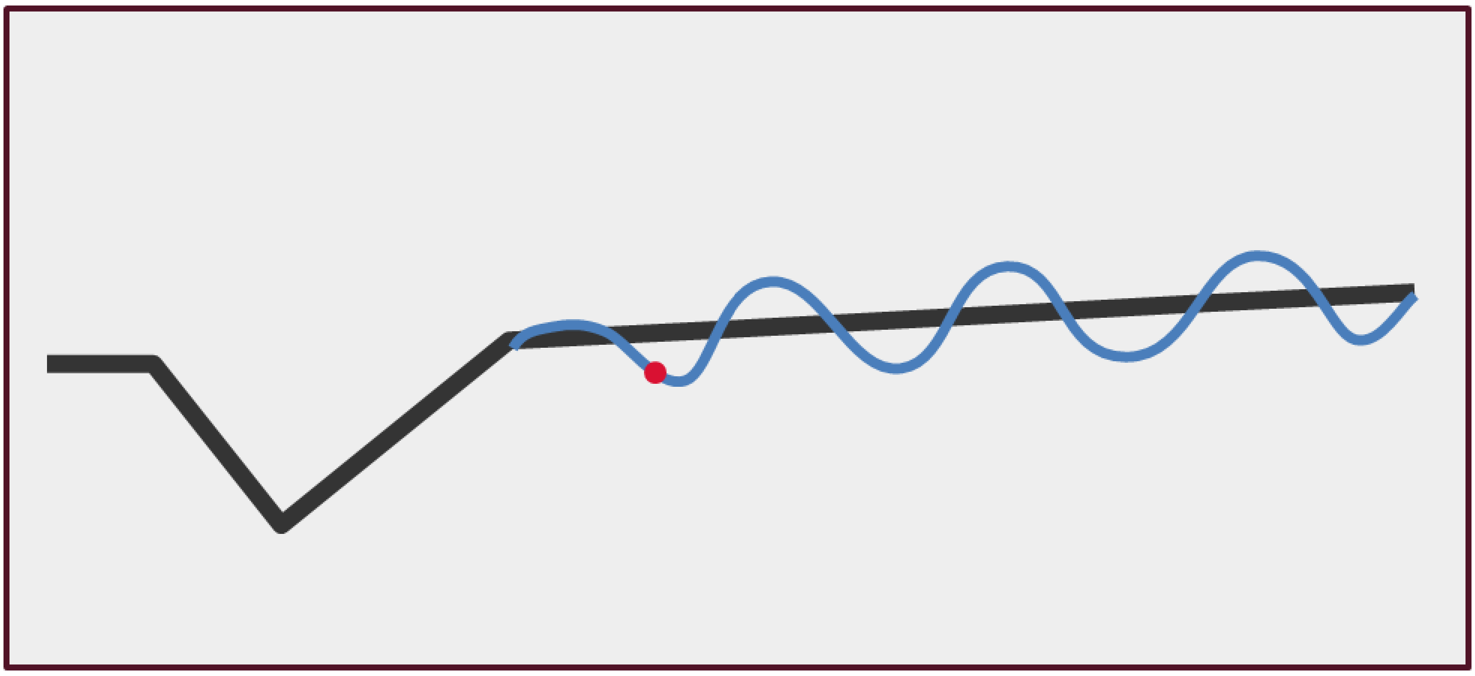
Chart of the Month

August 2011

The Square Root Economy



We first discussed "The Square Root Economy" in our Investment Strategy and Outlook in July 2009. The symbol captures the recent downturn and upturn, as well as the muted growth rate in the post-credit-bubble economy, which has been dubbed "The New Normal" by PIMCO. The left-hand side of the "V" represents the recession from December 2007 through June 2009, the right-hand side of the "V" depicts the recovery in the second half of 2009 through the first half of 2010, and the gently upward-sloping trend line portrays the forecasted growth trajectory in the years to come.

This Chart of the Month introduces the idea that the economy won't grow in a straight line. Instead, it will go through periods of decelerating and accelerating growth as the blue overlay suggests. While not designed to predict the immediate future, the red dot is an approximation of where the economy may be in the scope of the bigger picture.

With the foregoing in mind, the Gross Domestic Product (GDP) readings for the first and second quarter were revised downward to 0.4% and 1.0%, respectively, late last month. As a result, the economy increased only 0.7% for the first half, a much lower rate of growth than the consensus projection at the beginning of the year.

When we published our Chart of the Month for May, we knew the economy was slowing to what appeared to be an annualized rate of 2.0%-3.0% but did not realize that it was barely expanding as the subsequent data detailed. More than anything else, it was the recognition by investors that the domestic economy was worsening that sent the stock market into a tailspin in the final week of July and the first three weeks of August. The market, which had previously priced in a "Goldilocks" environment ("not too hot and not too cold"), simply adjusted to the less-than-inspiring economic reports that were released late last month and earlier this month. In fact, at the lows just over a week ago, stock prices were reflecting close to a 50-50 probability of a recession in the second half of the year.

While not dismissive of the possibility of another contraction, we believe the economy is more likely to eke out modest growth in both the third and fourth quarters. Meanwhile, we expect stocks to trade in a range between the recent lows and the old highs reached last spring. The volatility should provide opportunities to add to current holdings or create new positions on weakness and trim on strength as we aim to keep the portfolios fresh with our best ideas. On the fixed-income front, we continue to believe that interest rates are likely to remain lower and for a longer time than the consensus view.

Lederer & Associates
Investment Counsel

111 West Ocean Boulevard, Suite 1350, Long Beach, California 90802
Tel: (562) 495-2350 ▲ Fax: (562) 495-2006
www.lederer-associates.com