

What are the keys to the economic recovery?

Wealth Management Insights April 2010

Coming out of the most severe economic downturn since the Great Depression, the road to recovery so far has been erratic and has given rise to uncertainty among investors. Because the health of the economy and the markets are so closely linked, many people are wondering just what it will take to fuel sustainable growth. To address this important question, Baird recently convened a panel of our award-winning Senior Research Analysts. Below are just a few of their insights.

What You Should Know:

1. Financial institutions will help set the pace.

A little more than a year ago, the future of the entire U.S. financial system was in question. High-risk behaviors, complex interrelationships and complexly structured instruments created unprecedented leverage in the banking and investment industry, leading to the collapse or consolidation of several prominent firms.

- Fear of additional firms closing, as well as the possibility of bank runs and speculation about nationalization, played a major role in taking this sector to its near-historic lows in March 2009.
- The financial sector appears to have responded well to stimulus and has stabilized. Financials helped lead the 2009 rally and most firms are now extremely well capitalized.
- Recovery will be slow with several potential bumps. Government-assisted

measures that have stimulated growth will phase out and interest rates are expected to rise eventually.

- Proposed regulatory reforms may slow the recovery initially, but could ultimately be beneficial for the sector.
- ### 2. Employment must increase.
- Economic downturns frequently force companies to trim costs and, unfortunately, that often means layoffs. But the recent downturn was a little more complicated in that it involved a fundamental shakeup of the entire financial and credit system. As a result, many companies cut deeper than they had in generations. ▶



To hear directly from Baird's award-winning Research Analysts about the keys to the economic recovery, watch our recently released video at rwbaird.com/economy

- Employment is typically a lagging indicator following a downturn, meaning it can be some time after the recovery begins before we see improvement.
 - Small businesses are constrained by tight credit markets, which impact the number of new companies formed.
 - Offshoring of positions, particularly in manufacturing and services, is at unprecedented levels due to the cheaper cost of labor in many foreign markets.
 - Overall, the employment picture seems to be improving with the number of layoffs decreasing in general, and temporary employment, which usually leads permanent employment in a recovery, has increased dramatically in recent months.
- 3. A real estate rebound is central to full recovery.**
Homeowners are painfully familiar with the term “housing bubble,” and the inflated value of many homes was a big contributor to what became unprecedented debt leverage on the average consumer. The big questions now are whether the residential market has bottomed and what’s in store for the commercial side of the equation.
- As companies continue to look for cost-cutting measures, real estate occupancy and rents are declining, which impacts property values.
 - Without an increase in demand, continued decline of rents and values could lead to further de-leveraging on the commercial side.
- If other sectors begin to recover, public companies are very well positioned in terms of access to capital to stimulate the commercial real estate market, which is a positive for the overall sector.
- 4. Transportation can help us get there.**
With excess inventories largely depleted, manufacturing appears to be turning a corner. This has increased the need for freight.
- One of the early signs of recovery occurs when manufacturers and retailers cut inventories so low that they have difficulty keeping up with demand, which usually triggers an uptick in air freight.
 - We’re seeing increased air freight activity now, particularly in Asia (where manufacturing is a large part of the economy), which recently had some of its strongest freight months in history.
 - If we continue to see significant pull through in demand from the consumer, freight should continue to pick up through the spring and summer months as businesses begin to replenish inventories in anticipation of the holiday season.

What You Should Do Now:

The various sectors of the economy are all interrelated and can influence each other’s performance, especially coming out of such an unusually difficult downturn. For much more on the emerging dynamics of the nascent recovery, we encourage you to visit rwbaird.com/economy and watch the full video of our analysts’ insightful discussion on these topics. ■