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Economic Recovery May Falter and At Best Will Be Subdued, Economists Tell Attendees at 2010 CFALA Forecast Dinner

LOS ANGELES – The economic recovery remains tentative, with unemployment remaining high and daunting challenges facing policymakers in the long-term, three highly respected economists told attendees Thursday at the 2010 Economic and Investment Forecast Dinner presented by The CFA Society of Los Angeles (CFALA).

Two of the three experts, Komal Sri-Kumar, Ph.D, Chief Global Strategist of Trust Company of the West; and Robert Arnott, Chairman of Research Affiliates; were decidedly gloomy about the economic outlook. The third, Tom Higgins, Ph.D, Chief Economist at Payden & Rygel Investment Counsel, expects sub-par economic growth with the jobless rate remaining elevated for several more years. All are concerned about the possibility of surging inflation down the road.

"I do not believe the economic recovery is going to be up, up and away," Sri-Kumar said. "This is going to be a double-dip recession, with housing prices dropping again and leading us back down. Also, because of high unemployment, we are not going to see a resurgence in consumer spending. Consumers who are about to lose their jobs are not going to increase their spending, and consumer expenditures are 71% of GDP. You can't make that up with inventory buildups and government spending."

Although preliminary estimates showed strong GDP growth in the final quarter of 2009, Arnott isn't persuaded.

"There's a lot of wishful thinking in the reporting on the economic statistics," he said. "We see substantial evidence that the economy is deteriorating at a slower pace, but the evidence of an economic recovery is pretty limited. Tax receipts at the IRS for the fourth quarter were down 9% from the fourth quarter of 2008, which sure doesn't sound like a recovery. The deficit situation is deteriorating, and it's much worse than people realize, because it doesn't take into account off-balance sheet items, GSEs and unfunded liabilities like Social Security and Medicare obligations."

Though less pessimistic, Higgins agrees that consumer spending and therefore economic growth will remain restrained.

"For the U.S. economy, we expect sustained growth, although it will probably revert to more sub-par than what we saw in the fourth quarter of 2009," he said. "Trend growth will probably be closer to 2% to 2.5% annualized, as opposed to the 3% to 3.5% we saw before the financial crisis. Households are paying down their debts, which means they have less to spend on other things. That ceiling on economic growth is going to last for perhaps as long as the next decade. We're going to have to get used to a different speed limit."

Both Sri-Kumar and Arnott expect higher interest rates a year from now.

"Short-term rates are going to stay too low for too long and that in turn is going to spur inflation near the end of 2010 or early in 2011," Sri-Kumar said. "The Fed's recent decision to raise the discount rate does not change my thinking here," he added. "Maintenance of low short-term rates is going to cause bond yields to rise. The 10-year yield is about 3.6%. I think it will be 4.5% to 5% one year from now."

Arnott is particularly concerned about mounting debt and the prospects of higher inflation.

"Debt is not what people perceive it to be," he said. "It crossed 80% of GDP to much hand-wringing, but if you add in state and local GSEs, the true public debt is 140% of GDP. Add in household and corporate debt and it's 560% of GDP, which is not only the highest in the world but also the highest any country has ever seen. Although we expect a benign interest rate environment for the next six to 12 months, when inflation kicks in, which it could over a 12 to 24-month period, I think it's going to be scary."

Despite their concerns, all three economists see long-term opportunities in the markets.

"If the Obama Administration changes its policies drastically, I see U.S. equities as very well-placed for the future," Sri-Kumar said. "But that requires a complete rethink toward helping the private sector rather than bashing specific institutions."

"In any economic environment, there are interesting places to invest," Arnott said. "Among those we see are emerging markets debt, inflation-linked TIPS, and at some stage, commodities."

"We think there are opportunities in fixed income as well as equity markets," Higgins said. "But people are going to have to lower their investment expectations, because lower economic growth means lower profit growth.

Last year was a very low quality rally. We think this year will be more of a high quality rally, and we favor large-cap names that pay dividends."

The panel discussion at the Omni Hotel in downtown Los Angeles was moderated by Donald Straszheim, Ph.D., Senior Managing Director and Head of China Research for ISI Group. CFALA is a network of investment management professionals working to disseminate useful financial information and increase awareness of the value of the Chartered Financial Analyst (CFA®) designation, which is intended to lead the investment profession by setting the highest standards of ethics, education, and professional excellence.

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