

One Scoop or Two?

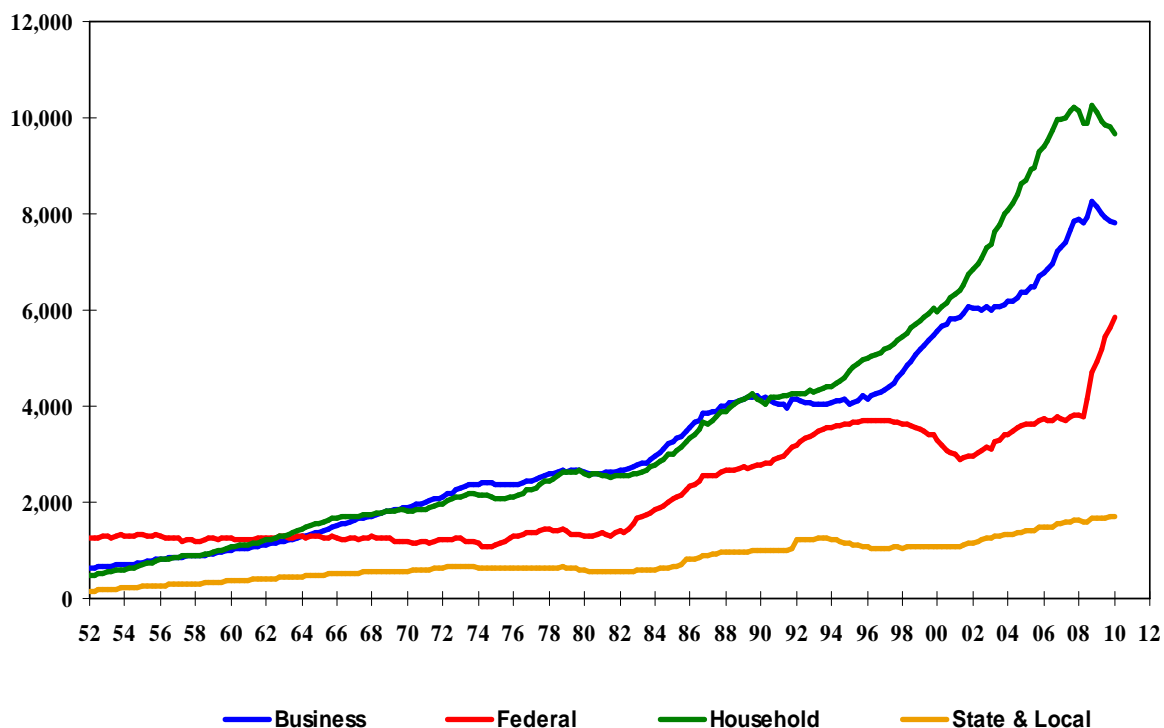
Nothing is quite as satisfying on a hot summer day as a dip of ice cream. In fact, the only thing better may be two scoops. Ice treats have been enjoyed since ancient times. During the 5th century BC, ancient Greeks ate snow mixed with honey and fruit in the markets of Athens.



Today, investors are focused on a different type of “dip”, the double-dip recession. A double-dip recession occurs when following a recession gross domestic product (GDP) growth slides back to negative after a quarter or two of positive growth. According to the National Bureau of Economic Research (NBER) there have been 33 recessions registered in the U.S. since 1854. Over that time frame, there have been only three recorded instances of a double-dip recession. The first one was in 1913, the second one in 1920 and the third in 1981. If we expand the definition of a double-dip to include all recessions within 18 months of the end of the previous recession, the number of occurrences rises only to five. Historically speaking, a double-dip recession is an extraordinary event.

Since recessions are important economic events and the potential for a rare double-dip is on the minds of investors, we thought it might be instructive to look at one of the best models we have for predicting recessions. Our analysis compares the twelve month rate of change in Real Gross Total Debt Growth versus the growth rate of Real GDP. Gross Total Debt is the sum of consumer, corporate, state and municipal debt plus U.S. government debt including that portion held by Federal agencies and trusts.

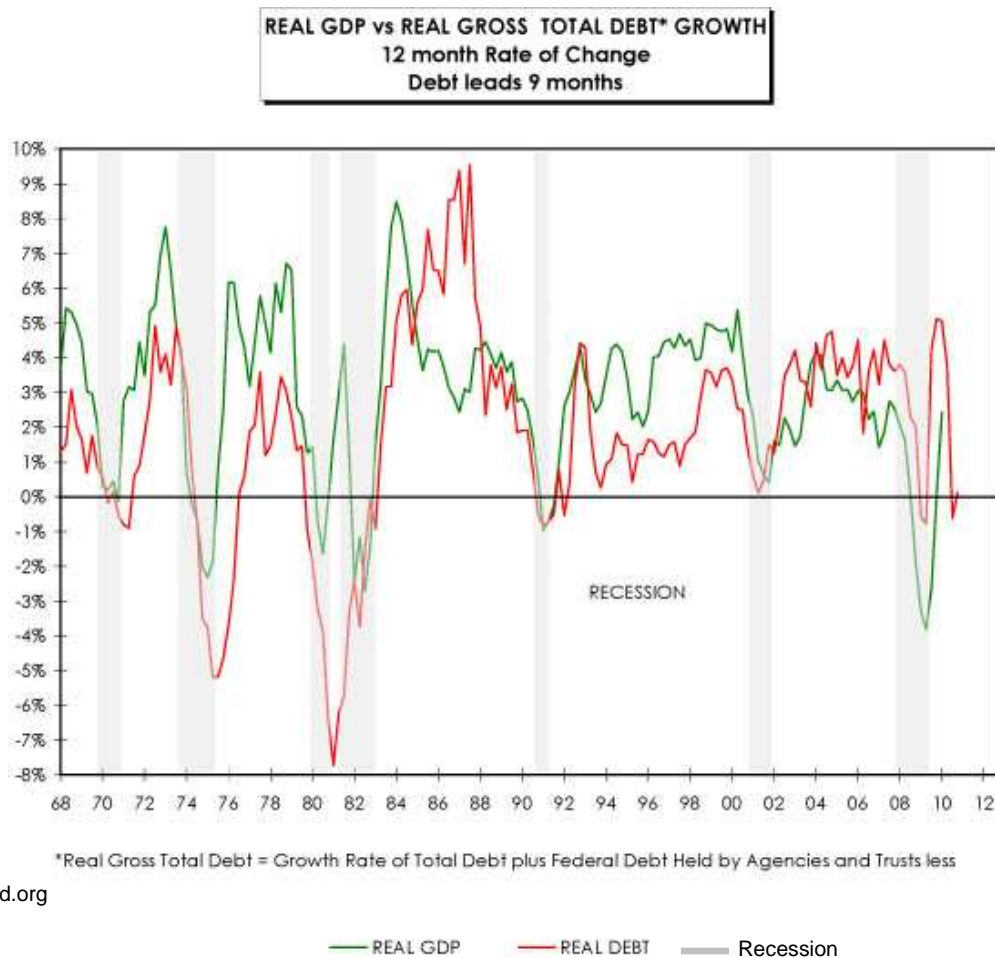
**Total Debt by Sector
in Billions of 1995 Dollars**



Source: St. Louis Fed.org

To compute real debt growth, we subtract the annual rate of change of the Consumer Price Index from the rate of change of Gross Total Debt.

The data for this analysis is only available back to 1968, but we can examine seven recessionary periods including the double-dip of 1981. As our study indicates, each recession in the past 42 years was preceded by a period of negative growth in Real Gross Total Debt.



Source: St. Louis Fed.org

Our economy grows on credit and the ability of businesses and consumers to obtain it and the willingness of financial institutions to extend it. Our analysis suggests that a severe contraction in debt or available credit is a key component in every recession.

The most recent recession began in the fourth quarter of 2007 and ended in the summer of 2009. It is the longest and deepest recession we have experienced in the U.S. since the Great Depression of 1929-1933 and has come to be known as “The Great Recession”.

We know that a major cause was the bursting of a housing bubble that had been driven by the extension of easy credit. Consumers had gorged themselves on cheap money and lax mortgage underwriting standards and the result was a record amount of debt.

Following the bursting of the real estate bubble and the financial crisis that ensued thereafter, businesses and consumers have begun to repair their balance sheets by paring back their debt levels. Initially, the reduction in consumer and business debt was more than offset by a dramatic increase in U.S. Government debt to fund various bailouts and the \$862 billion stimulus program. The net result was a significant increase in Total Debt during 2009. With the stabilization of the financial industry and expiration of many of the stimulus programs, the growth rate of Real Total Debt has decreased dramatically thus far in 2010. As the following graph depicts, commercial and industrial loans have been declining since late 2008 and only recently have we seen a leveling off of the credit contraction.



Stephens

Capital Management

Second Quarter Investment Review

By Brian Bush

July 2010

The major uncertainty in the stock market today is the outlook for growth in the second half of 2010 and beyond. To what degree will private demand accelerate as the positive contribution to GDP from reduced business inventory liquidation and government stimulus plays out? The U.S. economy is driven primarily by consumer spending. Roughly \$.70 of every \$1.00 (70%) is generated by the consumer. With the U.S. unemployment rate well above 9%, can the consumer save the day? Consumer spending remains sluggish due to continued concerns over the outlook for job growth, recent declines in the stock market, the sovereign debt problems of European countries and the Gulf oil spill. Corporations in the U.S. are sitting on record amounts of cash which their shareholders will eventually want them to put to better use with interest rates at historic lows.

Our analysis suggests that the outlook for growth in the second half of 2010 is uncertain at best and a double-dip recession is not out of the question. However, equity prices are currently as undervalued as any time in the past 50 years. It is possible that the stock market has already discounted a slow down in growth if not the dreaded double-dip in the year ahead. When it comes to ice cream two dips are better than one, but not when it comes to recessions. Our analysis indicates the economy may be headed for a "Rocky Road"; however, with the S&P 500 trading at 12.1 times projected earnings for 2010, we believe investors should maintain an overweight position in equities.



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