

Michael Brustkern: No. In our opinion we are in a slow recovery with uneven impacts geographically and by sector. Technology and construction are two examples that come to mind at each end of the spectrum.

Tom Goodwin: To me, the S&P downgrade is about politics, not economics. The downgrade is a loss of prestige for sure, and psychologically adds to the gloom many people feel. But economically speaking, it's a non-event. The proof is that yields on Treasuries fell following the downgrade. There is no other country or company in the world that could see its credit rating downgraded and yet see the yields on its debt fall. That's the special position the U.S. has as safe haven and home of the world's reserve currency.

The more meaningful downgrade was made by (Fed chief Ben) Bernanke when he virtually committed the Fed to keeping rates low well into 2013. That was based on an assessment that the economy is at a tipping point — any new shock could send us back into recession. It's not a new cycle, it's the same cycle we never got out of. We seem to be following the pattern described by Reinhart and Rogoff (“This Time Is Different”): that the recovery after a financial collapse is typically weak and subject to falling back into recession.

According to them, it takes at least four years for the deleveraging cycle to end. I am thinking more and more that they are right.

Christian Schiller: We do not believe that we have entered a new economic cycle yet, and while the risk is certainly there for another recession, we think this will take a few more rounds to play out the real impact of the downgrade and resulting market volatility as to its net effect on the economy.

While the impact to consumer confidence and the general population has been quite a roller coaster, there still remains a tremendous amount of liquidity in the bank debt and equity capital markets and rates are at a historical low point.

This is not 2008. Banks and corporate America have much stronger balance sheets, generally very solid cash flows and from what we see in our Pacific Northwest client and company relationships, most CEOs and CFOs are saying they feel in a much stronger position vis-à-vis where they were in 2008. Thus, we have not seen or heard the fear creep into Pacific Northwest executives and company owners, and generally they remain relatively positive on the outlook for their businesses in 2011 and 2012 even with the recent volatile events.

In fact, there are many positive dynamics going on in the global economy that we think bode well for U.S. competitiveness, including 1) the low dollar exchange rate; 2) the labor shortage and other issues in China which are making it much less competitive to the U.S. on a relative basis; 3) the lack of quality production out of Mexico and other low-cost areas vis-à-vis U.S. quality; 4) the increasing costs of transportation driven by the high fuel costs, which are also changing the paradigm of U.S. versus off-shore competitiveness due to high freight costs; and 5) the changing relative importance of long lead times in international sourcing for U.S. companies, versus cost differentials of U.S. onshore production, which, as offshore costs increase, are driving more companies to move more production back into the U.S.

We continually are hearing stories and seeing in our client base of U.S. manufacturing companies getting a significant increase in business over the past year due to these factors.

Stephen Kutz: We don't believe we have entered into a new economic cycle. We have been positioned conservatively in client portfolios since the beginning of 2011 in anticipation of the kind of volatility we have been experiencing over the past four to six weeks. While there are some clear and serious headwinds in the economy, like U.S. unemployment and the housing market, there are some counterbalancing tailwinds, like strong corporate profits and economic growth in developing markets.

What effects are you seeing in your particular industry?

MB: Merger and acquisition (M&A) activity is stronger due to pent-up demand from the recession. There are more sellers emerging now and massive amounts of capital from both corporate and private-equity sources. Closings are slowly improving but banking restrictions are still tight, forcing creative deal structuring with seller financing and carried equity as common features. Multiples are improving, but below peak levels.

TG: Consumers are still very cautious about spending. Even if they have good, secure jobs they feel poorer because their home equity and retirement funds are down. This impacts local governments through reduced sales tax revenues. Even so, we are seeing slow improvement in sales tax revenues.

CS: On the financial services/investment banking side, we again are not seeing much impact yet. We believe that institutional investors and public company buyers are able to separate the current market volatility and negative consumer perceptions from the reality of a specific transaction motivation and strategic benefit. We were fearful over the past couple weeks that buyers would use the market dip to try to leverage a purchase price reduction or some other terms of their deals, but across the board in our firm, we have not had a single case of this occur.

In many ways, the private equity markets are back to their peak levels of 2007, and we have heard in the recent past weeks that private equity firms are back to getting five times EBITDA (earnings before interest, tax, depreciation and amortization) debt in their deals (and even 5.5 to 6 times in some cases) with very limited covenants and lower rates than in 2007, which results in their ability to pay eight times EBITDA or more.

This is compared to 2009 and early 2010 levels of one to two times EBITDA debt at higher rates and very restrictive covenants. Strategic buyers also are showing a continued aggressiveness on acquisition valuations, and many of our clients are receiving valuations that are back at the 2007 levels (and in some cases even above).

SK: In wealth management, we continue the trend which began three years ago: Wealthy families are re-evaluating their investment strategies and their advisers. They are looking to

further diversify their investment portfolios to include alternative investments like hedge funds whose returns can be less correlated to stock and bond returns.

How is this affecting business activity broadly?

MB: Puget Sound and Washington seem relatively healthy due to strong support from **Boeing**, **Microsoft**, Amazon, health care and agriculture.

TG: Businesses are cautious about new hiring, and banks are still not lending much to small businesses with less than outstanding credit.

CS: Again we see this as a “blip” vis-à-vis the Pacific Northwest business community activity, so we have neither seen nor heard much real impact in the minds of CEOs or CFOs yet. We would envision that this would change if there is any additional dramatic drop (especially through the Dow 10,000 support level), or if this severe volatility continues to go on for a protracted amount of time (i.e., into Q4).

In fact, we have not had a single case of a CEO/CFO basing any change in strategic direction or immediate course of deal action on any of the recent events.

SK: The combination of an uncertain economic backdrop and general disapproval with our elected federal officials have caused businesses to remain cautious about hiring and capital expenditures, as evidenced by the high amount of cash on corporate balance sheets.

Is it mostly psychological, or are people taking actions?

MB: Perception becomes reality. Massive federal government intervention injected elements of uncertainty to decision making at all levels. This includes local and state governments, financial markets and corporate boardrooms. The lack of confidence in government policy making has led to indecision and to a certain degree contributed to a freezing of capital markets.

TG: As I said, the impact of the S&P downgrade is mostly psychological for businesses. State and local governments are worried about a trickle-down effect on their ratings: the response has been to proactively engage the ratings agencies on any concerns the agencies may have.

CS: Again, we believe at this juncture it is still psychological vs. actual, and are not seeing any actions being taken differently based on the past few weeks' events.

What specific examples of changes have you seen?

MB: Restraint in hiring and capital expenditures.

SK: Gold has been a hot topic, with its rapid price appreciation over the past year. We think gold can continue to appreciate with the demand coming from central banks for reserves. As an investment, there are smarter ways to invest in gold than simply the GLD exchange traded fund, which is a popular choice for the retail investor.

Are businesses still interested in borrowing, with interest rates so low, or has the Fed's pledge of two more years of low rates prompted people to wait and see?

MB: Companies with strong balance sheets are carefully evaluating leverage opportunities to grow organically or by acquisition. Clients with less robust balance sheets are unable to borrow under current banking requirements, so low rates don't generate much additional demand.

TG: Not yet. I think there are plenty of takers (for loans), but small businesses and home buyers are having a tough time prying the cash out of cautious banks and other lenders. The impact on the county has been of the two-handed sort: on one hand the county has had no trouble issuing new bonds at very low rates (good for the taxpayer); on the other hand, the credit slowdown is part of the general economic malaise that has caused consumers to hold on to their cash as well, which impacts the county's sales tax revenue. Before the recession, consumers in the county spent about 45 cents in taxable sales out of every dollar income. Now it's about 35 cents. So even though incomes are rising again, sales tax revenues are rising at a slower rate.

CS: We do continue to see an uptick in borrowing interest, both with private equity for deals and with corporations to take advantage of these low rates. Most of the region's banks have been extremely busy in the past four to six weeks in refinancing debt and adding additional new lines of credit or other term debt to position companies for growth and corporate action. We were not hearing that earlier this year, so that just took off since about June. Again here, if this deepens (i.e., Dow below 10,000) or continues into Q4 we would imagine there would be a risk that businesses would change course on borrowing, but for now we view it as an active market. Has the Fed's pledge of two more years of low rates prompted people to wait and see? No we think that has added an element of stability into the equation, which in fact causes CEOs, CFOs and business leaders to be more confident in taking action and making strategic moves based on this interest rate stability.

There is a lot of money in cash — so much that the Bank of New York Mellon is charging companies to park it for them. What effects will this have on business and the economy?

MB: This goes back to the issue of uncertainty. We believe many banks are in far worse condition than they disclose. Real estate portfolios are overstated because banks are holding too much property on the books above its market value. Housing and unemployment cannot improve until this is rectified.

TG: We are in a liquidity trap where most new cash does not get spent or lent. It is self-reinforcing because the lack of spending (demand) causes businesses to hold on to more cash instead of expanding, and the lack of expansion keeps consumers cautious about spending.

CS: On a relative basis, this only makes it more attractive for companies to find other uses of cash, including acquisitions and growth investments. The latter is also supported by the bonus depreciation tax advantage in 2011 (whereby qualified capital expenditures are entirely deductible in 2011, vs. over a five-to-seven-year period). We have many instances of capital-intensive companies that have taken advantage of that tax benefit to make investments now vs. wait, given they have the cash earning nothing (and now costing them to hold with a bank). The cash overhang in private equity which now stands at well over \$400 billion also is a factor, as private equity firms need to invest this in 2011 and 2012 or risk losing it — which is driving action near desperation among many of them.

SK: The high cash balances on corporate balance sheets will eventually be a positive catalyst for the economy. In the near term we will see companies making strategic acquisitions to grow their business. A bit further out we will see companies begin to make capital expenditures in people, facilities and equipment. This will further spur the economy as these larger capital expenditures will help small and medium size businesses grow as well.

What is your sense of how long this situation will last?

MB: We think it's realistic to believe this may take another five years.

TG: If we tip back into recession, it could be well into 2014 before things really get better. If we avoid a new recession, maybe by the end of 2012, beginning of 2013.

CS: We think the volatility will last through the September time frame and then hopefully will level off going into the later Q4 push. We are optimists in that we feel that this near-term volatility will not lead to another recession and that there are many fundamental differences between now and the 2008 market that support that view.

SK: The Fed has indicated they intend to keep interest rates low until 2013. That's a reasonably good sign we are in for at least another 12 to 24 months of low economic growth.

What further risks do you see if Congress fails to get the fiscal policy in balance?

MB: Continued weak dollar followed by inflation as recovery gains traction. Congress needs to take practical steps by reining in entitlement programs, developing a rational energy policy and improving the educational and competitive position of our economy. We need to stop exporting our talent and resources.

TG: In my opinion, more fiscal stimulus is needed now, linked to a long-term “grand bargain” on the debt. That view is out of fashion, so I only see downside risks from Congress. Failure to renew long-term unemployment benefits, failure to renew the payroll tax cut, immediate draconian cuts — any or all could tip the economy back into recession.

CS: The longer term (i.e., past 2012) is much less optimistic and clear if the government is not able to actually fix the root causes in the deficits, out of hand entitlement spending and tax situations. Thus, if action is not taken to address these root-cause issues, we would view the future economic outlook as much more risky and believe that we could be in for a long period of sideways economic performance similar to what Japan has endured over the past 10 years

Are we headed for a Double-dip, or second, recession?

MB: No — we see a long, slow slog unless business and Congress get their act together.

TG: Technically, it wouldn't be a double dip, as the last recession ended over a year ago. I put the chance of a new recession as high as 50-50. There is even a chance that we are already in a mild recession – we'll have to see if further downward revisions to GDP are coming. The economy is vulnerable to any new shock: something from Congress (see above), a major default in Europe, a new oil shock, etc.

SK: We do not believe we are headed for a double-dip recession, as we predict GDP growth will continue to be positive but quite low.

Where is the growth, and what opportunities do you see?

MB: We see growth in aerospace, alternative energy and infrastructure, food processing and wine, niche manufacturing and services. Many regional companies are taking advantage of this opportunity to diversify and capture market share. A global example comes to mind where we are retained by an Indian firm to pursue acquisition of a Brazilian aerospace contractor. Farsighted management teams are pushing aside uncertainty and moving forward.

TG: Retail and the hotel industry seem to be making a comeback. In real estate, commercial and multifamily seems to have turned a corner.

SK: We continue to see growth and investment opportunities in markets with an expanding middle class consumer base like China and Brazil. With interest rates at current lows and dividend yields on many blue-chip U.S. companies at relative highs, we have seen an increased demand for dividend-paying stocks in the U.S. Our clients have been net buyers of global equities over the past four to six weeks, as they have seen this as an opportunity to put some of their dry powder to work at better prices.

From the Puget Sound Business Journal:

<http://www.bizjournals.com/seattle/print-edition/2011/09/16/banking-finance-hot-spots-amid.html>

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