2012 2Q Commentary

German Chancellor Angela Merkel visiting Spain. At immigration, they ask her "Nationality?" She replies "German". "Occupation?" "No, just here for a few days..."

Barry Ritholz

As we attempt on a quarterly basis to share our thoughts on the current and prospective economic and capital markets, we are first drawn to the exercise of reading as many as two years worth of prior writings. We find this to be a healthy practice in that it acts both as a baseline for the evolution of our economic thoughts but also as a timeline for the progress or lack thereof towards many of the critical variables in our forecasts. Much like old photographs depicting dated hairstyles and fashion, however, such timelines often pose more questions along the lines of, "what were they thinking"? The most recent example that we noted in our 1Q commentary occurred only in late March when European leaders ECB President Mario Draghi and then French President Nicholas Sarkozy declared the worst of the euro crisis over and that the ECB stood ready to act should inflation risks grow? (inflation? really?) To be fair, however, at one time I truly did feel as if my "big" hair in the 80's was totally rad.

As the end of the second quarter approached, the headlines were filled with critical stories from the Supreme Court decision on the constitutionality of the Affordable Healthcare Act to the Barclay's LIBOR scandal. Even with these competing chronicles, the primary focus of the market continues to be Europe. We have often referred to the current imbroglio as a long term global deleveraging in a post-financial crisis environment. As we struggle through the process of balance sheet repair domestically, the challenges of the Eurozone are more difficult to navigate. Imagine disparate leaders charged with determining the collective good when their only concerns appear to be re-election and serving the constituency that issues their paychecks and maintain their authority. If it were like that in the United States, we…. never mind.

In order to reduce the extreme debt levels in Europe, the respective sovereigns must grow their GDP in excess of their borrowing costs. However, in a recessionary environment, most of these countries must borrow heavily from the ECB and then buy their own sovereign debt to effectively keep the financing yields low, borrowing time with the "hope" for a resumption of growth (divine intervention?). As growth

weakens and a Eurozone dissolution is broached, the populace understandably fears that monies may be subject to a forced exchange from the Euro to their weaker former currencies. Rational depositors may act swiftly to move their bank holdings to a safer entity. This is manifested in the extreme low yields on 5-year bonds on some of the perceived safest havens of Germany (0.31%) and Switzerland (-0.11%). That is not a misprint. Monies are being lent to the Swiss for a negative return.

Conversely, as deposits exit the local financial institutions in the weaker countries, the banks are then forced to go and sell the government bonds that were purchased. This places downward pressure on bond prices and raises the borrowing costs back up. While this has been occurring in Greece for over 2 years, in the last 6 months over $50B has now left Spain and the same appears to be in the early stages for Italy. These real fears of an escalating "run" are why the possible exits of Greece and Portugal are not contemplated by the European leaders.

The most recent actions at the European Union (EU) Summit in late June may have finally started to address the most critical shortcoming of the existing structure of the Eurozone, the lack of a central fiscal authority. EU leaders (and not the European Central Bank) may now use bailout funds of the ESM (European Stability Mechanism) to directly recapitalize banks without the debilitating austerity demands of prior efforts. This would be augmented by the critical establishment of a stronger EU bank regulator with deposit protection for consumers (similar to the FDIC) that would break the nexus of solvency crises between local banks and governments. An eventual political union is the clear goal as the currently constructed EU struggles to remain competitive with the emerging markets of China, India and even the United States. While German Chancellor Merkel fights for complete German control of sovereign debt issuance and authority on both economic and political issues, the eventual success of such a plan clearly requires all agreeing European countries to surrender their sovereignty to create such a fiscal union. As we contemplate a United States of Europe, we cannot ignore that the "fat tail" risk of a breakdown in negotiations must be considered a significant possibility.

Though these recent actions outline some necessary steps and we have little doubt that more promises of additional liquidity will be forthcoming at every near-crisis point, it is the issue of solvency (much as with our domestic mortgage markets) that continues unaddressed. As noted in our 3Q 2011 Commentary regarding how such excess debt grew globally, …." *there was little expectation of the debt to be paid off but rather just continually being rolled over. As leverage increased, the credit worthiness was defined less by the ability of the borrower to pay off the debt but rather the commitment to make the interest payments and refinance the debt. That becomes critical should the willingness of lenders to extend further credit vanish as confidence erodes."* Clearly, that confidence has long since eroded with lenders bidding up the yields (interest payments to the issuing country) to levels that are unsustainable with solvency concerns worsening amidst the current global slowdown. Efforts to stimulate growth in these economies without addressing the extreme debt obligations that cannot be repaid are fruitless. Eventually, debt restructuring will be the only solution.

For now, clearly the Eurozone has entered recession with a collective unemployment rate of 11.1%. The Purchasing Managers Index (PMI) indicating the economic health of the manufacturing sector and a barometer of economic growth has turned to contraction mode for the Eurozone at a level of 45.1 (below 50 indicates decline.). This is down from 52 one year ago and fully 81% of the Eurozone is in contraction. While the perceived pillars of Germany and France are not yet officially in recession, they clearly will be soon as the rate of PMI decline in Germany in June was the steepest in 3 years and the 4th consecutive monthly drop. More importantly, with Europe as their largest export destination, the decline has now spread to Asia where the PMI in China is also in contraction at 48.1. Looking at that timeline again, the expectation that this downturn would be confined to Europe and not impact the global environment was no more acute than Chairman Bernanke's legendary comment in March 2007 that the impact of subprime mortgages on the economy would be contained.

We have argued strongly over the last few years that we need to distinguish the noise from the trend. Short term moves or isolated data may send conflicting signals that an anxious investing community may extrapolate and confuse with the bigger picture. The overriding issues continue to be a highly indebted and aging demography and all short term information should be filtered through that prism. Housing is a great case in point. It is quickly becoming the majority view that the housing market has bottomed. It may have. Unfortunately, that sound bite may lead to various erroneous assumptions the most important of which is that housing and house prices will now go up from here and start to contribute to growth and jobs in a meaningful way. Trends are important but we also must look at the absolute levels.

The clear positives in the housing market are highlighted in the rise in prices on a national basis for three months running in the Case-Shiller index. Net household formation is the highest since 2006 modestly improving the demand side. Housing starts and new home sales are both up over 20% on a year-over-year basis with existing home sales up over 7%. The level of overall housing activity has increased over $17B from the same period in 2011 and residential construction is now contributing positively to GDP. It must be noted, however, that from the peak in 2006, starts have declined 65%, new home sales 75% and existing home sales over 35%. The positive contributions to growth are also muted as residential construction now represents only 2.3% of our gross domestic product from a peak of nearly 6%. As foreclosure inventories have been withheld from the market due to the Robo-Signing scandal, the supply-demand imbalance has been temporarily and artificially corrected with many markets reporting insufficient supply and multiple bids on homes. This is now changing with current foreclosure filings up 9% in May according to Realty Trac, the first annual increase in 27 months. In addition to this increasing inventory, Laurie Goodman of Amherst Securities estimates an additional 2.8M mortgage holders have not made a mortgage payment in 12 months. This is additional shadow inventory that will retard price increases for a few more years. Home prices are a function of many factors not just supply. Demand is a function of household formation, access to credit, and the confidence to service the debt which comes from improvements in jobs and wages.

It has been our stated view that the cyclical upturn in job growth experienced in the first quarter represented more of an impact of the warmest winter on record rather than a sustainable uptick in hiring and would therefore reverse as the second quarter unfolded. Unfortunately, this view appears to have been correct as the 225K monthly average of nonfarm payroll growth in the first three months of the year declined precipitously to 75K in the second quarter, the weakest quarter for job growth since the third quarter of 2010. Though the Administration has correctly pointed out that we have now added back over 4MM of the 8.5MM jobs that were lost from the employment peak of December 2007, it is the composition of those jobs and the wages generated that are of utmost significance. From the same peak in payroll growth in 2007, we have added 3.4MM part-time jobs. Full-time jobs with benefits enable home buying and increases in aggregate demand and we currently have 115MM full-time workers in the workforce. This, unfortunately, is the same level we reached in 2000 despite 33MM more people currently in the workforce! As has also been pointed out in these pages previously, more workers have enrolled in the Social Security Disability Insurance program than have found new jobs. According to the Social Security Administration, 3.1MM workers have signed up for disability benefits since June of 2009, a period during which the economy has created 2.6MM jobs.

Real disposable personal income is up only 0.7% over the last full year and slowing to less than half that growth in the last 2 quarters. Though consumer spending did increase 2.1% in 4Q 2011 and 2.7% in 1Q 2012, it was due to a drawdown in savings back down to 3.6% that contributed about $200B or 1.8% to this level. Despite the decline in energy prices aiding the consumer, wage and salary growth is needed to support increases in aggregate demand as access to credit (though moderately improving) and household net worth continue to act as drags. On this last point, according to the Federal Reserve Survey of

Consumer Finances, the median Household Net Worth in the U.S. has declined from $126.4K in 2007 to $77.3K in 2010.

Easy monetary policy has failed to boost demand and job creation as the expected impact via low interest rates on housing and manufacturing has been muted. Though manufacturing output has picked up, tremendous gains in productivity have inured to the bottom line of corporations rather than job or wage gains. While it is just this leverage that allowed corporate America to return to record profits, there are unmistakable signs that we are now passing the period of peak corporate profit margins and will witness a flattening and even rolling over of corporate profits.

The final release of 1Q GDP in late June was 1.9%, a level that we previously noted might end up being the high for the year and pathetically low for the third year of a recovery. Within this report, however, was a revision to U.S. corporate profits which jumped 10% from a year earlier when looking only at domestic profits. Unfortunately, profits from abroad dropped $48.1B. Our interpretation of this confirms our prior expectations of the U.S. being the best house in a bad neighborhood but also clearly shows a decelerating trend into the second quarter that appears to be bleeding into the current quarter. In our annual commentary we noted that consensus estimates for S&P earnings per share had recently been reduced from $113 to just over $107. Our view of a slowing economy with a strong possibility of recession placed our estimate in the range of $85-$95, a level way below consensus and seemingly out of touch with a consensus looking for GDP growth approaching 3% for the year. As we enter a critical earnings season, we maintain this range but still feel confident that earnings will maintain a higher floor as low wage pressures, lower commodity input costs and strong corporate balance sheets should support higher than historical average margins.

Despite the recent (and prospective) realization of our continued economic concerns, many clients have been surprised at the slight hint of optimism that has permeated some of our meetings. Perhaps it is the seemingly permanent contrarian in us as more people come around to our view (always uncomfortable). More likely it can be found in looking at some of the long term attributes that favor the U.S.

Understanding legitimate concern over the baby boomer demography, it must also be noted that we have more than 80 million Americans now under the age of 20. Maybe it may be found in the fact that according to the U.S. Congressional Budget Office, the U.S. is now the world leader in total fossil fuel reserves and now meets over 81% of our energy demand (the highest level since 1992) which could lead to another manufacturing revolution with up to 30% of China imports made here in the next decade. It could be that the incredible amount of innovation emerging from the ground up allowing us to start businesses, publish books, store in the "cloud", have leading companies all of which are headquartered and domiciled in America (Google, Apple, Twitter, Amazon, Facebook, etc….).

Maybe it is simply that with all the concern over taxes and tax reform, debt ceilings and especially the pending "fiscal cliff", we are reminded of the famous words of Herbert Stein, the former Chairman of the Council of Economic Advisors. "If something cannot go on forever, it will stop". Well, maybe we are just contrarian.