

Week ended August 13<sup>th</sup>



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For over 20 years, Dr. Webman has been involved in the investment and economic markets—as a researcher, financial advisor and portfolio manager.

Dr. Webman holds a B.A. in political science, with honors, from the University of Chicago where he graduated Phi Beta Kappa, and a Ph.D. in political science from Yale University. He is also a Chartered Financial Analyst.

## Don't Double Dip

The “fear trade,” following a month-long hiatus, roared back this week as weaker economic data sparked concerns that a double-dip recession threatened the United States. Investors also responded nervously to reports of slower Chinese investment and factory output growth in July. We view fears of a China slowdown as overwrought, especially considering that not long ago, markets were concerned that the Chinese economy was at risk of overheating. Following a concerted effort by the Chinese government to cool growth, the nation appears to be on a more sustainable path.

Elsewhere overseas, the Eurozone reported a 1.0% rise in gross domestic product (GDP) in the second quarter, the strongest quarterly pace of growth since 2006. Germany, aided by robust exports, led the way with the best quarterly growth since reunification.

Back in the U.S., however, market conditions deteriorated ahead of the Federal Open Market Committee's (FOMC) acknowledgement of what we already know: that the economy is slowing and that the pace of recovery is likely to be modest. On Wednesday, the release of trade data drove home the extent of the slowdown as weakening exports and surging imports in June widened the U.S. trade deficit by a record \$7.9 billion to \$49.9 billion, the largest it's been since October 2008. Initial Bureau of Economic Analysis estimates for second quarter GDP growth clearly underestimated the drag from the growing trade deficit. Second quarter GDP will be revised to a soft 1.0–1.5%, versus the 2.4% initially reported.

Markets responded to the data by following what by now has become an all-too-familiar pattern. Global equity markets sold off, the yen rallied, and money flowed to securities backed by the full faith and credit of the U.S. Government. Of all the market forecasters, the bond market gets it right most often, and recent activity in the Treasury market has been particularly disconcerting. The benchmark 10-year Treasury fell below 2.70% on Wednesday and closed the week only 62 basis points off the all-time low we saw in late 2008. The Treasury Inflation-Protected Securities (TIPS) rates also continued to trend lower, signaling mounting concerns of future deflation. Fortunately, the Consumer Price Index (CPI), a key gauge of inflation, ticked higher in July, rising 0.3% overall. The core CPI, which excludes more volatile food and energy prices, rose 0.1%. The overall index had declined for three months in a row. Year over year, the headline CPI rate rose to 1.3%, still below the Federal Reserve's unofficial target inflation rate of 1.5–2.0%.

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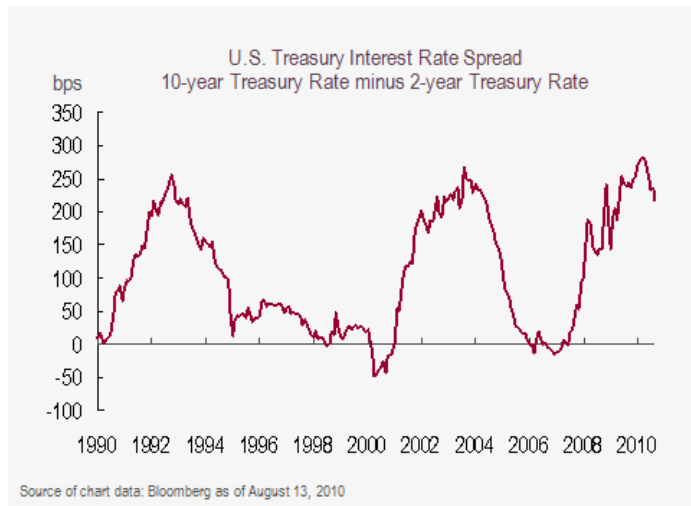
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On another positive note, the spread between the 10-year and 2-year Treasuries has compressed in recent weeks, but at 215 basis points, is not signaling a pending recession.



## Another recession is unlikely

Double-dip recessions are very rare. Once an economy the size of the U.S. gets moving, it is uncommon for it to be derailed. There have been 33 official recessions since 1850 and in only three instances—once in 1913, again in 1920, and then not again until 1981 when the Fed ratcheted up short-term interest rates to whip inflation—has the economy fallen back into a recession within a year of the previous recession ending.

Technically, a recession is a period of diminishing economic activity. The economy has been recovering, growing slowly, since the summer of 2009. For many Americans, particularly the millions who are unemployed, the recent technical recovery is cold comfort. Ultimately, this recovery was always going to be more modest than those of the past with businesses cautious, employment lagging, and consumers saving more and spending less. History suggests that financial crises usually lead to prolonged periods of weak economic growth. A de-leveraging process takes time, and the U.S. and much of the developed world is still in the early to middle stage. Don't forget that when you go from trying to move a rock

with a lever to trying to move it with your bare hands, you're going to move it a lot more slowly and a much shorter distance—and your hands will hurt. That's the position we are in the American economy: Our lever broke and we are still recovering slowly and somewhat painfully.

The National Bureau of Economic Research, which decides the official dates of recessions in the U.S., looks for a general decline in five areas: 1) real GDP, 2) industrial production, 3) wholesale and retail sales, 4) employment, and 5) real income.

- **Real GDP** – While there is no denying the slowdown in domestic demand growth, the economy is still expanding. Despite the weak second quarter, real GDP is only 1.5% below the peak reached at the end of 2007
- **Industrial Production** – Led by gains in business equipment, including a sharp uptick in information processing, production in the U.S. continues to trend higher. Recent surveys by the Institute for Supply Management indicate that purchasing managers continue to expand inventories as new orders grow
- **Sales** – Retail sales in July rose by a less-than-expected 0.4% after falling 0.3% in June. Most of the improvement came from motor vehicle and gas station sales, while core sales, which exclude these and other volatile categories, fell 0.1%
- **Employment** – the private sector has created an average of net 90,000 jobs per month in 2010 but, the pace has slowed since May. Expecting a greater contraction than came to pass, businesses eliminated workers aggressively and remain cautious about adding to their payrolls. Productivity growth soared as businesses were able to meet demand with fewer workers but has recently peaked indicating that firms are finding it harder to squeeze any additional efficiency gains out of their existing workforces. History suggests that a post-recession peak in productivity growth has been consistent with a 10% increase in employment growth over the next eighteen months. The jobless recovery of 2002 was an outlier with employment growing 4.6% eighteen months after the peak in productivity



- Real income – despite ongoing weakness in job creation, gains in the work-week and wages are yielding improvements in disposable income. The average salary has increased by over 1% from the beginning of the year

## What will drive a pick-up in activity?

### *Consumption*

A sharper recovery depends more on a revived consumer than on aggressive policy decisions. Recent upward revisions to the savings rate hint that consumer balance sheets are better than originally estimated. Real incomes are rising. Pent-up demand remains high. But we consumers were the ones who made the greatest use of last decade's credit boom, and we are the ones now trying to move that rock without a lever. Outsized, consumer-driven growth is, therefore, not in the offing, but consumption should bounce off the weak levels of the second quarter to a modest but sustainable pace.

### *Business Investment*

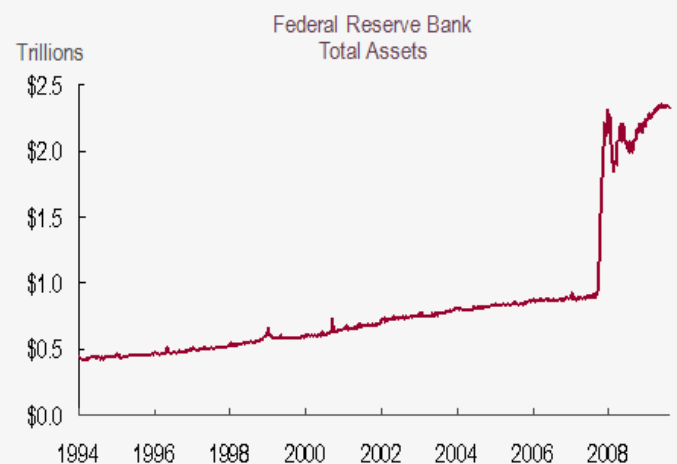
Corporate earnings in the second quarter are shaping up to be the third-best quarter on record both in terms of breadth and magnitude of upside surprises. With nearly 90% of S&P 500 companies having reported earnings, three-fourths of the companies have beaten earnings estimates while revenue growth (ex-financials) is poised to be up 13%. Profits are providing wherewithal for capital spending as companies are investing to replace worn-out and obsolete equipment. Additionally, although the large boost to growth from the inventory rebuild is largely behind us now, inventories are still relatively lean in relation to sales. If final sales pick up as we expect, inventory levels will likely fall too low unless production steps up in tandem. Stepped up production should, in turn, support employment.

### *Government: Don't Count on It*

On the fiscal side, the weak data will likely pull policy in the direction of more fiscal easing despite the growing demand for fiscal restraint. Nonetheless, any additional fiscal stimulus at this point would have a small impact on the economy as Republicans are likely to resist larger spending measures. The fate of the Bush tax cuts remains up in the air. Administration officials and

Democratic leaders are committed to raising the upper bracket tax rates next year. It will take a significant deterioration in economic activity for the administration to change course.

On the monetary side, the FOMC retained its commitment to keep its benchmark interest rate close to zero for an extended period. Additionally, to help support the recovery, the Committee will maintain the holdings of securities on its balance sheets to prevent money from being drained out of the financial system. The Fed's decision to reinvest the proceeds from maturing agency and mortgage-backed security (MBS) holdings into Treasury securities avoids a passive shrinkage of its balance sheet. The Fed is essentially reinvesting into Treasuries the returned principal from mortgages that are prepaid earlier than expected. Rough estimates suggest the Treasury reinvestments to total \$10–\$20 billion per month, compared to the \$2.55 trillion of gross new issuance in notes, bonds, and TIPS scheduled to come to market in 2010. The Fed is not currently engaged in further quantitative easing; rather it's just not tightening. This posture does however, set the stage for a more aggressive asset purchase program should conditions deteriorate.



Source of chart data: Federal Reserve Board as of 8/4/10.

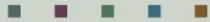


Is such a move imminent? I am skeptical that the Fed would now be willing to restart its asset purchase program because the impact will be limited. The housing market is not constrained by high interest rates but rather by soft employment growth and a glut of available homes. Large company expansion plans are certainly not constrained by high interest rates. Just two weeks ago, International Business Machines raised \$1.5 billion at the lowest interest rate on record. Even corporate bonds issuances from below investment-grade companies hit a record level this week. Further, buying large quantities of Treasury securities would leave the Fed open to claims that it was monetizing the debt, a stigma the Fed would like to avoid unless completely necessary. The Fed may look to reduce the interest paid on commercial banks' excess reserves, but in actuality banks are already well compensated to lend their excess reserves; they simply remain cautious about doing so. Again, there is only so much that our policymakers can accomplish. A sharper recovery will be dependent on the private sector returning to the fore.

What does it mean for investors?

While we don't expect a double-dip recession, we do expect only modest appreciation in the foreseeable future from assets that derive their value from U.S.-based revenue streams, be they homes or stocks. As a result, investors, who still need to grow their net worth, are likely to have to save more, let investment income compound and search for new sources of more robust growth, such as various international markets. It's also worth mentioning that while the state of the U.S. economy clearly warrants some degree of concern, U.S. stocks appear to be trading at reasonably attractive valuations based on second-quarter earnings.





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