Q1 2012 Commentary

"Would you tell me, please, which way I ought to go from here?"
"That depends a good deal on where you want to get to," said the Cat.
"I don't much care where--" said Alice.
"Then it doesn't matter which way you go," said the Cat.
"--so long as I get SOMEWHERE," Alice added as an explanation.
"Oh, you're sure to do that," said the Cat, "if you only walk long enough."

Alice's Adventures in Wonderland-Lewis Carroll

Resist the crowd: cherish numbers only.

Jeremy Grantham-GMO

The predominant theme of our 3Q 2011 Commentary focused upon how we got here. How technological and financial innovations expanded the use and growth of credit over a quarter century seemingly eradicating the business cycle. Total Credit Market Debt as a % of GDP during the period from 1982 to 2007 rose in the U.S. from just over 160% to over 370% in 2007 obfuscating the festering reality of slowing sustainable economic and income growth underneath the surface. During this period debt grew at a rate of over 7% per year while real median household incomes rose at just over ½ of 1% per year. Nonetheless, the U.S. was still able to generate Gross Domestic Product growth of over 3.5% per year via such leverage. This increased access to credit along with the declining cost of debt created an illusion of prosperity and engendered a culture change in our society of immediate gratification. Much as in the famous Stanford Marshmallow Experiment on children in 1972, our society, administration and politicians has been seduced by the easy path of current consumption and seemingly inability to self-regulate. The roads we choose prospectively in the U.S. are littered with difficult choices much as we see unfolding in Europe.

Reacting strongly to the largess of central banks and some modestly improving economic data, the equity markets enjoyed the best 1Q returns since 1998, a period that is evoking many comparisons as some strategists feel the start of another bull market has begun. For the quarter, the S&P 500 enjoyed a 12.6% gain with the Dow Jones Industrial Average moving up 8.8%. Foreign stocks fared well also with the MSCI EAFE index of developed countries surging 11% while MSCI Emerging Markets were up 14.1%. Comparisons to 1998 might not be complete without some comments on Apple which was up 48% during the quarter and comprised almost 20% of the total gains of the S&P 500. The recent asymptotic move in Apple stock causes some pause and perspective as analysts fight over themselves to be the first to suggest a $1,000 price target. The most incredible statistic we note is that in just the last 2 months, the increase in the market capitalization of Apple exceeds the total market capitalization accrued over the 125 year history of Johnson & Johnson. It is not a prediction to note that history has not been kind to such crowded love affairs.

We continue to classify the current period as a secular and global deleveraging in a post-financial crisis environment. The Bernanke-like actions of the ECB and President Mario Draghi in late 2011 and early this year to extend nearly 800 billion EUR to foreign banks via the Long Term Refinancing Operations (LTRO) has seemingly removed the tail risk of a financial meltdown and effectuated a period of relative calm. The markets are not the only ones that have ostensibly declared victory as European leaders such as Draghi and French President Nicholas Sarkozy have declared that the worst of the euro crisis is over. However, the facts seem to disagree. While these actions do buy the banking system more time to attempt to increase capital and improve asset quality, the primary issues (as in the U.S.) remain too much debt and too little growth. Central Bank actions have done little to change this stark reality and we are surprised at the seeming complacency that has surrounded this situation.

While Greece and its $300B GDP (about 2.5% of the Eurozone total) seem to have been sacrificed, the Eurozone is now ignoring Portugal and its $228B GDP all the while espousing the containment of the crisis. Indeed, Portugal is witnessing the unraveling of an economy much faster than occurred in Greece. With private debt to GDP ratios of 249% and 10-year bond yields approaching 12%, deposits are fleeing Portuguese banks. In Italy (an economy of $2.04T GDP), financing costs have benefitted from the LTRO and 10-year bond yields have dropped to 5.15% from over 7%. With low private debt levels they may only have to endure a recession as GDP in 2012 is expected to contract by 1.3%.

However, it is now Spain with a GDP of about $1.4T (almost 12% of the Eurozone) that may be representing the tipping point. With a housing bubble that is considered to be multiples of that of the U.S., private debt level currently at 227% of GDP, and an economic contraction that is expected to be over 2% in 2012, the 4th largest economy in the EZ is suffering the worst employment issues in the region. Recent job releases show an unemployment rate of 23.6% and over 51% for those under the age of 25. A generation of highly educated youth may have little choice but to vacate their homeland. The crisis in economic terms is horrible but in human terms is devastating and is destroying the optimism and social fabric of many of the peripheral nations of Europe.

Indeed, outside of Germany with a 5.7% unemployment rate, the next 6 largest countries in the Eurozone have unemployment rates in excess of 9%. The collective EZ jobless rate is at a 15 year high of 10.8% and increased austerity measures will further slow economic growth and thus hiring. Markit Economics, an independent global provider of business surveys, manufacturing gauge of European Union purchasing managers fell to 47.7 in March from 49 in February marking the 8th consecutive month of declining manufacturing activity with even core nations of Germany and France exhibiting contractions. The situation on the periphery of Europe appears to be worsening. The contraction in economic activity in the EU is also taking its toll on China where it represents nearly 19% of exports. While China has projected a slowing of their growth rate to 7.5%, their challenge will be to grow exports to other emerging markets to engineer a soft landing. This is critical for global growth which is clearly slowing.

Back home we had noted with some skepticism that improving data in the 4th quarter of 2011 on employment and housing (our primary areas of concern) had added to the liquidity-driven optimism and led most all economists to reduce or remove all material concerns of an economic slowdown. Employment data in the first quarter of 2012 continued to test our viewpoint as jobless claims furthered their improvement to levels last seen in March of 2008. Additionally, nonfarm payroll growth through February has now averaged over 250K per month in the last 3 months and about 190K in the last 12 months. While these are not great levels of job creation as it is estimated that over 115K new entrants into the labor force occur each month (so in theory only the excess above that should reduce the level of unemployment), it has managed to bring down the headline rate of unemployment to 8.3% from 9.1% as recently as August. Human emotions seem to react more to rate of change rather than absolute levels. A related behavioral flaw is that we also are excellent at extrapolating data into the future based on these recent trends. Again this was on display with the extreme disappointment in early April with the release of the March payroll data coming in about 50% below expectations and lending greater credence to the upwardly biased impact of the weather on prior reports. Therefore, excuse us for not yet seeing an all clear sign and let us share some more reasons for that.

The National Oceanic and Atmospheric Administration (NOAA) has already declared the winter of 2011-12 (defined as December-February) as the 4th warmest on record. As March is already considered the warmest on record for most of the United States, clearly the first quarter of 2012 will end up being the warmest ever. These extremes wreak havoc on economic data which are almost always seasonally adjusted. This is not the government manipulating the data but rather attempting to adjust for this component to better discern the underlying trends. This makes sense. However, if the expected seasonality does not occur as allowed for, the adjusted data may be biased upwards. For example, layoffs in construction are normally very high in this period. If the weather is unseasonably warm, layoffs will not occur to the same degree and housing starts will be much higher as the ground is not frozen. Traffic in open houses is higher as would be spending in retail and casual dining all of which would otherwise have been expected to be lower during cocooning months. We suspect that much of the jobs and housing data in this period benefitted from this upward adjustment and/or pulled demand forward that will reverse as the second quarter unfolds.

Many skeptics of improving jobs data have continued to point to the decline in the Labor Force Participation rate (% of the population that is in the labor force) from 66% in December 2007 to 63.7%, the lowest since 1983, as a sign that employment is worse than headlines indicate. Critics of that metric point out correctly that we are an aging population so that as much as half of that decline is due to the retirements of early baby boomers and that this metric will continue to decline for that reason. However, using that same ratio but just for workers 25-54 (which factors out the changing demographics) shows a similar picture. J.P. Morgan points out another very interesting statistic in that working age group that also artificially lowers the unemployment rate. Currently 5.3% of the people in the 25-54 age brackets are on disability. This is very interesting in that this number was only 4.5% when the recession began. They are also, therefore, not considered part of the labor force further reducing the denominator in that ratio. Anomalous to this is that this increase in the number of disabled has occurred despite a greater loss during this period of jobs such as construction that have a higher incidence of injury.

Similar confusion on this data was noted by Fed Chairman Ben Bernanke in trying to reconcile the improving jobs figures with declining Gross Domestic Product. Though the 4Q GDP data was 3.0%, the full year of 2011 came in at only 1.6% compared with 3.0% in 2010. Such a decrease in the unemployment level would be expected to be associated with an increase in potential GDP. Our view on this has both short term and long term implications. We believe that the relationship has broken down for a couple of reasons. The first of which is that we feel that part of the recent hiring (jobs are a lagging indicator) represents a "catch up" in hiring from corporate America after aggressively downsizing during the financial crisis. The other represents a notable decline in productivity that we will discuss further below.

We note that this productivity decline is short to intermediate term but some of these factors will have a long term impact on potential GDP growth. While some dismiss the magnitude of the Labor Force Participation decline due to demographics, the corollary to that is the increasing stress an aging population will have on our economy going forward and at an accelerating rate. We all are frighteningly aware of the massive debt with which we are burdening the next generation. However, even without these levels of debt, future prosperity would decline simply due to the aging of the population. According to studies done by Research Affiliates, in the early part of the last decade there were 10 new members of the workforce for every 1 retiree. It is expected that by 2020, that ratio will completely reverse so that we will add 1 new worker for every 10 retirees! The overhangs of debt and demographics are correctly pointed out by this group to have major implications including slower GDP growth and eventual rising inflation.

A more concerning note about the critical importance of employment is the obvious impact on wages. Despite employment growth, little gains have been made in this area indicating that what growth in jobs we have seen is confined to low-paying areas of the economy. Leisure and hospitality, health care and social assistance, retail and temporary jobs account for almost 70% of the jobs created in the last 6 months. Though much has been made of the manufacturing renaissance in America, it is again rate of change versus levels. The 1980's economic model has been dismantled by global competition, technological change, and industry obsolescence. Factory jobs peaked in this country in 1979 at 19.4M or 21.6% of total payrolls. We now are at 11.7M or 8.9% of an increased level of payrolls. Manufacturing output is up 15% from the lows of 2009 but much of that is due to productivity gains which are up 10.7% while the level of jobs is flat. While there have been some recent manufacturing gains in the jobs data, many of these are lower paying and the middle class has fallen further behind. Moreover, 93% of the additional income created in the country in 2010 from 2009 ($288B) went to the top 1% of taxpayers with 37% of that amount going to the top 0.01 % of households (15,000) making an average income of $23.8M.

This is reinforced in the data on income from the Census Bureau which did show a 4th quarter 2011 gain in real median household income of 1% to $51,413. However, this is a level that is equal to that of a decade earlier due to a decline in this figure of 3.2% during the actual recession and a further decline of 6.7% during the "recovery" of June 2009-June 2011. Average hourly earnings adjusted for inflation are actually -0.85% over the last year and real disposable personal income is up only 0.3% during the same period. This last statistic is weighed down by the following incredible fact. Interest income (interest on bonds, CDs, etc…) is at $974B down over 30% from 2008! Zero interest rate policies as followed by the Federal Reserve have many current as well as future consequences. Without income growth, we note that savings rates have declined to 3.7% in February (lowest since August 2009) in order to maintain consumption. History shows downturns in job growth lag declines in consumer spending growth. With gas prices rising from $3.28 per gallon at the start of the quarter to $3.94 before the onset of peak driving season, we foresee further pressure on the consumer and a subsequent impact on employment as a heightened risk and expect economic data for the next two quarters to moderate from the pace of the prior months.

The Flow of Funds data that is released quarterly from the Federal Reserve continues to paint a picture of an ever widening economic divide. Household Net Worth figures were up $1.2T in 4Q but down on a year over year basis for the first time since 2008 (this has only occurred 1 time in history without being in or entering a recession). This figure is now up $8.0T from the lows of 2009 but still down $8.4T from the 2007 peak despite equities having recouped over 80% of the decline. Housing is down from a collective value of $22.7T in 4Q 2006 to $15.9T. As stock market gains inure more to the upper incomes, this is another example of how the stratification has widened.

Deleveraging at the consumer level has continued with debt falling another 1.1% in 4Q 2011 to $11.53T with mortgage debt now off 11% from the peak. According to McKinsey, total Household Debt is now down about 5% from the end of 2008 but defaults account for between 70%-80% of the decrease in mortgage and consumer debt. The good news is that McKinsey estimates that we may be as much as 50% through the debt unwind which may have 2-3 years remaining to return to historical debt ratios.

Similar optimism has been noted that housing is finally carving out a bottom and ready to turn up (a claim echoed every year since 2007). Until declining in February, the National Association of Home Builders (NAHB) sentiment survey had shown increased optimism rising for 5 straight months to the highest levels since June of 2007. Additionally, before falling back in February, both new and existing home sales had exceeded expectations in the prior 2 months. Putting this into context again highlights rate of change versus levels. For the January-February period, new home sales averaged an annualized rate of 315K units. This compares with a 30 year average of 714K and a 2005 peak of 1.4MM units. Existing home sales averaged an annualized rate of 4.58MM during this 2 month period versus a 12 year average of 5.5MM units and a 2005 peak of 7.4MM. The primary issues remain excess and increasing supply with tepid and even declining demand. So while we do agree that the levels of home sales should not take another turn down, prices are another story.

With the moratorium on foreclosures due to so-called robo-signings now over, foreclosure starts are increasing again rising 28% in January from December according to Lender Processing Services (LPS). In 2011 foreclosures represented 24% of all existing home sales and this will increase in 2012. LPS estimates that there are currently 2.1MM homes in the foreclosure process with another 4.1M delinquent loans. Laurie Goodman of Amherst Securities estimates there are fully 10.1M properties at risk of current and future foreclosures factoring in additional homes that are current but hold large negative equity positions (potential strategic defaults). As the Congressional Oversight Panel suggested, the single best predictor of default risk is equity in a home. The increasing supply of homes will place even greater pressure on home values which Case-Shiller indices suggest are already down 35% from the 2007 peak to levels last seen in January of 2003. Additionally, the pricing trend is declining further now down almost 4% year over year. The recovery will come but not this year.

We have marveled at the strength of corporate America and continue to note the quality of balance sheets. Taking advantage of historically low interest rates, corporations now possess a long term debt to total debt ratio of 77.6% near an all-time high compared with 65.8% a decade prior. Lower interest expenses and little rollover risk are major benefits. Liquid asset ratios versus short liabilities have risen to 59.3% in 4Q 2011 versus 32.2% a decade earlier with cash assets to the highest percentage since 1963. Though many of these gains in cash are held outside of the U.S., this gives us continued confidence in increased share repurchase along with steadily rising dividends and possible mergers and acquisitions. We have noted the muted gains inuring to labor, however, according to the Wall Street Journal, efficiencies in S&P 500 companies have grown the average revenue per employee generated from $378,000 in 2007 to over $420,000 in 2011. While these aggressive actions have been central to returning to record profit margins, we have been vigilant to watch for signs of decline and feel we may have already witnessed the cyclical peak.

With aggregate hours worked up over 3% yet GDP slowing, we are witnessing declining productivity for the first time in this cycle. Though earnings for 4Q 2011 still increased

9.2% year over year, we note it was the first sequential quarterly decline since 4Q 2008 and this result amazingly declines to an increase of only 6.2% if Apple is removed from the equation. S&P profit margins suffered the largest quarterly decline since 2008 dropping from a near record level of 9.5% to 8.7%. Declines in productivity normally portend increases in hiring. It will be interesting to see how corporate America reacts to declining productivity with little to no spending growth. We would not be surprised to see the defense of profit margins to be the primary concern at the expense of increased hiring.

Consensus earnings estimates have dropped for 2012 from $114 to $106 partially reflecting this margin decline. We continue to be below consensus looking for flat to modestly declining earnings as the economy softens in the second and third quarters and we feel strongly that consensus estimates will come down further. Though we are looking for about 2% GDP growth in the current quarter we expect further weakening in job growth, and spending to augur a slowdown in the following quarters. While we continue to reiterate our theme from the annual commentary favoring the U.S. as the best house in a bad neighborhood, we still must respect the numbers. Those that continue to promulgate the cheap values in the market ignore that the calculation is based on current profit margins that are fully 50% above historical norms and rolling over. Markets continue to be highly dependent on liquidity provided by the Federal Reserve and the European Central Bank which when removed in the middle of 2011 precipitated a 20% correction. While we still expect further support in this area, it does not change the calculus of the markets.