issues could lead to a double-dip recession, the most likely outcome is continued growth. Recessions are concentrated in the most cyclical areas of the economy—autos, home-building, business equipment spending and inventories. These four sectors, which account for less than 20% of economic growth in the long run, have accounted for 140% of the output lost in the average recession in the last 50 years. However, as can be seen in Exhibits 1-4 on the following page, both housing and auto sales remain very subdued while the recovery in business spending, although better, has still left equipment spending and inventories at low levels.

This very muted recovery in cyclical areas has two important implications. First, it greatly reduces the risk of a double-dip recession—it’s hard to collapse when you are already in the basement. Second, it implies a building pent-up demand in these areas.

1 The charts in this article come from the quarterly Guide to the Markets book produced by J.P. Morgan Asset Management; data as of September 30, 2010.
areas, and this pent-up demand, combined with improved household and corporate balance sheets could fuel a modest uptick in economic growth to perhaps 4% in 2011.

The Jobs Market: Stuck in the Doldrums

If the recovery in economic output has been slow, the recovery in jobs has been worse. In the two years which ended in December 2009, the U.S. economy lost 8.4 million payroll jobs and, so far, has recovered only 600,000 of them. Meanwhile, the unemployment rate in September was 9.6% compared to 9.7% in January. Statistical analysis suggests that it takes sustained real GDP growth of above 1.5% to create payroll jobs but it takes 2.9% growth to create enough jobs to offset the natural increase in the labor force plus those drawn back into the labor force by an improving economy, thus reducing the unemployment rate. Over the summer, this recovery settled into a growth pace between these two thresholds, suggesting

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**EXHIBIT 1: LIGHT VEHICLE SALES**


**EXHIBIT 2: CHANGE IN PRIVATE INVENTORIES**


**EXHIBIT 3: HOUSING STARTS**

Source: Census Bureau, J.P. Morgan Asset Management. Data reflect most recently available as of 9/30/10.

**EXHIBIT 4: CAPITAL GOODS ORDERS**

Source: Census Bureau, J.P. Morgan Asset Management. Data reflect most recently available as of 9/30/10.
little hope for a near-term reduction in the unemployment rate, and some danger of an increase.

Having said this, if economic growth does pick up to 4% in 2011, the unemployment rate should begin to fall. As can be seen in Exhibits 5–6, the unemployment rate does not tend to plateau at a high level in the wake of recessions but rather tends to drift down and this is the most likely path for this expansion also. The bad news is that in the average recovery, the unemployment rate only falls by about 1% per year, suggesting that it could take until 2015 for the unemployment rate to fall to the 5% rate which many economists regard as full employment.

Profits: A “V-Shaped” Recovery Continues

If the economic recovery has been in second or third gear and the jobs recovery has been in first, the rebound in corporate profits has arguably been in fifth. As can be seen in Exhibit 7, the operating earnings of the S&P500 fell from a peak of $24.06 in the second quarter of 2007 to -$0.09 at the end of 2008. However, since then, profits have staged a remarkable comeback, with earnings hitting $20.90 in the second quarter of 2010. Part of this reflects decent gains in revenues and productivity. However, as seen in Exhibit 8, more of it is due to the very subdued costs which are part of today’s

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**EXHIBIT 5: CIVILIAN UNEMPLOYMENT RATE, SEASONALLY ADJUSTED**

![Graph showing civilian unemployment rate, seasonally adjusted.](image)


**EXHIBIT 6: EMPLOYMENT–TOTAL PRIVATE PAYROLL**

![Graph showing employment–total private payroll.](image)


**EXHIBIT 7: S&P 500 EARNINGS**

![Graph showing S&P 500 earnings.](image)

Source: Standard & Poor’s, J.P. Morgan Asset Management. EPS levels are based on operating earnings per share. Data reflect most recently available as of 9/30/10. Most recently available is a 2Q 10 99% complete estimate.

**EXHIBIT 8: ADJUSTED AFTER-TAX CORPORATE PROFITS (% OF GDP)**

![Graph showing adjusted after-tax corporate profits (% of GDP).](image)

environment—low interest costs, low depreciation expense and particularly subdued wages as workers find it hard to win wage increases in an intensely competitive job market. The truth is that the immediate aftermath of a recession often sees a strong bounceback in profits due to very low growth in costs and this recovery is no different. Indeed, in the absence of any shock to the economy, operating earnings could reach an all-time high by the end of 2011.

Over time, as recovery matures into expansion, the pace of improvement should even out. Economic growth should accelerate, job gains should strengthen and profit increases should moderate. However, in the meantime, it is very important that investors recognize the multi-speed nature of the recovery. Since March of 2009 the stock market has logged strong gains for good reason. Going forward, as the expansion matures, stock prices should move higher still and interest rates are likely to increase. Because of this, even as the labor market recovery lags painfully behind the recovery in financial markets, it is important to invest in a way which allows investors to take advantage of an eventually more balanced expansion rather than being victimized by it.

— David Kelly  
Chief Market Strategist, J.P. Morgan Funds

### Inflation versus Deflation: Balancing the risks

The emergency actions of central banks may have rescued the global economy from the brink of disaster, but the uncertain economic environment means that there are still many question marks hanging over the potential impact of policy from here. As the previous article by David Kelly attests, the recovery in economic activity looks as though it will prove insufficient to make a major dent in the unemployment rate, while current rates of inflation are very low and there are ongoing fears that a double-dip recession (though unlikely in our view) could lead to outright deflation. On the other hand, the economy is growing again, monetary stimulus is already in extreme territory after the first round of central bank asset purchases and another dose of quantitative easing is likely to be announced before long. This also has investors uneasy about the potential for much higher inflation in the future.

What does all this mean for investors and institutional portfolio strategy? There is clearly a great deal of uncertainty around the prospects for inflation, but our main conclusions are as follows:

- In the near-term, inflation is likely to remain tame, given a “slower for longer” economic recovery.
- While not a likely scenario, a non-trivial risk does exist that the economy could fall into a period or renewed weakness in which deflation becomes the overriding concern.
- In the longer-term (perhaps three to five years out) an inflation flare-up continues to be a threat, particularly as the global economy gets on a firmer footing.
While inflation may be low today, investor portfolios ought to incorporate a degree of protection against the likelihood of higher inflation tomorrow.

Deflationary “Double-Dip”— a Remote Possibility

Double-dips occur when economic activity contracts anew shortly (within a year or two) after the previous recession has ended. They are rare. In fact, the last and only double-dip in post-World War II history occurred between July 1981 and November 1982, when the Fed aggressively raised interest rates to control double-digit inflation—an environment quite different than today’s.

Should an economic relapse occur, it could lead to deflation (declining prices), a problem that is harder for policymakers to solve than inflation. Even the anticipation of lower prices can cause consumers to delay purchases in expectation of future discounts, leading to a deflationary trap in which prices continue to decline, debt becomes larger in real terms, production stalls and employers are forced into wage cuts and layoffs, further weakening consumer demand and perpetuating the deflationary process. This is clearly a condition which government officials and monetary policymakers wish to avoid.

Inflation—a Clear, but Not Present Danger

The massive amount of reserves pumped into banking systems by the Federal Reserve and Bank of England since late 2008 have provided the fuel for higher future inflation, should there be a spark to ignite it; a second round of quantitative easing could raise the inflation stakes yet further.

But we do not think that an inflation flare-up is imminent. Unemployment rates are high and will likely remain so for some time as growth stays weak, keeping labor costs in check. Moreover, in contrast to the 1970’s, when unions were strong and the labor market less globalized, the last 30 years have witnessed a weakening of labor’s position. According to the IMF, the global working age population rose by 60% between 1980 and 2005, but over the same period, the export-weighted global labor force (as a measure of those involved in the production of goods and service for global markets) grew almost fourfold—intensifying competition. Similarly, between 1970 and 2002, U.S. trade union density fell by more than half, declining from 27.4% to 12.6%, while similar declines were witnessed across other OECD countries. It could be argued that these developments have structurally eroded worker bargaining power, and therefore led to declines in wage growth and core inflation that are also structural in nature (see Exhibit 9).

But while wage-driven inflation seems unlikely, a weaker dollar, combined with the prospect of relatively rapid growth in the emerging-market economies could increase the risk of inflation from rising commodity prices—particularly for energy—as well as other imports. And the longer that high unemployment remains a problem, the greater the political pressure for more potentially inflation-inducing policies—both from central banks and elected officials—could become.

Clearly, policymakers continue to face a delicate balancing act—staying sufficiently accommodative to sustain the current recovery and avoid a deflationary relapse on one hand, and being careful not to spark a sharp rise in inflation on the other.

Implications for Portfolio Strategy

While we would assign the greatest probability to a “slower for longer” scenario (suggesting continued low inflation), neither a more inflationary nor a deflationary environment can be ruled out. In our view, investors need to manage their portfolios, not only for the scenario they think is most likely to unfold, but also with an eye toward the possible but less probable outcomes. While there is no sure way to quantify what degree of inflation (or deflation) protection is appropriate, it might be prudent for investors to devote a moderate share of their portfolios to it at this stage.

**Exhibit 9: Slow Wage Growth Has Led to Sustained Low Levels of Core Inflation Since the 1980s**

Inflation versus Deflation (continued)

Below, we suggest some general asset allocation strategies for protecting investments against these different outcomes (see Exhibit 10). In short, potential investment strategies for an inflationary regime include, for Fixed Income: short-duration assets (to protect against capital losses from rising rates), inflation-protected bonds (e.g. TIPS) and break-even inflation swaps; for Real Assets: commodities, direct real estate and infrastructure and for Equities: inflation-sensitive strategies and Real Estate Investment Trusts (REITs). A deflationary regime calls for: developed world government bond duration, high quality credit, defensive, high quality, high-yielding stocks and U.S. dollar cash (as a “safe haven” and to keep some powder dry for reinvestment). We encourage Taft-Hartley plans and all investors to monitor economic activity indicators and the direction of policy, adjusting these strategies in line with their individual inflation risk tolerance.

— Stu Schweitzer and Ehiwario Efeyini
Global Markets Strategists

Legislative Insight: A Measure of Relief for Multiemployer Plans

On June 25, 2010, President Obama signed the Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (PRA 2010) into law. Of greatest relevance for the Taft-Hartley community, the bill provided some pension funding relief to both single employer and multiemployer plans. Specifically, the Act would:

• Allow investment losses for 2008 and 2009 to be amortized over a thirty year period. This provision applies to the first two plan years beginning after August 31, 2008, and the amount to be amortized is the difference between expected returns and actual returns.

• Allow specific assets smoothing for 2008 and 2009 investment losses. Plans would be allowed to smooth assets over a ten year period rather than a five year period.

• Temporarily expand the asset smoothing corridor for the first two plan years beginning after August 31, 2008, and increase the upper limit of the smoothing corridor from 125% to 130%.

EXHIBIT 10: INVESTMENT RECOMMENDATIONS FOR CURRENT INFLATION AND ECONOMIC RISKS

<table>
<thead>
<tr>
<th>INFLATION</th>
<th>DEFLATION</th>
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<tbody>
<tr>
<td>• Short duration</td>
<td>• Developed world government bonds</td>
</tr>
<tr>
<td>- Limited capital losses as inflation and rates rise</td>
<td>- Capital gains as inflation and rates fall</td>
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<tr>
<td>• Inflation-protected bonds/breakevens</td>
<td>• High quality credit</td>
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<tr>
<td>- Protection from upside inflation surprises, though still vulnerable to increases in real rates</td>
<td>- Provides income in a world of low yield</td>
</tr>
<tr>
<td>• Commodities/commodity currencies</td>
<td>- Lower scope for spread widening in weaker, deflationary economic environment</td>
</tr>
<tr>
<td>- Likely to benefit from dollar weakness and increased demand from emerging economies</td>
<td>• Defensive, high quality, high-yielding stocks</td>
</tr>
<tr>
<td>• Real estate</td>
<td>- Provides income in a world of low yield</td>
</tr>
<tr>
<td>- Asset replacement costs rise with inflation</td>
<td>- Less exposure to economic cycle and healthier balance sheets limit price weakness in market sell-offs</td>
</tr>
<tr>
<td>- Leasing income typically linked to CPI inflation</td>
<td>• U.S. dollar cash</td>
</tr>
<tr>
<td>• Infrastructure</td>
<td>- “Safe-haven” in times of financial stress/deflation risk</td>
</tr>
<tr>
<td>- “Allowed return” for regulated industries captures inflation</td>
<td>- Ammunition for re-investment</td>
</tr>
</tbody>
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MACROECONOMIC UNCERTAINTY

Hedge funds and absolute return strategies
Capitalize on market volatility and opportunities in distressed assets
Diversification
Lower volatility

Source: J.P. Morgan
In order to take advantage of this relief, certain requirements are placed on the plan:

- The plan actuary must certify that the plan is expected to have sufficient assets to pay benefits and expenses over the extended amortization period, and
- Plans taking advantage of the relief may not make benefit improvements during the two years following the plan year in which relief was applied.
- Exceptions exist for the benefit improvement limitation in cases where the benefits are required to maintain the plan's qualified status, or the improved benefits are paid for through additional contributions.

On July 30, 2010, the Internal Revenue Service issued guidance for both single employer and multiemployer plans wishing to take advantage of the funding relief available under PRA 2010. For multiemployers, this can be found in IRS Notice 2010-56, which primarily outlines what future guidance IRS is working on with respect to the PRA 2010 funding relief.

The notice also clarifies, in the case of a plan year ending before guidance is issued, that funding relief may be used for that plan year without regard to whether the plan sponsor has filed the Form 5500 (and Schedule MB) for that plan year.

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Future Legislative Action

It appears unlikely that multiemployer plans will receive any further legislative relief this year. The shortened legislative calendar in the lame duck session following the mid-term elections and the need to address budget concerns will limit any opportunity for further action this year. We are hopeful that 2011 will provide a better chance of moving funding relief forward.

– Robert Holcomb
Vice President, Legislative and Industry Affairs

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