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Advocacy Investing®

TERRIFYING PROSPECTS?

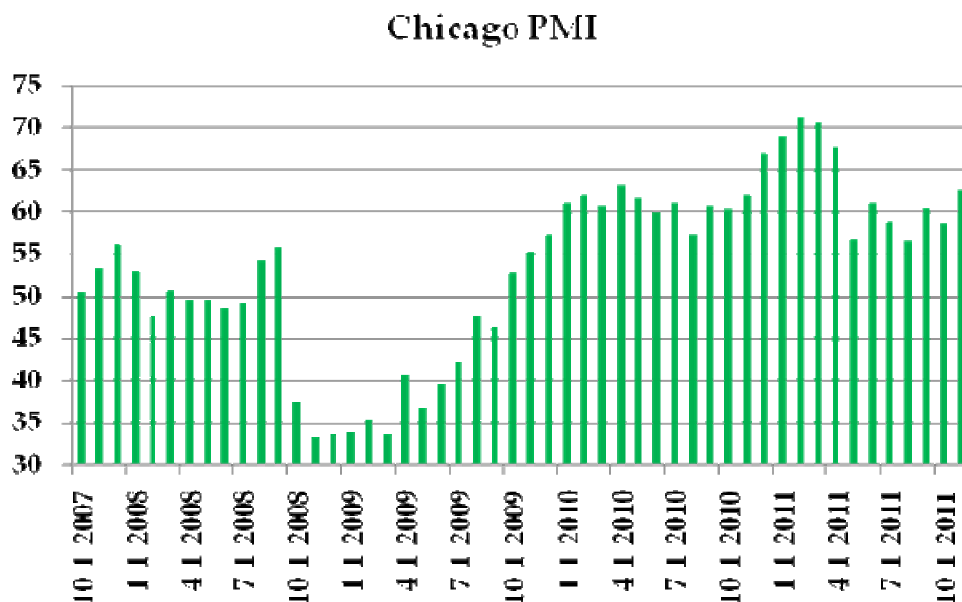
- **Economic data releases point to a steady, albeit slow, pace of recovery**
- **Payrolls have maintained momentum in the past three months and the unemployment rate is down**
- **The eurozone sovereign debt/financial crisis is far from being resolved and presents both a cyclical threat and, in the extreme case, a "black swan" danger to the US economy**
- **Unsettled oil markets and a policy impasse in Washington also pose a threat to the US economy**
- **A strong 4Q11 is likely to be followed by a below-trend growth in 1H12—if the eurozone stabilizes**
- **Markets vacillate between hope and fear**

The strong Black Friday sales performance offered a respite to the markets, but could not hide the fact that once again, the US economy is facing significant headwinds. The Eurozone sovereign debt crisis is threatening to spiral out of control, a rise in tensions with Iran has led to another spike in oil prices, and any reasonable solution to the US debt problem has hit another impasse as the so-called Super Committee ended empty-handed.

The first revision of the 3Q11 GDP numbers has led to a downward adjustment of the growth figure (annualized) from 2.5% to 2.0%, most of it as a result of a greater inventory adjustment numbers. Otherwise, the macroeconomic data releases continue to point to a modest, but persistent improvement in economic performance. Industrial production was up 0.7% (month-on-month, m/m) in October, durable goods (ex-transportation) also rose by 0.7%. Survey data also improved, with both the Empire State (+.61) and Philadelphia Fed (+3.6) numbers back in positive territory. The Chicago PMI for November rebounded to 62.6, while the ISM manufacturing index rose from 50.8 to 52.7. The consumer side was mixed. Consumer confidence improved—the University of Michigan/Reuters Index was steady at 62.1, while the Conference Board (which comes out later) jumped from 39.8 to 56 at the end of November. Retail sales gained 0.5% (m/m), while consumer spending lost some momentum (+.01%, m/m). Disposable income rose by 0.4%. The ISM non-manufacturing index held steady at 52.0, showing continued, albeit modest momentum.

Payrolls maintain momentum: the labor market data releases indicate that while the economy that is gaining momentum, it has yet to translate into robust jobs creation. Overall payrolls rose by 120,000 in November, with a 100,000 upward revision for the previous two months. Private payrolls increased by 140,000, while the government sector continues to shed jobs (minus 20,000). The private sector gains were concentrated in the services sector (+146,000), while the goods producing sector lost 6,000 jobs. Manufacturing job gains remained modest (+2,000), while construction fell by 12,000. Overall, the private sector job gains have averaged 159,000/month in the past three months—good, but not enough to turn around the labor markets. Hours worked remained constant, while hourly earnings increased by 0.1%. The unemployment rate, computed on the basis of a separate household survey, fell from 9% to 8.6%. About half of the improvement came from a fall in the labor participation rate from 64.2% to 64%. High frequency data is also consistent with a gradual improvement in the labor markets, as first-time unemployment claims have been under 400,000 for the past few weeks.

Fig. 1: A Manufacturing Revival



A prolonged U: The housing market seems to be at the bottom of a prolonged U. Data on new and existing home sales and housing starts has remained unchanged at low levels for the past few months, the Case-Shiller 20 housing price index showed a 0.6% m/m decline in September. Foreclosure activity has accelerated, while at the same time the foreclosure pipeline is rising. The average time for foreclosures has risen to 631 days, which does not bode well for a faster housing market recovery.

America held hostage: The steady performance of the US economy is held hostage by the rapidly unraveling situation in Europe, where stabilizing the sovereign debt crisis has gained a new urgency.

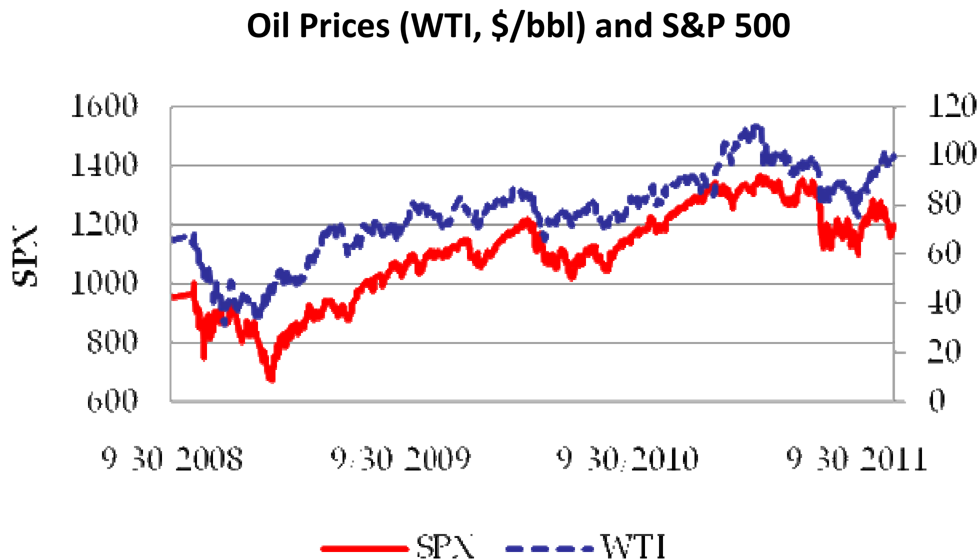
The Organization of Economic Cooperation and Development (OECD, which represents both the industrialized countries and the major emerging markets) has warned of the dire consequences of a eurozone meltdown and has downgraded its G-10 growth forecast for 2011 and 2012 to respectively 1.9% and 1.6%. Another danger signal is the increasingly open talk of the potential demise of the euro. While economists and policymakers have yet to agree on a solution to the eurozone's sovereign debt woes, there is broad agreement that time is running out. The rot has already spread from the small and marginal eurozone members (Greece, Portugal and Ireland) to the much bigger countries (Italy and Spain), with the latter group seeing a sharp but unsustainable spike in borrowing costs—climbing to a high of 8% before backing off somewhat. More significantly, France and even Germany are under pressure. France's AAA rating is in doubt, and the most recent German "bund" auction failed—although this failure is more likely to have been a glitch rather than a serious problem. European banks, which hold significant amounts of eurozone sovereign bonds, are facing liquidity shortages and calls for significant write-offs. As a result, they are hoarding cash, contributing further to the liquidity shortage. Moreover, the European banks are being gradually pulled into a vicious circle of write-downs of their sovereign debt portfolios, asset sales and downsized balance sheets. The Eurozone leaders are trying to achieve the impossible: stabilizing the markets in the short-term while engineering long-term structural changes. In the short-term, deep differences remain. The European Central bank (ECB), under pressure from France but backed by Germany, remains steadfast in its refusal to use its balance sheet to buy sovereign bonds—although it is doing so on a limited scale. Meanwhile, German Chancellor Merkel is pushing for greater economic policy integration, in particular in the fiscal area. Ultimately, a solution will have to involve the ECB purchasing significant amounts of sovereign debt of the troubled countries, a massive increase in the European Financial Stability Fund (EFSF) resources and the restructuring of Greek (and possibly Portuguese and Irish) debt, a recapitalization of European banks and the exit from the euro of several of the smaller and weaker members. The next key date is the December 9th eurozone summit, at which time the continent's leaders will have to come up with convincing answers on a durable solution to the crisis. There are strong indications that France and Germany have agreed on a new tough fiscal surveillance and monitoring framework, changes that have to be ratified by all eurozone members. Meanwhile, the threat by Standard&Poor's to downgrade all of the eurozone countries has added to the pressure on Europe's leaders.

Not so Super! The failure of the SuperCommittee set up in August to reach a long-term agreement on deficit reduction was predictable, and it triggers $1.2 trillion in automatic spending cuts across the board over a decade. However, those cuts would not kick in until 2013 and will not have an immediate economic impact. More relevant to the short-term prospects is the need to agree on two key items: the extension of the payroll tax cuts (which the Obama administration proposes to finance with a small surtax on incomes over $1 million) and the extension of jobless benefits. In combination, a failure to extend the payroll tax cuts and unemployment benefits could cut GDP growth by 0.7-0.9% next year. Failure to extend some of the Bush tax cuts which are due to expire at the end of 2012 will add to the fiscal drag. The resolution of these issues does not look promising in an election year, although public opinion is pushing for a compromise. Meanwhile, failure to adopt a long-term reasonable deficit

reduction plan has prompted Fitch to downgrade the US rating' (AAA) outlook to "negative"--with a review scheduled for 2013.

Geopolitics Once Again: Broadly speaking, the oil markets are driven by both geopolitics and economics. As such, oil prices have been strongly correlated to equity markets, with a correlation between WTI and S&P500 of 0.95 for the past three years. However, geopolitics are now trumping fundamentals. The worsening stand-off between Iran and the West over the nuclear issue has led to another surge in oil prices despite abundant supplies and inventories. Since the publication of the International Atomic Energy Agency (IAEA) on Iran on November 8th, oil prices have jumped by $5/barrel (bbl) to over $100/bbl—34% higher than the 2011 low point reached on October 4th. The storming of the British Embassy in Tehran, the threat of new sanctions by the US and a potential embargo against Iranian oil by the US and the European Union have further unnerved oil markets.

Fig.2: <u>Geopolitics</u>



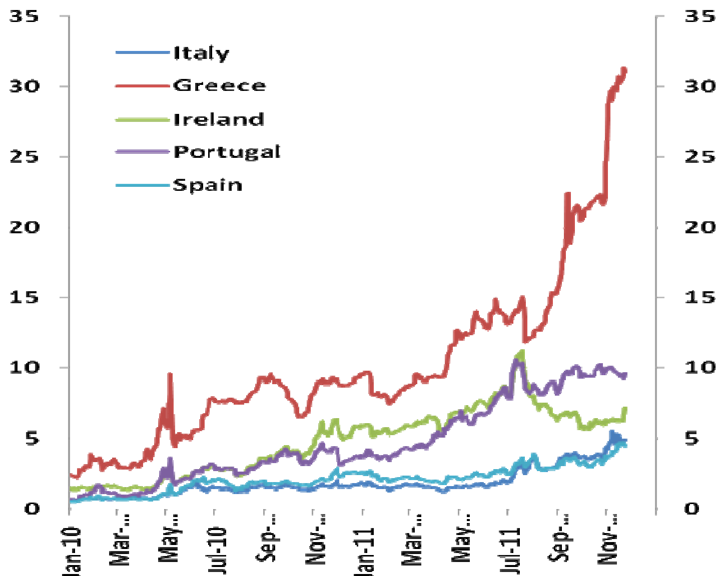
A weak to moderate performance, unless…On its own, the US economy seems to have gained momentum in 3Q11 and 4Q11, and the underlying economic data points toward relatively strong 4Q11 macroeconomic performance. However, maintaining the economic momentum in 2012 might be more difficult. The problem comes in large part from a deteriorating global environment, characterized by slowing growth in the major emerging economies and the high risk of financial and economic contagion from a eurozone in crisis. In addition to a tough global environment, the domestic economy will face high and volatile oil prices as well as unresolved policy issues in the upcoming election year. The eurozone is almost certainly going to return to recession in early 2012, while China's growth rate will continue to slow. Moreover, households will remain under financial pressure and will continue deleveraging and building up their financial reserves. Under these circumstances, growth could

accelerate to over 3% in 4Q11, but slow to 2-2.5% in 1H12—assuming the European situation stabilizes somewhat. Finally, we are likely to see added pressure resulting from fiscal tightening in the United States and unsettled oil markets. On the positive side, most recent surveys indicate that manufacturing is expected to remain robust in 2012.

The European crisis can affect the US economy through three channels: trade, corporate profits and financial contagion. We are already seeing the impact of the European problem in a developing credit crunch. Nevertheless the US economy has enough resilience to weather the European problem, as long as the situation stabilizes. Ultimately, the bigger risk remains a "Black Swan" (or "unknown unknown" to quote former Secretary of Defense Rumsfeld) facing the global economy, a multi-country sovereign default and the collapse of the euro. ***A terrifying prospect indeed, although I still consider it a low probability outcome.***

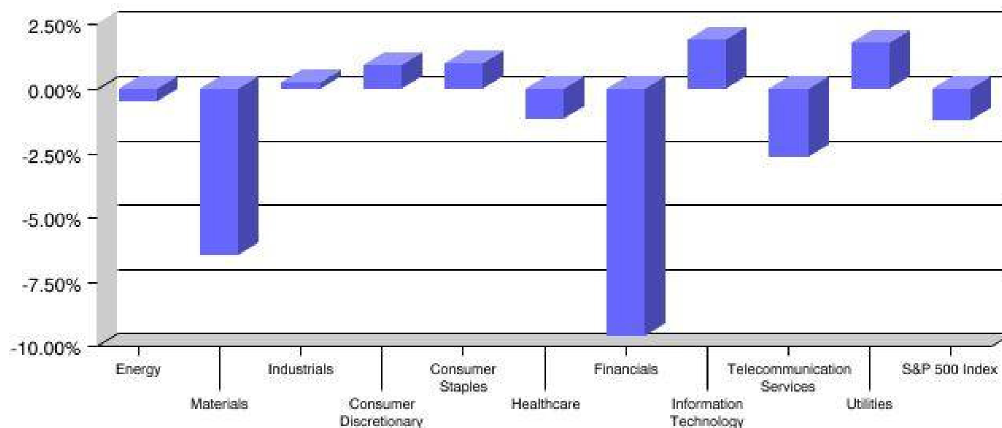
Hope and Fear: The markets were battered by the escalating European sovereign debt crisis for most of November. The S&P500 lost almost 10% between its October 27th high and its November 25th low, as the markets reacted to soaring eurozone sovereign spreads and finally to the failed German "bund" auction. Nevertheless, the markets rallied at the end of the month, with the S&P500 jumping by 6.4% in the last three trading days of November as optimism mounted about official intervention. Six central banks (the Fed, the ECB, the Bank of England, the Bank of Canada, the Swiss National Bank and the Bank of Japan) agreed to extend the maturity and lower the cost of their dollar swap lines to provide dollar liquidity to the European banking system. At the same time, the People's Bank of China (PBOC) eased its monetary policy in the face of falling real estate prices and a slowing economic momentum. The market has continued on its momentum in the first week of December.

Fig.3: <u>The GIPSIs</u>



However, the dollar liquidity injection is only a band-aid that had been tried twice in the past three years, and is likely to only have a limited impact on the eurozone banks, which are relying almost entirely on the ECB for liquidity. In addition to the need for significant amounts of new capital, the European banks face a refinancing need of $240 billion for bonds maturing in 2012. In a related development, several global US banks will be required to complete a new stress test in the next few weeks on a downside European scenario.

Fig.4: Standard & Poor's 90-day Sectoral Performance (end-November)



US Treasuries have benefitted from the flight to (a relative) safe haven, with 10-year yields falling briefly under 2% before settling around 2.10% in the past few days.

Despite the preponderant impact of eurozone news, the markets have also been attuned to US economic conditions. Corporate profits remained strong, rising 6.5% year-on-year (y/y) in 3Q11 from 0.3% in the previous quarter. Bank earnings also rose for the 9th consecutive quarter (for the FDIC insured banks), increasing by 49% q/q in 3Q11. However, the improved performance of the financials has failed to impress markets, who continue to be concerned by earnings and asset quality and regulatory pressures. Clearly, since the beginning of the eurozone debt crisis 18 months ago, the "risk-on, risk-off" cycle has shortened, leading to an increased volatility in the equity markets. In the past few months, market sentiment has shifted back and forth between "cyclical" and "defensives", with the cyclical getting thrashed in the latest monthly cycle. Under these circumstances, a steady hand and trading on "hope" seems to be the best option.

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November 2011 Economic Data

Data Releases	Column2	Column3	Column4	Column5	Column6
	Column2		Column3		
November 2011	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (3Q11, % Annualized-1st revision	2.5%		2.0%		
CPI (m/m) Oct	0.3%	0.0%	-0.1%	-0.1%	0.2%
Core CPI (% m/m) Oct	0.1%	0.1%	0.1%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) (Sep)	0.1%		1.4%		
Imports (% m/m) (Sep)	-0.2%		0.3%		
Trade Deficit $ billion (Sep)	$43.1	$46.3	$43.1	$43.1	$44.2
Current Account Deficit ($ billion) (2Q11)					
Industrial Production					
Empire State (Nov	-8.48	-2.60	0.61	-7.20	2.20
Philadelphia Fed (Nov)	8.7	9.0	3.6	2.0	14.3
ISM-Mfg Sep	50.8	51.5	52.7	50.5	52.5
Chicago PMI (Nov)	58.4	59.0	62.6	56.0	60.0
Industrial Production (% m/m) Oct	-0.1%	0.4%	0.7%	0.3%	0.8%
Durable Goods (m/m) Oct	-1.5%	-1.0%	-0.7%	-2.1%	1.2%
Durable Goods (y/y)	4.3%		7.5%		
Durable Goods, ex transp (m/m)	1.7%	0.6%	0.7%		
Durable Goods, ex Transp (y/y)	7.1%		11.7%		
Inventories (m/m) Oct	0.4%	0.2%	0.0%	-0.1%	0.5%
Factory Orders (m/m) Oct	0.3%	-0.3%	-0.4%	-1.1%	0.7%
Services					
ISM non-mfg Oct	52.9	53.9	52	51.5	54.6
Consumer Spending					
Retail Sales (% m/m) Oct	1.1%	0.2%	0.5%	0.2%	0.5%
UMich Consumer Sentiment Nov	64.2	64.6	64.1	63.5	66.0
ConfBd Consumer Confidence (Nov)	39.8	45.0	56	41.0	46.0
Personal Income (m/m) (Oct)	0.1%	0.3%	0.4%	0.1%	0.5%
Personal Income (y/y) (Oct)	4.4%	4.0%	3.9%		
Consumer Spending (m/m) (Oct)	0.7%	0.3%	0.1%	,002	0.5%
Consumer Spending (y/y) (Oct)	5.2%		4.7%		
Housing Market					
Housing Starts ('000) Oct	630	605	628	580	640
New Home Sale ('000) Oct	303	310	307	300	320
Existing Home Sales (MM) Oct	4.91	4.80	4.97	4.69	5.15
Case Shiller-20 (m/m) Sep NSA	0.0%	0.1%	-0.6%	-0.2%	0.2%
Case Shiller-20(y/y) Sep	-3.8%	-3.0%	-3.6%		
Employment					
First Time Claims ('000) (Last Week Nov)	396	391	402	385	405
Non-Farm Payroll Oct	120,000	131,000	120000	90,000	175,000
o/w Private Sector Oct	117,000	150,000	140000	111,000	190,000

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