2012 3Q Commentary

"But prosperity can never be achieved by cheap credit. If that were so, no one would have to work for a living. Inflated prices only deceive one into believing that real wealth has been created. But easy come, easy go. It is fun when the bubbles are forming and many can live beyond their means; it's a different story when they're forced to live beneath their means in order to pay for their extravagance...."

Ron Paul

We mean nothing political in choosing on the eve of a critical Presidential election to quote Ron Paul but nonetheless do enjoy the irony. Long time readers are aware that we have been moderately critical and strongly dubious of many of the policy actions of Federal Reserve Chairman Ben Bernanke (though nothing like Mr. Paul) along with those of the Treasury and Administration over the last 4 years in addressing what we have termed a post-financial crisis environment. We have felt the traditional monetary policy tools available to the Fed would be rendered ineffective. The traditional transmission mechanisms to spur housing, investment and overall aggregate demand would be overwhelmed by a continuing and long dated process of deleveraging.

The preference of many economists during this crisis may have been for much less policy intervention allowing both our fixed income and housing markets to clear and fostering true price discovery. Many postulate that we would now be much further along to a sustainable economic recovery if that were the case. While that may be true, this counterfactual argument ignores the potential devastation to our economy that may have ensued with depression-like consequences in a period of massive debt deleveraging. We feel confident that it was just this fear of a deflationary spiral, that has led Chairman Bernanke (considered the preeminent student of the Great Depression) to expand the balance sheet of the Federal Reserve from $900B in April of 2008 to the current $2.8T. QE3 now promises to expand that further towards as much as $4T. We cannot re-write history (though we have previously written extensively on how we got here) and are sometimes left with choices that may best be categorized as bad and worse.

Ray Dalio of Bridgewater Associates has interestingly categorized this process as a "beautiful deleveraging" especially as compared with that of the Eurozone. A government and central bank can undertake this process in three ways: austerity, an attempt to reduce sovereign spending and hold debt growth below the rate of economic growth; restructuring, a method whereby existing debt is written off or renegotiated (otherwise called default); and monetization or the printing of money by the central banking authority. We only need to look across the pond to see what Dalio really means.

During the second quarter of this year, the greatest fear of global investors may have been a complete break-up of the European Monetary Union and the collateral damage that would be caused by the disintegration of the Euro. On July 26th, European Central Bank (ECB) President Mario Draghi vowed to the world to do “whatever it takes” to preserve the Euro. With the formation of the European Stability Mechanism (ESM) and a €500B lending capacity, Draghi announced a plan in early September of Outright Monetary Transactions (OMT).

The highlights of the OMT include virtually unlimited purchases of sovereign debt with maturities of 1-3 years both sterilized and transparent providing that the country submits to strict conditionality. By sterilization, the ECB means they will not be printing money but rather have an offsetting asset sale. While the intent is clearly to lower the short term borrowing costs to better enable the funding of all debt maturing during that period, the counter transaction will most likely be high quality and longer term higher rated debt. The ECB also is placing itself on a parity claim with private investors to encourage broad participation. Though these purchases will create quite an ugly ECB balance sheet, it may achieve the goal of removing the “fat tail” risk of a Eurozone break-up. We are just not sure for how long.

Europe is attempting to impose austerity budgets while still fostering economic growth and reducing interest rates on sovereign debt while improving overall debt to GDP ratios. Good luck with that. This is what Mr. Dalio refers to as an “ugly deleveraging” whereby it appears more likely that incomes will continue to decline faster than debt contracts. While the crisis has eased over the very short term, Europe enters this experiment at a time when overall Eurozone unemployment is at an all-time high of 11.4% and about to print a 3Q GDP lower than the -0.2% of the second quarter. Though Italy (which just announced that for the first time since World War II that bicycle sales exceeded car sales) and France are also in recession, the first big test for the OMT will be Spain.

Global markets rallied on the results of the Spanish bank stress tests which showed only a capital shortfall of €60B instead of the feared €100B. These stress tests are based on an expected decline in GDP of only 0.5% in 2013. Spain is already in recession with an unemployment rate of over 25% (over 50% for those under 25 years old) currently facing country-wide protests over the recent €40B in austerity measures. Additionally, separatist protests in Catalonia (the wealthiest area) and the Basque regions threaten to tear the country apart. Real estate loans (which comprise 10% of those total bank loans) are facing a housing price collapse that has already exceeded 25% with another 15% expected over the next year. In fact Citigroup views the real estate decline to be only 50% complete with a peak-to-trough decline expected to be 60%. The stress tests were not designed for such outcomes. We fear the recession in Europe will last for a protracted period while the southern tier may fall into a near depression. These are outcomes that do not appear to be priced into the global markets.

A greater concern for global growth may be emanating from Asia. Japan with its horrible demography continues to maintain the highest debt-to-GDP ratio of all the large economies and while enduring a near three decade stagnation has just embarked on the eighth stimulus program from the Bank of Japan (BOJ) in the last decade. However, it is China with the world’s second largest economy (12% of Global GDP) that is most concerning. The largest marginal consumer of raw materials is now experiencing severe excess capacity in most industries and we note the still falling prices of cement, coal and steel. Chinese imports are declining while industrial output and GDP growth have fallen to the lowest levels in three years. As noted by Morgan Stanley, we now have global trade growth falling near 0% on a year-over-year basis. It is difficult to envision anything but a continued global downturn without the participation of a recovering China.

We have long postulated 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 4 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 was 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 was little perceptible economic benefit while also triggering the unintended consequence of contributing to rising commodity prices. Moreover, the more positive inflation of rising financial asset prices was offset by commodity inflation which drove up costs and curtailed consumption and real income growth. Additionally, this fostered a widening bifurcation in our social system with the more affluent being the beneficiaries of rising stock prices while middle-income families have been more impacted by rising food and energy costs.

Will QE3 via the open-ended purchases of $40B per month of mortgage-backed securities achieve the desired objectives of jump-starting the economy? The intent of Chairman Bernanke appears to be two-fold. The first is to increase household spending via the "wealth effect" by raising the value of financial assets (primarily stocks and housing) and the second to spur business investment through the lowering of the cost of capital. We believe that by making the purchases "open-ended" along with the prior commitment to hold short term interest rates near zero through 2015, Bernanke has removed any uncertainty around Fed intentions. This may be a drastic and dangerous experiment and clearly one that will further exacerbate our already historic wealth gap.

The Employee Benefit Research Institute recently noted that only 35% of workers with less than $35K in household income (down from 49% in 2009) own stocks via a retirement plan. For households with incomes greater than $75K, this figure is over 93%. People who need the help the most own the least amount in the stock market and savers are obviously further penalized by historic low interest rates.

The School of Austrian economics (led by Ludwig Von Mises and F.A. Hayek) did ground breaking work in explaining the boom and bust credit cycles in economics. The view is that artificially easy credit leads to malinvestment in economic projects unjustified by their prospective rates of return and discourages savings while encouraging borrowing and consumption. Noted economist Lacy Hunt has noted that increases in debt are only productive if it generates an income stream to repay the debt. In the United States, debt-to-GDP levels have increased since 1999 from 250% to in excess of 350% (though down almost 10% from the peak in 2007). During this time, the Census Bureau notes that real household median income has declined from over $54,900 to the current level of $50,964. This entire increase in debt not only reduced our standard of living but may have engendered the worst wealth inequality since the 1920's.

Since the start of 2010 we have averaged about 125K per month in job growth, a level only slightly exceeding the number of new entrants into the labor force. This rate of increase is exhibiting improvement as following the positive release of the September nonfarm payroll report we note an average increase for 2012 in excess of 145K jobs per month. However, one must note the surprising upward revisions to prior data all centered on the government payrolls while the private sector job growth has actually slowed to an average of 105K per month over the last half year.

The most widely noted indicator, the unemployment rate, dropped to 7.8% marking the lowest level since the first month of President Obama's administration. Though there has been major political controversy around this number, it is not a manipulation of the data but rather a statistical quirk as to how it is calculated. This major decline was due to the findings of the Household Survey (a phone sampling of 60,000 households and a volatile data point) which showed an increase of 873K jobs, the largest monthly increase since June of 1983. While those numbers are moving in the right direction, we cannot ignore the flaws of only looking at this data without the context of the Labor Force Participation rate which has dropped to 63.6 or levels seen last in 1981. With the total labor force contracting and employment growing modestly, the unemployment rate declines.

Too much attention in our view is centered upon the number of newly created jobs and not enough on the quality of what job growth we have experienced. Though the most recent payroll data did have some very welcome positives in the areas of hours worked and average pay, this is anomalous and must be sustained. While our administration trumpets the recovery of nearly 4.8MM of the 8.5MM jobs lost during the Great Recession and the reduction of the unemployment rate below 8%, we must focus on the disturbing fact that most of these positions are in leisure and hospitality, retail or temporary positions that pay less than $14 per hour. Even the excellent number released by the Household Survey must be further scrutinized as fully 2/3rds or 583K jobs are classified as part time for economic reasons. The National Employment Law Project refers to this recovery as the "Minimum Wage Recovery" noting that it is just these lower wage occupations that represented 21% of recession job losses but fully 58% of those recovered.

For two decades the benefits of globalization have been trumpeted as vast markets have opened up for corporate America and global trade. While this truly has many long term benefits few of them inure to the middle class as this has also opened up a tremendous supply of cheap labor willing to work for far less than Americans. Many middle class jobs have shifted overseas as technological innovation and industry obsolescence have reduced the level of factory workers (medium to higher wage positions) in the U.S. from over 21% of total payrolls in the late 1970's to less than 9% currently. For a generation we were able to mask many of the disparities in aggregate wealth in this country as declining interest rates and free flowing credit allowed many to live beyond their means while millions of residential construction jobs replaced jobs lost from other sectors overseas.

Here are some sobering statistics. Currently, 15% of the U.S. population lives below the poverty line (defined as $22,811 for a family of 4) with 44% of those living on less than one-half that amount. 46.5MM Americans or over 15% are on our Food Stamp program which compares with an average of less than 8% during the three decade period ending in 2000 and represents an increase of over 64% in just four years. From the pre-recession peak in 2007, wages & salaries have risen only 4.2% on a nominal basis and real disposable income per capita (after taxes and adjusted for inflation) has actually declined 5%. Yet according to estimates of the U.S. Census Bureau, the 1.2MM households whose incomes represent the top 1% of the U.S. saw their earnings increase 5.5% in 2011 while the 96MM households in the bottom 80% experienced a decline of 1.7%.

Absent sustained income growth, consumer spending which represents fully 70% of U.S. Gross Domestic Product (GDP) has remained tepid. Real consumer spending is up 2.0% year-over-year but has slowed to a 1.1% annualized rate over the last quarter. The one bright spot in this area has been the growth of auto sales which are annualizing at a rate of 14.9MM cars, a level last reached in 2008 though still way below peak levels. Without income growth consumers have had to reduce their savings rates just to maintain this level of spending and the current savings rate of 3.7% is one of the lowest since the onset of the recession. Median Household Net Worth has declined a whopping 39% from $126.4K in 2007 to the most recent figure of $77.3K. It is with the background of this mosaic that we remain skeptical on the ignition power of rising asset prices on consumer spending. We need wage and income growth.

Having been the major contributor to the Great Recession, housing is clearly being targeted by the Federal Reserve as key to a sustainable economic recovery and on this front the recent data has been positive. Residential investment has now contributed positively to GDP for 5 consecutive quarters (though it represents only 2.4% of GDP versus 6% at the peak). New home sales are up over 25% from year ago levels and existing home sales over 9% as historically low mortgage rates have moved housing affordability to all-time high levels. These positive data points are accentuated by the Case-Shiller Home Price Index showing national home prices now up on a year-over-year basis by 1.2% with a similar analysis from Core Logic estimating over 4% one year increases. This is critical as it is estimated that such a price gain would move about 1.3MM homeowners out of negative equity. While these are welcome numbers, we continue to be much less sanguine.

Following the robo-signing scandal of 2011, banks undertook a voluntary moratorium and foreclosure abatement for over a year. Laurie Goodman of Amherst Securities, a mortgage specialist, estimates that 2.9MM homes with a mortgage have made no payment in more than 12 months. The impact of this abatement should not be ignored as it has removed much of the dramatic overhang of supply from the marketplace on a temporary basis. Distressed sales as a percentage of total sales have declined from a four year average of 35% to 22%, a level also well below normal. Distressed sales normally sell for 20%-30% below comparable properties. This mix change alone can account for the entire increase in home prices. Realty Trac estimates that of the 44.2MM homeowners with a mortgage over 28% or 12.4MM, are still underwater. More importantly for future demand, Zillow notes that this figure jumps to 48% of borrowers under the age of 40, many of which purchased during the peak years.

First time homebuyers now represent only 32% of the total compared to a historical average of 40%-45%. A disproportionate share of new buyers are investors. While this is clearly healthy in removing some of the excess inventory, we are losing the new and move up buyers that are critical for the sustainable functioning of the home buying market. Young adults facing higher employment uncertainty along with much higher debt levels from student loans are still holding back household formation. We are teetering on a very tenuous recovery and the recent positive data may be very misleading. Without job and wage growth the next 6-12 months may show this to have been an aberrational period as foreclosure and distressed supply pick back up.

We entered 2012 with the view of a higher level of recession risk than the consensus (which was forecasting GDP growth in excess of 2.5%) and noted again after the 1Q GDP of 2% that it may represent the high for the year. Though growth has continued positive, it has slowed to 1.3% in 2Q and appears to again be less than 2% for 3Q 2012. The Institute for Supply Management manufacturing index has contracted for 3 of the last 4 months while Industrial Production declined 1.2% in August and Durable Goods orders dropped 13.2% during the same period. While these are weak readings they are not at recessionary levels. After growing 2.4% in 2010 and 1.8% in 2011 (levels significantly below historical trend growth of over 3%), we are estimating an even weaker annual reading for this year as risks of the "fiscal cliff" intensify in the final quarter of the year.

As most are painfully aware, the "fiscal cliff" is the term used for the $607B in tax increases and spending cuts set to take effect at the end of 2012 and early 2013 as our dysfunctional Congress has been unable to come to a budget agreement. This represents approximately 4% of GDP over this period according to the Congressional Budget Office. Many look at this as a binary event or are assuming that some extension will obviously be achieved while an agreement is worked on. However, there are clear components such as the payroll tax cut ($95B estimate) and extension of unemployment benefits ($25B estimate) that will almost assuredly expire. Collectively, we would estimate this minimum drag as impacting GDP by almost 1%. In an economy growing at trend this would have minimal impact but one plowing along at 1.5% becomes more concerning.

While noting the most attractive values for the long term may reside in European equities, we suggested in our Annual Commentary that the U.S. was positioned to be the best house in a bad neighborhood and suggested a relative overweight in U.S. equities as corporate earnings growth had continued to be the catalyst for strong market moves. However, we also have continued to point out the unsustainability of profit margins that have been at or near all time high levels and fully 50% above long term averages. With our view of a higher than expected risk of recession, we forecast S&P 500 earnings to be south of $95 for 2012 way below the consensus of $107 as we foresaw a higher recession probability. Though this is looking less likely, the direction is clearly coming towards this estimate. We are noting revenue growth to have stagnated (revenue per share for the S&P 500 was less in 2Q 2012 than 4Q 2011) and estimates are now looking for a quarterly decline in earnings for this quarter as profit margins have started to contract. Consensus estimates for most Wall Street strategists are now near $100. With a very slow growth economy and pending "fiscal cliff" we are maintaining our original estimates for now.

The sea of liquidity provided by the Central Bank and the impact it has had on the markets (and some discretionary spending via the wealth effect) may have succeeded in staving off the recession we feared in 2012. However, we do not believe that monetary intervention can alter the economic cycle and see a still not insignificant possibility of a mild recession over the next 12 months. Wall Street continues to understate this possibility and currently forecasts another near 10% gain in earnings over the next year. The illusion of prosperity from higher stock prices can be seductive. We leave you with this thought from economist Paul Krugman:

"*Human behavior often stubbornly clings to ideas and historical relationships we feel we know and understand. Unfortunately, it may just be this irrationality that often leads to booms and busts. One such anchor that Wall Street strategists often cling to is the stock market as a barometer of economic performance. We have seen how accurate that turned out to be as the market peaked in March of 2000 and again in October of 2007.*"