COHO PARTNERS, LTD.

Q2 2011 Commentary

"Globalization presumes sustained economic growth. Otherwise, the process loses its economic benefits and political support."

Paul A. Samuelson, Nobel Laureate in Economics

The original goal of the European Monetary Union (EMU) was to synchronize economic growth rates among member countries meeting certain conditions that would eventually allow them to adopt a single currency, the euro. With mostly a political motivation, it was thought that creating a single currency could integrate Europe and foster a strong presence on the international stage to compete with the United States. From an economic perspective additional benefits were seen as creating high labor mobility and minimizing individual country shocks. This idyllic blueprint confronted the reality that structural reforms for each member country that were required to converge productivity and growth rates never materialized. Rather, it became very easy for nations with weaker economies to exploit the new shared lower interest rates fostering asset bubbles in some areas (Spain & Ireland) and a lack of fiscal discipline in others (Greece & Portugal).

At the time of its introduction, Milton Friedman observed that the euro would not survive the first European economic crisis. In a global economy of floating exchange rates, weaker individual countries within the Eurozone lacked the option to allow their currency to decline. Without this currency flexibility, competitiveness might only be regained through real economic adjustment. Exhibit A for this is Greece where massive labor cuts, tax increases and reductions in public sector defense and spending have plunged that country into a deflating economic situation amid civil unrest.

But a credible path back towards solvency for Greece is not truly the goal of the Troika (International Monetary Fund, European Commission and European Central Bank). With Greece sitting on an estimated $340B euro debt burden (over 160% of GDP), the concern is more for the balance sheets of the creditor banks of the EU along with those of China, Japan and the U.S. Why did the capital markets react so positively to the "voluntary rollover" (a new term that replaced restructure which in turn replaced default) of Greek debt yet exhibit a benign response one week later to the Moody's downgrade of the debt of Portugal to junk status? This reaction comes despite one of the biggest sell-offs since the sovereign crisis last year in credit default swaps (insurance to cover a default) for the peripheral European nations and the reason is clear. Portugal's previously received bailout package has covered all liquidity needs until 2014. The near term risk for Greece (re: the banks) is the need to access the bond market as early as the first quarter of 2012. The sound you hear is the can being continually kicked down the road.

The eventual default of Greece and most likely Portugal, Ireland and Italy is nearing inevitability. To reduce debt-to-GDP levels, a country must grow its nominal GDP above the level of its average cost of debt. The U.S. currently maintains a home team advantage with the same concern via our reserve currency status and the very low (for now) cost of our debt. It is estimated that the troubled PIIGS (Portugal, Italy, Ireland, Greece and Spain) would have to grow nominal GDP (including inflation) in excess of 4%-6% just to stabilize this important metric. This will not happen. Forced austerity is the friend of deflation (which raises the real value of the debt) and the enemy of economic growth. One may be excused for thinking we have seen this before. The names may have changed, however, from Bear Stearns, Lehman Brothers, etc. but concerns are common. For the U.S., we expect the impact to be yet another impediment to an already anemic U.S. recovery (via reduced U.S. exports) though direct impact should be minimal. However, the U.S. does have indirect exposure via credit default swaps and money market mutual funds that cannot be ignored.

We have consistently stressed over the last few quarters that the cyclical recovery of the U.S. economy has lacked the ingredients for sustainability. The major headwinds for a persistent recovery have remained the same over the last 3 years: employment, housing, credit formation, and excess debt. Through the purchases of $1.425T in mortgage debt and other liquidity backstops, the Federal Reserve succeeded via QE1 with the objective of stabilizing and restoring normal functions to our credit markets (at a cost of shifting these liabilities to the public sector balance sheets). However, the success of QE2 has been quite dubious. The objective (via purchase of $900B in Treasury debt and serious jawboning) was ostensibly to raise asset prices which in turn would spur spending and job creation. While achieving the increase in asset prices, there has been no perceptible economic benefit and has had the unintended consequence of contributing to rising commodity prices. Moreover, the good inflation of rising financial asset prices has been offset by commodity inflation which has driven up costs and curtailed consumption and real income growth. Additionally, this has fostered a widening bifurcation in our social system with the more affluent being the beneficiaries of rising stock prices while middle-income families are more impacted by rising food and energy costs.

Entering the year on a cyclical upswing with GDP in the fourth quarter of 2010 coming in over 3.1%, consensus estimates were for 1Q 2011 to be over 4%. Indeed, ISM Manufacturing data, a strong coincident indicator of economic growth, had increased by February to 61.4 (a level above 50 indicates economic expansion), a 7-year high. Global PMI readings for manufacturing also peaked in February at 55.8 and optimism was on the upswing. But the U.S. consumer, long burdened with housing and employment concerns, faced a clear and present concern of rising costs and never joined the party. From the February peak, we have seen the ISM index in the U.S. decline to 55.3 with the Global index now down for 5 consecutive months. The New Orders component of the index represents the best leading indicator of the survey and has now declined from 68 in February to 51.6 in June. The disaster in Japan added an additional global supply chain disruption mostly apparent in autos, auto parts and technology. 1Q GDP came in at a very disappointing 1.9% growth rate.

Despite the softening economic data, most economists were quick to attribute this again to a transitory “soft patch” anticipating that the fading impact of the Japan earthquake and tsunami along with a decline in commodity costs might pave the way for a return to growth. We had argued in our most recent commentary that the inflation in food and energy represented an inflationary spike within a deflationary post-financial crisis. This was one area where we did apply the term transitory and expected a plateau or moderation to ensue. We have now enjoyed a decline of 8.2% on the Reuters-Jefferies CRB index (a commodity price index) since the recent peak in early May. Though headline inflation measured by the CPI has now increased year-over-year from the 1.5% level at the start of the year to the current reading of 3.6% in May, we see that level moderating soon and then turning lower reflecting a one-time but not persistent increase in prices.

However, this increase in prices has had a decided impact on consumer confidence and spending as we have not seen the improvement in the labor markets that was hoped for in the early spring when the average Nonfarm Payroll growth was over 200K new jobs per month. The period of increasing payroll growth, however, was very misleading as it represented a net figure of new hires less discharges. The JOLTS (Job Openings and Labor Turnover Survey) data from the Bureau of Labor and Statistics has painted a different and not widely understood picture of the labor market. During the depths of the financial crisis in February of 2009, U.S. companies reported 4.7M separations (jobs lost) for the month. By contrast, in March of 2011 that figure was only 3.8M. The data shows definitively that the improvement in payrolls has been due to a decrease in layoffs and not an increase in hiring. Indeed, in a normal functioning labor market typical of the last 20 years we see American firms hiring over 5M workers monthly. In that same month of March 2011 that figure was about 4M (hence the 200K job growth reported). Starting in late March, we have now seen weekly jobless claims data spike back up to over 400K per month. With layoffs now increasing and a seeming moratorium on hiring, it should have been totally expected to see a rolling over in the headline employment data and that is exactly what has occurred. For May and June we have now seen an average of only 21K jobs created and only 65K in the private sector. An unemployment rate that leveled at 8.8% has now jumped to 9.2%. More importantly, aggregate payrolls have stagnated so real incomes have declined.

Parsing the data, a concerning divergence also emerges and continues to highlight the structural nature of our employment woes. The latest report for June continues to show a declining labor force with a Labor Force Participation rate at a new 25-year low of 64.1% and an Employment-Population ratio of 58.2% which is a level last seen in 1984. Reviewing the data by education levels show that the unemployment rate for those with a college degree is only 4.4% and improving from over 5% in early 2010. Those with an advanced degree have a jobless rate of less than 3%. Many interviews with major manufacturing company executives have been full of comments of how they want to hire but cannot find qualified workers. As manufacturing grows in sophistication, the technical requirements for the positions are a mismatch for the skill sets of those unemployed. We may have created a workforce spanning an entire generation that lacks the necessary education and training to succeed in today's marketplace while facing an uncertain future of a failing social benefit system.

The Case-Shiller index of national home prices showed a glimmer of positive news for April declining only 0.1% over March prices (though -4.0% year over year) prompting perhaps the 18th call for the bottoming of housing values. Core Logic reports that if one excludes distressed home sales (bank-owned REO and short sales) then prices are basically flat over the last year. Additionally, new delinquencies continue to decline and housing affordability as measured by the National Association of Realtors (shocking) is at an all-time high. However, 35% of total home sales are distressed and we have another 1.8M foreclosures on the market along with an estimate by Lender Processing Services of another 2.2M behind that. Additionally, more than 33% of home sales now are cash buyers compared with a historical average of less than 20%. This is a reflection of the tightness of the mortgage lending markets and the increasing investor demand for rental properties. The spring selling season has been disappointing. Core Logic estimates that 23% of total mortgages are currently greater than the value of the underlying home and that another 5% decline in home prices would increase this level to over 28%. With jobs and confidence weak, we do not anticipate a rebound in housing over the next year.

It is no surprise that faced with a still weak housing and job market and rising food and energy costs that consumer confidence levels have weakened dramatically. The Conference Board measure of Consumer Confidence has declined from a cycle peak of 72 in February to the current reading of 58.5. During expansions (as this is technically called) the historic average is over 100 while the average reading during recessions is 73. Again this is a statistic that shows a different picture based on income as the middle to lower income readings are near the levels of the 2009 crisis. Upper incomes have also weakened though not nearly as much.

Though June chain store sales appeared strong, real consumer spending declined for two consecutive months in April and May for the first time since 2009. While 4Q of 2010 showed a 4% annualized growth rate in real consumer spending (70% of GDP), 1Q of 2011 was just above 2% and we are looking at a little over 1% for 2Q 2011. We have long postulated that we are seeing and would continue to see an increasing aversion to debt and greater frugality. On this front there continues to be positive news. Federal Reserve Board readings of the Household Debt Service ratio (mortgage and credit card payments as a percentage of disposable personal income) of 11.5% are at levels that are the lowest since 1995 while credit agencies continue to report improving credit scores. Total consumer debt-to-income ratios of 112% are down from 127% though still way above the mid-80% average of the 1990's. The consumer is repairing his or her balance sheet. While this is economically painful over the short term, it plants the seeds for greater sustainable consumption in the future.

The current lack of consumer demand along with still challenged access to credit have been cited as reasons for the continued weakness in the small business optimism index of the National Federation of Independent Businesses (NFIB). This index has declined for four straight months and also sits at levels consistent with a recession. In a recent survey of small business by U.S. Bancorp, 78% indicated the belief that the U.S. is still in recession. Small businesses account for fully 65% of new job creation and contribute about 50% of total GDP. This dichotomy to large, multi-national companies that have benefitted by growing overseas demand and large cost-cutting highlights the growing divergence between Main Street and Wall Street.

The U.S. markets entered the 2nd quarter on an upswing and enjoyed over an 8% rise following the decline associated with the Japanese disaster. In early May the string of weakening economic reports along with increased concerns over Greek debt wiped out all of those gains. These concerns did not last long, however, and the markets rebounded to end the quarter back where they started with both the S&P 500 and Dow Jones Industrial Average along with most major domestic and international averages advancing or declining less than 1%. Investors have seemingly ignored the weakening economy and have been comforted by the belief that moderating commodity prices will increase consumer confidence and spending and the global supply chain coming back on line will strengthen manufacturing into the second half of the year. As most of the leading indicators peaked and started to decline before the Japanese disaster, we fear this may be false hope.

We noted after the first quarter that we felt the consensus for 2011 GDP of 3.5%-4% and the S&P 500 earnings estimate of $97 to be the unlikely best case scenario. Profit growth for U.S. companies has been nothing short of spectacular during the economic expansion as companies have cut costs, reduced interest expense and fortified balance sheets. Profit margins have quickly returned to the levels prior to the financial crisis. While estimates for GDP have clearly been reduced, this has not been the case with earnings which are still expected to exceed $98 for 2011 and $112 for 2012. As we enter earnings season for the second quarter we are expecting a slowing in profit growth due to rising input costs and moderating global demand. We also anticipate that the outlook will be a little more cautious for the next couple of quarters. Though valuations are not excessive, we do not feel that declining estimates are factored into expectations creating downside surprise risk.

This remains a disappointing U.S. economic recovery and should not be blamed on transitory factors that contributed to the slowdown. In the three years since the financial crisis policymakers have yet to successfully address the major headwinds of housing, employment and debt. As we fly with only stall speed, it may not require much of a shock to cause a downturn. There are currently many candidates. We continue to feel that the next few months will be critical for political and economic direction. We maintain a more defensive position in portfolios with a continued focus on high quality, demand-defensive companies and view these areas as the best value in the present environment.