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ABOUT BILL SULLIVAN

William V. Sullivan, Jr. serves as Chief Economist at JVB Financial Group, working closely with the firm's trading desk, providing analysis and commentary on the U.S. economy and the financial markets. Among his duties are authoring a weekly report on credit market trends and maintaining a regular schedule of conference calls that focus on interest rate developments. He appears frequently on Bloomberg TV and is often quoted in Barron's.

Mr. Sullivan is the familiar voice that JVB features on our weekly conference call, where he discusses the economy and the events that affect the marketplace.

He was previously associated with Morgan Stanley in New York City for more than twenty years, where he was an Executive Director and a Senior Economist in the firm's Retail Fixed Income Division. Bill published a widely quoted weekly letter on the financial markets and was a frequent guest commentator on several business networks, including Bloomberg TV, CNBC, and Fox News.

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JVB FINANCIAL

Weekly Commentary

by Bill Sullivan, JVB Chief Economist

December 8, 2009

Circular reasoning at work?

One of the amazing attributes of the 2009 market environment has been the outsized impact that the exchange value of the U.S. dollar has had on the valuation of other financial assets. This relationship is centered on the perceptions that institutional investors have regarding the status of Federal Reserve monetary policy. In its simplest form, any data input that points towards a weak or sluggish economy are viewed as keeping the Fed on hold for an extended period. The maintenance of a historically low target for Fed funds encourages the selling of dollars and the concomitant purchase of foreign currencies. The weaker greenback, in turn, boosts the prices of internationally traded commodities, such as crude oil and copper. The firmer tone to material prices is more often than not associated with strength in the broad equity averages, both here and abroad. As stock markets climb, the preference for quality and safety diminishes, leading to occasional selling pressure in U.S. Treasury securities market as well as other sovereign debt arenas. While these trading strategies have served many risk managers well as the year has progressed, there nonetheless appears to be a weak link that suggests several of these relationships cannot persist for the indefinite future. Indeed, if the original premise is correct, that the domestic economy remains weak, such a situation would point toward soft demand conditions. Without a turnaround in final demand, it is doubtful the upward movement in commodities can be sustained, no matter the exchange value of the dollar. Similarly, if business and personal spending continues to under perform, the earnings growth to justify current equity valuations may never arise.

An additional consideration for investors, even if the signs of a recovery prove legitimate, is the fact that there may be a huge obstacle to a prospective acceleration in overall economic activity. Specifically, any sense that the U.S. economy is poised for sustained gains will create an increasing potential that yields on outstanding Treasury securities could escalate in a dramatic fashion. Clearly, as the expansion process widens, fears concerning a buildup of inflationary pressures would mount. These worries would be occurring in the context of record or near record borrowings by the Federal Government that would inevitably require the Treasury to pay markedly higher rates on their offerings. The rising trend in Treasury yields would spill over to the private sector, with households and corporations ultimately forced to borrow funds at a higher cost. The worrisome nature to this situation is that mortgage rates would quickly move higher which would short-circuit any ongoing rebound in housing and home prices. A retreat in residential construction and in the volume of home sales would represent a major headwind for the economy that would limit the magnitude of a recovery process. Effectively, borrowing costs must remain low for housing to register a meaningful recovery. If and when open market yields do begin to climb well above current levels, the eventual response would be to downgrade the future growth prospects of the economy.

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Needless to say, the prospects for the economy next year and beyond are intertwined with the performance of the job markets over the period ahead. Admittedly, the November employment situation report provided some welcome news on the labor front. However, no one should rule out the potential for additional deterioration as the first half of 2010 progresses. As an example, the peak unemployment rate for the current cycle may still be in the future, not in the past. Specifically, the drop in the nationwide jobless rate last month wasn't really that surprising when viewed in the context of prior experience. Previously, when the unemployment rate had registered an outsized move in a given month, it was usually followed by an adjustment in the opposite direction during the following period. Considering that the actual level of joblessness soared by 0.4% during October, a downward move in November appeared highly probable and may represent little more than statistical noise. With new hiring apt to remain subdued in the months ahead, another upturn in the jobless rate seems possible, particularly if the labor force begins to grow on a regular basis.

Additional restraints on labor market activity include the health care reform debate and the persistence of rigid credit standards. As business firms review budgets for the upcoming year, the impact of Federal legislation on health-related issues is simply unknown. No doubt, most companies sense that employee costs for health benefits could climb as a result of Washington action. Higher expenses for staffing will tend to limit the willingness of businesses to add workers and it is still possible that the initial response early in the New Year is to continue to layoff workers to better manage budgetary expenses. If so, payrolls could remain weak through the middle part of 2010, rendering the modest decline in November as somewhat misleading regarding the eventual direction of labor market activity. Beyond the machinations in the nation's Capitol, it is very apparent that the access to credit for many business platforms is limited. The persistent contraction in business loans on commercial bank balance sheets underscores the tighter regime for credit availability that is in place versus prior recoveries. From our perspective, the difficulty that many firms have in raising new cash from traditional lenders is a huge impediment for a sustained economic rebound, including a return to aggressive new hiring. The lack of funding will limit working capital positions and will thus reduce the wherewithal to bolster payrolls, to add to inventories and to expand plant and equipment. Against this backdrop, the outlook for employment may not be as upbeat as the November report initially implied. ■

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