

Dan Fuss and the Eisenhower Recession Redux

By Robert Huebscher

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Those of us old enough to remember Studebakers and the military-industrial complex will recall the Eisenhower Recession, which began in 1957, lasted eight months and was followed by the 10 month “Rolling Adjustment” recession beginning in 1961. The W-shaped path of the US economy during this period is the correct analogy to today’s crisis, according to Loomis Sayles and Company’s Dan Fuss.



Fuss is one of the industry’s preeminent bond investors and was the keynote speaker at New England Pension Consultants’ client conference on May 21.

Fuss said the crucial impediment to economic growth is the collapse in capital spending, as corporations have cut back their spending plans on everything from software to new plant construction. He forecast a repeat of the W-shaped recovery and a six-year period of slow growth, warning investors that “things are going to be very disappointing.”

Eisenhower’s recession certainly bears similarities to the current downturn. Both were world-wide crises marked by a sharp decline in investment in fixed capital. Eisenhower faced a 31% slowdown in automobile sales in 1957, which is not quite as bad as today’s drop of nearly 50%, and the Rolling Adjustment recession marked the beginning of the shift to buying foreign-made cars – perhaps the first nail in today’s coffin.

Fuss is well aware those recessions were mild by today’s standards – GDP declines of 3.3% and 2.4% and unemployment of 6.2% and 6.9%, respectively. He called the current inventory contraction “horrifying” and, although this correction may be complete, he said the impact on capital goods spending is a “long way from over.”

The four P’s

At a macro level, Fuss was somewhat more optimistic. “No matter when or which market you analyze, four key themes guide the future,” he said. Those themes are peace, people, politics, and prosperity, and Fuss offered his views on each.

“Peace is the most important factor, and we don’t have it,” Fuss said. Wars in Iraq and Afghanistan will cost the government about 2% of GDP, which he called a “serviceable” amount, similar the outlays for conflicts other than the World Wars, the Korean War, and the Vietnam War. Longer term, however, Fuss’ fears lies in the impact this 2% will have on the Treasury’s debt burden.



Demographics will slow growth in the US and most Western economies, according to Fuss. These populations have moved from a pyramid, with a small number of elderly at the top and a large number of young at the bottom, to an oval, with a bulging segment at or near retirement age. As democracies spread – Fuss cited China as an example – governments will be forced to care for their elderly, pressuring expenditures at the Federal level.

Although he does not support many of Obama's policies, after hearing him speak at Notre Dame (at Fuss' son's graduation) he regards him as a "formidable" political force in guiding policies. Fuss was critical of the handling of the Fannie Mae and Freddie Mac bailouts, but his greatest concerns are with spending on programs "away from the financial markets" and their impact on Federal deficits.

On the subject of prosperity, Fuss admitted he failed to see many of the problems in the economy last year, which he said were obscured by news about the election. "The key to the mischief in the markets was the absurd amount of liquidity that was created," he said. He recalled how, in 2007 and early 2008, European banks began investing in SIVs as a way to boost profitability, when flat yield curves impeded their normal sources of profits. In June of 2008, when Moody's placed some CDOs on their credit watch list, the Germans were the first to react, sensing they were overexposed to weak credits. Events unfolded quickly thereafter.

Investment opportunities

Near term, Fuss expects rates to remain low and the government to issue long-term debt to finance its budget. His "guess" is that interest rates overall will remain near their current levels for the next three years until, eventually, long-term rates are forced higher, followed by intermediate rates and then short-term rates. "We went through this in the 1960s and 1970s," Fuss said, but added that he did not expect a return to 1970s-level interest rates and inflation.

"There is a trap in the current market," Fuss said, "credit is very attractive but highly dangerous." Danger lies not just among the high-yield sector, which Fuss said is unattractively priced, but within investment-grade bonds, which he said were fairly valued.

As interest rates go up, Fuss said, the market will become "wary" of the corporate sector. "This will be wonderful for the top companies in each industry," he said, who will have access to capital and will ride the wave of a growing economy. These companies will expand, gain market share and their stocks will become growth stocks.

Below that, however, things will be difficult, according to Fuss. Second tier companies may be good credits, but will struggle to find needed financing and achieve sustainable



growth. "If you own the long bonds of these companies, eventually you will own stocks," he said.

"The market is cheap if you know what you are doing," Fuss said. He thinks investment-grade spreads will contract, but that will be offset by increases in Treasury bond yields. "Corporate bonds are more attractive than most stocks." Fuss said high-yield stocks, in particular, are not a good alternative to bonds, because "they have high yields for the wrong reasons."

One "sweet spot" in the market is the opportunity to buy asset-backed securities in leveraged portfolios, provided that cheap financing is available through programs such as TALF and PPIP. But Fuss said his firm, Loomis Sayles, is not set up for these opportunities.

Large-cap stocks returned 7.0% for the decade starting in 1962, following the end of the Rolling Recession, and small-cap stocks returned 12.3%. Credit market returns were muted, as long-term corporate bonds returned 3.1%. If the economy follows a similar W-shaped path, let's hope the markets react more favorably.

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