Q3 2011 Commentary

"But highly leveraged economies, particularly those in which continual rollover of short-term debt is sustained only by confidence in relatively illiquid underlying assets, seldom survive forever, particularly if leverage continues to grow unchecked".

This Time Is Different: Eight Centuries of Financial Folly
by Ken Rogoff and Carmen Reinhart

How did we get here? Where are we going? While the answers to those questions might occupy a separate tome, let us simplify by positing that perhaps the most influential financial innovations in both the domestic and global economies in the last half century have been centered on the creative and expanded uses of credit. Many readers are mature enough to recall how we used to receive our paychecks on Friday and proceed to queue up at our local bank for over 20 minutes depositing all but enough cash to get us through to the next payday. For the most part, spending was limited to what was in our pockets or our checking accounts. Credit cards were generally the purview of only the most affluent consumers and almost exclusively used for dining, travel and entertainment with balances due and payable each month. The emergence into the mainstream of Visa, MasterCard and American Express brought with it changing attitudes towards credit and the ability and willingness now to maintain outstanding and revolving balances.

As the use of credit cards expanded, so did more creative financial innovations designed to allow greater current consumption. Soon we didn't have just conventional 30-year mortgages with 20% down payments, we now had loans with little or no amortization and no down payments. Home equity loans were designed to further lever what were viewed as long term assets into long term liabilities. A common denominator with most all of these new products was little concern for whether the balances would ever be paid off.

The pronounced growth of credit extended far beyond consumers as technological and financial innovations extended the borrowing power of corporations via increases in corporate debt issuance and the creation of the commercial paper markets. Permanent capital could now be created by constantly rolling over short term maturities of debt. Here too 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.

Under Federal Reserve Chairman Alan Greenspan, it was believed that monetary policy had succeeded in tempering the business cycle. In the quarter century prior to 1982, our economy was in recession over 20% of the time. From 1982 to 2007, we were in recession only 5% of the time. Recessions were no longer viewed as necessary for the economy (as argued by Joseph Shumpeter) to wring out excesses and pave the way for the next expansion. Rather during this period the policy makers used monetary and fiscal policy to control these cycles but in reality were allowing and creating far greater imbalances and instability along the way.

What was termed as the Great Moderation (from the reduction of the volatility of the business cycles of developed nations) was almost solely due to the expansion of debt. Total Credit Market Debt as a % of GDP in the U.S. rose from just over 160% in 1982 to over 370% in 2007 before recently declining to 350%. Additionally, during that same period the Federal Reserve Board calculates that household debt as a % of disposable income rose from just over 60% to a peak of around 130% in 2008 (it has since declined to 114%). But Gross Domestic Product was rising at just over 3.5% per year while debt was increasing at more than twice that level. All the while real median household incomes were growing just over ½ of 1% per year. The illusion of wealth, however, was created as increased access to credit and the declining cost of the debt were the preconditions for a generational increase in the price of financial assets. As we know, this phenomenon was not confined to our shores but most of the developed world.

As we fast forward to our current global environment, the choice of the Rogoff and Reinhart quote above becomes more apparent. It is confidence or what John Maynard Keynes termed “animal spirits” that allow these leveraged engines of growth to roll along and gather steam. However, the capriciousness of human nature is a large reason why we cannot accurately predict financial crises or when they may occur. The body of their work, however, makes one thing abundantly clear. When countries (or companies or individuals) become too deeply indebted, the due bill will be paid.

We have consistently stressed in our commentaries our view that we were in the early stages of a global post-financial crisis environment. Our belief was the growth from the depths of the 2009 recession were no more than a cyclical recovery lacking sustainability being fueled by the failed attempts of our Federal Reserve and administration to ignite those animal spirits. The attempted cure by the Fed and our policymakers has been to flood the system with liquidity assuming that lowering the cost of debt would ignite economic flows. Unfortunately, they have been reading from the wrong playbooks. The private sector after years of the accumulation of debt is in a vast deleveraging mode. This is a classic liquidity trap and no change in the pricing of debt will alter this unwinding.

Efforts such as the most recent Operation Twist (designed to keep long rates low via the purchase of long term and sale of short term Treasury bonds) continue to push on a string. Not only will they not increase demand but they may perversely have negative consequences. Conservative investors will see lower yields and thus face reduced investment income. Additionally, pension plans for S&P 500 companies, already estimated by Credit Suisse to be underfunded by $390B will face greater pressure as lower yields (and lower stock prices) increase the assumptions for future liabilities. The potential earnings impact in this area is not widely addressed.

However, at least Chairman Bernanke and the Fed have been active in their efforts as fruitless as they may have been. This is much more of a fiscal issue that falls at the feet of our ineffective policymakers. Though an aggressive and realistic plan to address our long term fiscal deficits is mandatory, now is not the time for austerity. Rather what may be needed are more targeted and productive efforts to focus upon job growth and infrastructure while setting the regulatory framework conducive for small business growth.

Our previously stated view of the domestic economy turning back down in the second half of 2011 was in harmony with the winding down of much of the fiscal stimulus of the last two years. Noted in the most recent commentary was that there were many candidates eligible to shock our system and that the next few months would be critical for political and economic direction. As our policymakers fought in debt ceiling debates and Standard & Poor's removed our exalted AAA credit rating, confidence declined even further. However, our biggest overriding concern would be fears that a continually unaddressed European financial crisis would foster contagion to our markets. We believe that there is enough of a tally of data points in these areas to now point towards the signposts of recession.

We agree with the findings of Lakshman Achuthan, co-founder of ECRI (Economic Research Cycle Institute), who has postulated that a negative feedback loop has developed. This starts with a persistent decline in confidence that feeds into weaker sales, declining production and potentially into contracting employment, lower income and thus back to weaker sales. We have recently noted the drastic plunge in consumer confidence readings of the Conference Board and the University of Michigan sentiment index from recent peaks in February back to levels last seen in the depths of the financial crisis. Indeed, even the recent peaks in confidence readings corresponded to historical levels previously consistent only with recessions. To the U.S. consumer, this is a depression and the statistical economic and profit recovery witnessed on Wall Street did not materialize on Main Street where the concerns of employment and housing remain ground zero.

Though the Case-Shiller index of national home prices has shown stability over the last four months (due to seasonal factors), we note that prices are now down 4.1% year over year and still more than 33% below peak levels of 2007. The Flow of Funds report for Household Net Worth for the second quarter of 2011 shows that on a national basis, owners equity in real estate has plunged from $13.48T in 2006 to less than $6T with the average homeowner equity declining from 60% to 38%. With over 30% of homes not having a mortgage this indicates that the average homeowner with a mortgage has only 12% equity. Core Logic data show that 23% (10.9M) already have negative equity. In September, the OCC reported that 12% of Americans with a mortgage missed at least one mortgage payment or were in foreclosure during the second quarter up from 11.4% in the first quarter. Realty Trac further notes that Notice of Defaults (the first step in the foreclosure process) increased 33% in August from July indicating that lenders are pushing through foreclosures previously delayed by the robo-signing and other documentation problems.

With current mortgage rates of 4% near all-time lows and housing affordability at all-time highs, we repeat that the issue is not one of the costs of debt. In fact according to Capital Economics, these low rates have resulted in a 90% gain in mortgage refinance applications. While this may seem high, it pales in comparison to surges in 2003 and 2009 of 720% and 560% respectively and speaks to the inability of applicants to qualify. Mortgage resets, principal forgiveness and lower loan-to-value requirements for refinancing with an existing lender are needed to address this issue and would go a long way towards freeing up disposable income and placing a floor under housing values. Without such intervention, it may take many years and many levels of further price declines before we reach equilibrium of supply and demand.

The monthly release of the employment data is noise that obfuscates the trend. Employment has seemingly flatlined. Jobless claims have been above 395K per week (a level consistent with little to no job growth) for 26 consecutive weeks. The Household Survey indicates that the number of employed persons has increased 647K over the last year. All of this is during a recovery with massive stimulus. Though the unemployment rate of 9.1% is what makes the headlines, the data underneath are actually more concerning. The employment to population ratio is now 58.3%. This is the same level of employment participation in our country as existed in 1969 before the widespread entrance of women into the work force. This level was 64.4% in 2001 and when included in the broader definition of unemployment (discouraged workers, part-time workers who desire to be full-time, etc.) brings the true broader level of under or unemployment to over 31M or 20%! Of the 14.0M unemployed according to the Bureau of Labor & Statistics, fully 44.6% or 6.2M have been looking for work for over 27 weeks. This is a persistent concern showing no signs of reversing. Infrastructure programs targeting employment for building and/or improving our transportation system, schools and housing stock have been mired in political gridlock for far too long.

With employment weak, real disposable personal income is estimated to be up only 0.3% year over year and actually declined in August for the first time since October 2009. Real weekly earnings (wages & salaries) are worse down 1.8% y/y and in August for the third consecutive month. Government transfer payments continue to augment wages and comprise over 18% of disposable personal income which contrasts sharply with the 1980 figure of 11.7%. According to the Census Bureau, the median household earnings fell for the third year in a row and sits at the levels of 1996 in inflation-adjusted terms fully 7.1% below the 1999 peak. Perhaps more startling, the earnings of the median American male working full time is back to levels of 1978 with woman making the greater relative strides since then.

With the equity markets declining in the 3rd quarter along with the continued housing malaise, total Household Net Worth declined modestly (0.3%) in the 2Q figures in the Flow of Funds but are now on pace (according to ISI) to decline at a 21% annualized rate quarter over quarter. The stock market decline adds another piece of data pointing towards recession as the top 5% of wage earners now account for 37% of aggregate spending and over 70% of discretionary spending according to Time magazine. As this segment is more sensitive to movements in the markets, we expect discretionary spending to be moderating further in the quarters ahead.

For much of the first seven months of 2011, the markets appeared to ignore this softening economic data and the potential impact of the European financial crisis. The consensus view was that of a transitory “soft patch” blamed upon the earthquake and Tsunami in Japan and temporary increases in commodity costs. This confidence in the economic recovery was dashed in late July. After entering the year with expectations of near 4% gross domestic product growth, an already anemic 1Q GDP report of 1.9% was revised down to 0.4% coinciding with the second quarter release also near stall speed of 1.3%. This release marked the last day the S&P 500 index hovered over 1300 and depicted an already weak economy rolling over. In fact, the economic recovery has been so tepid that most all major economic indicators such as real GDP, industrial production, employment and real incomes still remain below the peaks achieved in late 2007.

The S&P 500 officially entered bear market territory with a decline from the late April highs of 1363 to an intraday reading of 1074 in early October. For the quarter, the S&P 500 index declined nearly 14% with the Dow Jones Industrial Average also experiencing the worst quarter since 1Q 2009 with a loss of 11.5%. The Russell 2000 small cap index declined nearly 22% with the international market indices of the MSCI EAFE and MSCI Emerging Markets off 19% and 22.5% respectively. As fears of a potential global recession increased, all risk assets moved down in sync with only the previously reviled long term U.S. Treasuries appreciating to the tune of over 15% in the quarter alone.

As financial market pressures intensify, European banks are finally moving to shrink their balance sheets to increase solvency ratios. We anticipate that European authorities will attempt to use the ESFS (European Financial Stability Fund) as the U.S. did with TARP and expect private sector bondholders of Greek debt to take a massive haircut and try to prevent the debt crisis from reaching Italy and Spain. Europe has been very slow to acknowledge and address the issues and getting 17 Parliaments to agree on the terms of the ESFS is still a challenge. Declining business and investor confidence in even the stronger markets of Germany and France have moved the manufacturing and service sectors into contraction and we would anticipate that most of the Eurozone will experience a recession over the next year. However gloomy the economic prospects appear, the market valuations clearly reflect much of this weakness with many countries in the Eurozone selling for less than nine times trailing earnings. While the economies may be challenged, we need to remember that many of the great companies within these borders are global. At some point even such weak economies will be valued too inexpensively to ignore. We feel we are getting close.

A big difference from 2008 and a growing concern is the slowing in Asia. Emerging markets are always more volatile and sudden outflows into the U.S. dollar (ironically but expectedly still viewed as a safe haven) have hit stocks and bonds denominated in emerging market currencies very hard. With the biggest export destinations for emerging markets slowing, these economies will be more challenged. The IMF (International Monetary Fund) has lowered their growth forecasts for these markets to 6.1% (we should be so lucky) as compared with the developed Eurozone of 1.9%. This will be a very interesting period for Asia. They have considerable policy flexibility built up by years of accumulating excess reserves. Will they act in a counter cyclical manner to ameliorate the decline of the developed markets or will they turn inward and safeguard domestic growth? Regardless, these do represent very attractive long term entry points for economies with debt to GDP ratios of less than 33% compared with over 100% in the developed world, with more attractive demographics and natural resource abundance. Though the ride will assuredly be bumpy, many of these markets are currently priced at less than 11 times trailing earnings. The MSCI Asia ex-Japan index is currently valued at less than 1.5 times book value as compared with the extreme lows of 1.3 times realized during the depths of 2008.

As we now anticipate recession in our not too distant future, comparisons to 2008 abound. We must stress some key points. The European financial crisis, large housing overhang, political impasse and weakened policy maneuverability remain major negatives. However, this is not 2008 in the U.S. We have no excess bubbles lingering, private debt is decreasing and housing and autos are already depressed. Perhaps most importantly, our financial system is in much stronger shape with strong capacity and willingness to lend. Corporate America has perhaps never been stronger. Cash as a per cent of total assets in the S&P 500 has risen from 7% in 2008 to over 10% currently. Total corporate balance sheet cash is now sitting at over $2.1T, an increase of 40% over 2008 levels and surging in the most recent quarter by over 20% at an annualized rate. We do not foresee any funding problems in our markets.

We have long noted the incredible profitability of corporate America and the return of profit margins to peak levels. By capitalistic definition, this is unsustainable and inflates current earnings thus creating the appearance of value by traditional price earnings metrics. Consensus estimates for S&P 500 earnings are for growth in the next two quarters of over 13% and 15% and have only been reduced modestly in the face of the slowdown. Wall Street analysts maintain a $98 estimate for 2011 and $111 for 2012. We expect that will not even be close. In a typical recession, earnings drop between 20% to as much as 40%. We expect this to be a shallow recession for the reasons cited. We do note with some optimism that during the precipitous earnings decline of 2008 to 2009, that ex-Financials, the earnings drop was 20%. Our EPS projection for 2012 earnings for the S&P 500 is currently in a range of $80-$90.

Optimism is low, the immediate outlook is gloomy. In looking at markets, it is important to distinguish between what will happen next versus what is already priced in to the markets. Some asset classes are becoming attractive. We have retained a very defensive position for clients and continue to focus upon capital preservation. High quality, dividend-paying and growing companies still represent the best value in the current environment. We will continue to look for the opportunities to buy good companies at very attractive values.