Title: Advocacy Investing® Portfolio Strategies, Issue 30
By: Karim Pakravan, Ph.D.
Copyright: Marc J. Lane Investment Management, Inc.
Date: October 20, 2011

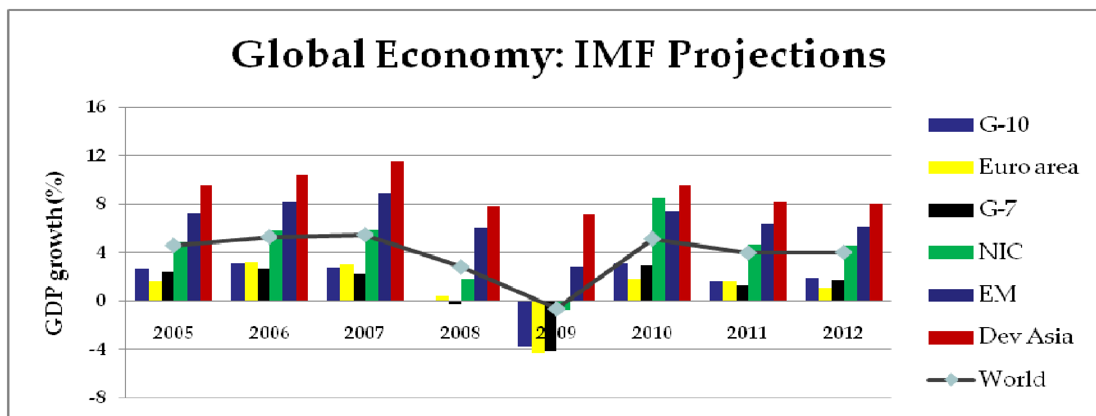
Advocacy Investing®

ALL EYES ON EUROPE

- **The global economy shows signs of faltering**
- **All eyes are on Europe as the eurozone leaders shift the policy focus to banks**
- **US data releases improve by the end of the months**
- **A better-than-expected payrolls report boosts expectations**
- **At best, the US economy should creep forward at 1.5-2.0% (annualized) over the next 2-3 quarters**
- **Nervous markets are driven by European news, but so far avoiding bear territory**

"The global economy is in a dangerous new phase". With these words, the IMF sounded the alarm at its September annual meeting. While the US economy continues creeping ahead, the epicenter of the global economic turmoil remains in Europe. World economic policymakers and masters of the global financial universe gathered at the IMF annual meetings on September 23-25 were unable to agree on any policy coordination measures. Moreover, European policy makers and political leaders, as well as academics, remain bitterly divided over a solution to the European sovereign debt crisis.

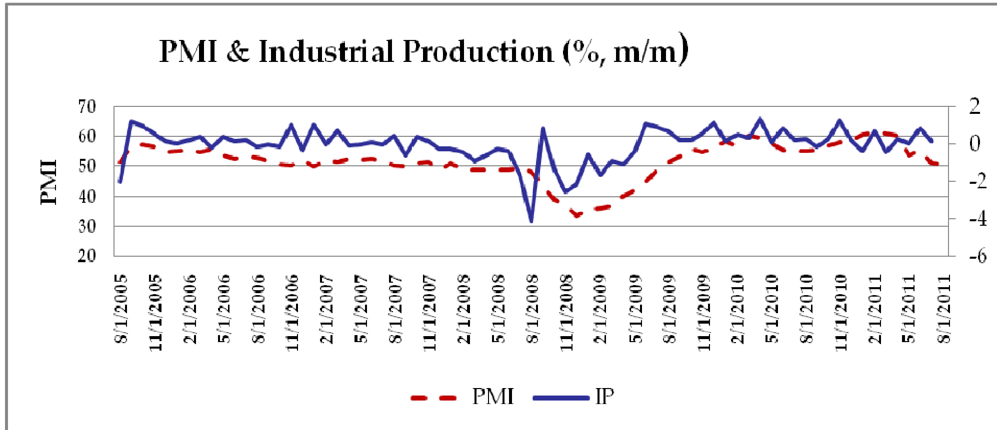
Fig. 1: <u>The IMF Global Forecast</u>



All eyes on Europe: The European approach to the crisis has been two-fold: first, put in place a European bail-out mechanism, the €440 billion ($600 billion) European Financial Stabilization Fund (EFSF); and second, push the highly indebted countries (the so-called GIPSI—Greece, Italy, Portugal, Spain and Ireland) to adopt further and credible austerity measures. After months of dithering and with time running out, strong pressure from the United States, major emerging market countries and the IMF forced the European governments to move forward on the EFSF, which was approved overwhelmingly by the German legislature. So far 11 out of the 17 eurozone countries have approved the legislation, and with the key German vote out of the way, approval by the others before the mid-October deadline is likely. The new EFSF will have expanded powers, being able to purchase troubled countries bonds on the secondary markets, as well as recapitalizing private sector banks. Nevertheless, these measures are seen by the financial markets as too-little, too-late, and most experts continue to predict a Greek default within the next 6-12 months. Pressure on Spain, Portugal and Ireland has receded, but Italy, with its dysfunctional government, is now at under threat. Meanwhile, Europe seems to be caught in a vicious circle of severe austerity measures, economic contraction and a diminished debt servicing capacity. The latest blow was Moody's
3-notch downgrade of Italy's sovereign debt to A2.

Data releases: Revised GDP data shows that the US economy grew faster than earlier expected in 1H11, albeit still at an anemic pace. Economic output growth numbers (annualized) were revised upward from 0.4% and 1.0% respectively in 1Q11 and 2Q11 to 1.0% and 1.3%. Other data releases show marginal improvements. Consumer confidence, as measured by both the University of Michigan/Reuters and the Conference Board indices, has improved, but the August numbers for personal income and personal consumption expenditures were somewhat disappointing. Personal income (minus 0.1%, month/month, m/m) fell for the first time in 2 years, while personal consumption expenditures rose by 0.2% m/m after a 0.7% increase the previous month. However, the most recent high-frequency retail surveys (ICSC-Goldman and Redbook) show a strengthening of sales in the past week after several flat or down weeks. While early September industrial production surveys (Empire State and Philadelphia Fed) remained negative, they were somewhat less so. Moreover, there have been a number of positive surprises in recent days. Durable goods and factory orders showed a sharp increase in capital expenditures. More recent survey data also showed improvements, with the end-September Chicago PMI surging over 60 from 55.4 in August and the ISM-manufacturing rising from 50.6 to 51.6. Construction activity also expanded. The service sector also grew, as reflected in an ISM-nonmanufacturing of 53.

Fig.2: **The PMI and Industrial Production**



The housing sector remains flat on its back. Housing starts and existing home sales increased marginally in August, but new home sales fell and the Case-Shiller 20-city price index for July was unchanged. Meanwhile, the delay in returning to a solid recovery means that the structural (and related) problems in the housing and labor markets and their interaction with the financial system can only get worse, further delaying a return to normal economic conditions.

Global Slowdown: The relative improvement in the US economic outlook is, however, offset by a continued deterioration in the global outlook. The September JPMorgan Global PMI fell for the fourth month in a row. Moreover, the index, at 49.9, breached the 50 level, indicating that the global economy is in a slowdown, with most of the deterioration coming from Asia and Europe. The JPMorgan All-Industry Index inched up to 52, but is still at its lowest level in 2 years. The eurozone economy and the UK have also slowed down, and the expectation is that, absent government action, Europe could enter a recession by early next year. On the plus side, the impact of the tsunami-related disruptions of the global supply chain has faded away, and global industrial production is up.

Let's Twist Again: The FOMC meeting did not herald a new round of quantitative easing. Instead, the September 21 meeting statement underscored "… significant downside risks to the economic outlook, including strains in global financial markets…" to propose what has been dubbed "Operation Twist", a reallocation of $400 billion of government securities on its balance sheet from bonds with maturities of less than 3-years to maturities of 6-30 year bonds. Moreover, the Fed will continue to reinvest maturing agency debt in their mortgage-backed securities. At his most current testimony to Congress (October 4), Bernanke reiterated his gloomy view of the economy, but added that the Fed has the ability to take additional steps to boost the economy.

Independently of Fed actions, the US government debt continues to benefit from the global flight from risky assets. 10-year yields, which fell to as low as 1.67% in the past month, have recovered to over 2%, while the 30-year yield rose back over 3.0%.

Commodities Slump: The silver lining to the economic turmoil has been the sharp fall in oil and commodity prices. Crude oil prices (West Texas Intermediate, WTI) fell to their lowest level in over a year in early October, down to around $77/barrel (bbl), a 32% decline from their 2011 high and a14% fall since end of August. Brent crude prices are falling also, edging down to $100/bbl. Gold is off its highs, trading now at around $1,680/oz, and other commodity prices are on the decline. While this softening of the commodity markets reflects the global economic gloom, it also represents a welcome respite and increased purchasing power for the consumer. While crude oil prices (WTI) jumped back to over $80/bbl by the end of the first week of October, ($85/bbl on 10/10) they should settle in the low to mid-80s in the next few weeks.

Labor Markets Improve, but Not Enough: High frequency labor market data showed an improvement at the end of September, with first time jobless claims falling once again to around the critical 400,000 level (395,000 for the last week of September and 401,000 for the first week of October) after several weeks of deterioration. The September payrolls numbers exceeded market expectations, with a 103,000 increase in employment. Private sector jobs rose by 137,000. With the exception of manufacturing (minus 13,000) and retail (flat), all sectors saw a rise—construction (+26,000). Services (+119,000), Healthcare (+48,000). Government payrolls continued to shrink. With the 57,000 upward revision for August, this brought the monthly average increase since April to 72,000—down from the 161,000 monthly average in the previous seven months—mildly positive, but clearly insufficient to make a dent in the bleak employment situation. Weekly hours edged up by 0.1 to 34.3, and hourly wages were up 0.1%, after a 0.2% loss in August. The participation rate edged up from 64% to 64.2%, and the unemployment rate (which is derived from a separate survey) remained at 9.1%.

A Faltering Economy: Conditions underlying the short-term (1-3 months) and medium-term (3-12 months) economic outlook remain more or less unchanged: a gridlocked US administration and Congress, a dysfunctional European political and policy framework and depressed business and consumer confidence. In addition, The Senate has passed the so-called Schumer Bill (which would put a 27.5% tariff on Chinese imports to offset Chinese currency manipulation). This legislation is fiercely opposed by the Chinese government, and if enacted could lead to retaliatory trade measures.

The Congressional "Supercommittee" agreed upon in the summer debt ceiling agreement is supposed to complete its work in the next few weeks. Its members, equally divided between Democrats and republicans, are unlikely to come to an agreement, in which case automatic cuts would be triggered. Since President Obama's Jobs for America legislation faces fierce opposition from the GOP, the US economy faces the prospect of a significant fiscal tightening later in the year in 2013.

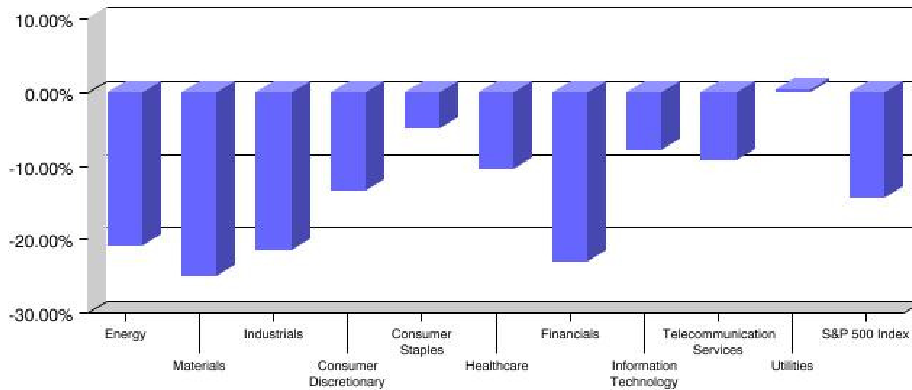
The biggest threat to US economic prospects remains the continued shocks from Europe. The European leaders stand at a cross-road. Either the European Union has to continue to provide an indefinite lifeline to Greece (and potentially to other GIPSIs) or focus on restructuring the ailing sovereign debt and move the recapitalize the banks. However, the threat of collapse of a major European bank (the Franco-Belgian Dexia, with $750 billion in assets) seems to be finally concentrating European minds and the latest moves by the eurozone leadership indicates that they are moving in fits and starts toward a joint effort to recapitalize the banks.

The gridlock over economic policy is not helpful either. In his testimony to the Joint Economic Committee of Congress, Bernanke made the case for an economic program with four goals in mind: avoiding sharp short-term budget cuts, reducing the debt to a sustainable level, adjusting spending and tax policies to promote growth and improving economic governance. Whether Congress and the White House heeds Bernanke's advice is a matter of debate.

However, all things considered, the economy has been remarkably resilient in the face of repeated shocks—as reflected in the positive payrolls month after month. I continue to believe that we will avoid a double-dip recession. The major threat comes from Europe, where a significant degradation of the economic and banking situation would inevitably lead to transatlantic contagion. Under these circumstances, the IMF forecast of US economic growth of 1.6% and 1.9%, respectively for 2011 and 2012 seem to be on par.

Indiscriminate Selling: The global equity markets completed their worst quarter since 2008, with the S&P500 down by 12.1% in 3Q11(compared to a drop of 22% in 4Q08) Since peaking at the end of July, global equity markets have been highly volatile, with indiscriminate selling across the board since the end of August. Markets have been basically reacted in a bipolar manner to European news. Global indices and national indices in both developed and emerging countries have seen sharp fluctuations around a relatively flat trend, reacting equally strongly to snippets of good and bad news and data releases. The S&P500 has averaged 1,176 from July 27 to the end of September, a full 9% below its June 30-July 26 average. The index has been very volatile in the first week of October, barely avoiding a bear market before recovering by over 70 points by the end of the week. The market is dominated by high-frequency, algorithmic traders, with much of the daily action concentrated in the beginning and end of the trading day. This has led to soaring volatility with the VIX index peaking at 45 on September 30th and averaging over 30 since August 1 from around 18 in the previous four months.

Fig. 3: Third Quarter S&P500



The markets' narrative is depressingly familiar. Concerns about lower global growth have been intensified with the release of poor numbers for Chinese manufacturing and German consumer demand. European sovereign debt uncertainties and US political gridlock hamper a recovery in business and consumer confidence. However, it has been clear that the markets have been driven by European news, with the sharp ups and downs reflecting the latest "solution" to the Greek problem and/or the latest "emergency meeting" of European economic and financial decision-makers.

Within these unsettled markets, financial stocks have been hit quite hard. European banks in particular, have seen their shares plummet. In the latest iteration, Dexia, a major Franco-Belgian lender, is being restructured. American financial institutions haven't been spared; with even the best names such as JPMorgan is sharp decline. Nevertheless, as stated earlier, a coordinated European effort to boost the banks' capital and provide stop-gap liquidity could help stabilize the situation.

With the S&P trading at a multiple of 12, the upcoming 3Q11 earnings season will be crucial. Analysts do not expect the record-breaking 2Q11 to repeat itself. Nevertheless, analysts seem to believe that there is still room for corporate earnings growth, forecasting a rise of by 15.4% (year-on-year, y/y) in 3Q11 and 13.5% in 2012 as a whole. This would mean that S&P500 profits would rise from around $100 to $110/share over the next few months.

In the first week of October, we have seen the market rally being driven by Materials, Consumer Discretionary, Energy and Technology, which shows a reversal from the previous month's trend were the best performing (or least-worst performing sectors) were the defensive ones. This is one more indication that the markets have not given up on the recovery.

Data Releases

September 2011	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (2Q11, % Annualized)	1.0%	1.2%	1.3%	0.9%	1.4%
CPI (m/m) Aug	0.5%	0.2%	0.4%	-0.2%	0.1%
Core CPI (% m/m) Aug	0.2%	0.2%	0.2%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) (Jul)	-2.2%		3.6%		
Imports (% m/m) (Jul)	-0.2%		-1.1%		
Trade Deficit $ billion (Jul)	51.6	51.9	44.8	49.0	55.0
Current Account Deficit ($ billion) (2Q11)	119.8	122.0	118.0	120.2	132.0
Industrial Production					
Empire State (Sep)	-7.72	-3.6	-8.82	-15.0	0.0
Philadelphia Fed (Sep)	-30.7	-15.0	-17.5	-25.0	-10.0
ISM-Mfg Sep	50.6	50.5	51.6	49.0	52.0
Chicago PMI (Sep)	56.5	55.4	60.4	52.0	58.0
Industrial Production (% m/m) Aug	0.9%	0.1%	0.2%	-0.1%	0.3%
Durable Goods (m/m) Aug	4.1%	0.2%	-0.1%	-1.5%	2.7%
Durable Goods (y/y)	9.5%		12.3%		
Durable Goods, ex transp (m/m)	0.7%	-0.2%	-0.1%	-1.9%	1.0%
Durable Goods, ex Transp (y/y)	9.6%		7.8%		
Inventories (m/m) Aug	0.3%	0.5%	0.4%	0.3%	0.6%
Factory Orders (m/m) Aug	2.1%	-0.3%	-0.2%	-0.4%	0.4%
Services					
ISM non-mfg Sep	53.3				
Consumer Spending					
Retail Sales (% m/m) Aug	0.5%	0.2%	0.0%	-0.3%	0.7%
UMich Consumer Sentiment Sep	55.7	56	57.8	52	59.6
ConfBd Consumer Confidence (Jul)	44.5	46.5	45.4	42.0	48.0
Personal Income (m/m) (Jul)	0.3%				
Personal Income (y/y) (Jul)	5.3%				
Consumer Spending (m/m) (Jul)	0.8%				
Consumer Spending (y/y) (Jul)	5.1%				
Housing Market					
Housing Starts ('000) Aug	571	592	571	570	634
New Home Sale ('000 Aug	302	294	295	275	307
Existing Home Sales (MM) Aug	4.67	4.75	5.03	4.57	4.97
Case Shiller-20 (m/m) Jul SA	0.0%	0.1%	0.0%	-0.5%	0.0%
Case Shiller-20(y/y)	-4.4%		-4.1%		
Employment					
First Time Claims ('000) (1st Week October)	395	410	401	395	415
Non-Farm Payroll (Sep)	57,000	65,000	103,000	30,000	115,000
o/w Private Sector Sep	42,000	95,000	137,000	54,000	135,000

The Advocacy Investing® Portfolio Strategies newsletter is a publication of Marc J. Lane Investment Management, Inc. We attempt to highlight and discuss areas of general interest that may be useful for anyone interested in the dynamics of our economy and our markets. Nothing contained in Advocacy Investing® Portfolio Strategies should be construed as investment advice or a market recommendation. Consultation with a financial professional is recommended before implementing any of the ideas discussed herein. Copyright © 2011 Marc J. Lane Investment Management, Inc. Reproduction, in whole or in part, is forbidden without prior written permission.

"Advocacy Investing", "Advocacy Avatar", "The Next Generation of Socially Responsible Investing", "Promoting Your Own Values", "SRI Open Forum" and "Your Profit. Your Passion. Your Power." are trademarks of Marc J. Lane Investment Management, Inc. Registered in the U.S. Patent and Trademark Office and may be registered in certain jurisdictions. "Protecting Today's Wealth. Building Tomorrow's." and the Marc J. Lane Wealth Group logo are trademarks of The Law Offices of Marc J. Lane, a Professional Corporation Registered in the U.S. Patent and Trademark office and may be registered in other jurisdictions. "Marc J. Lane Wealth Group" is a trademark of The Law Offices of Marc J. Lane, A Professional Corporation and may be registered in certain jurisdictions.

Dr. Pakravan has been a senior economic strategist in global financial markets for 25 years. Dr. Pakravan is a recognized specialist in leading-edge applied macroeconomic and financial research on currencies and emerging markets, country risk assessment and modeling in an enterprise-wide risk management context, as well as international financial architecture. Dr. Pakravan has a Ph.D. in Economics, University of Chicago, a M.Sc. in Econometrics and Mathematical Economies, London School of Economics, and a B.A. in Mathematical Economics, University of Geneva. He is the author of numerous publications and is an Associate Professor of Finance at the Kellstadt Graduate School of Management at DePaul University.