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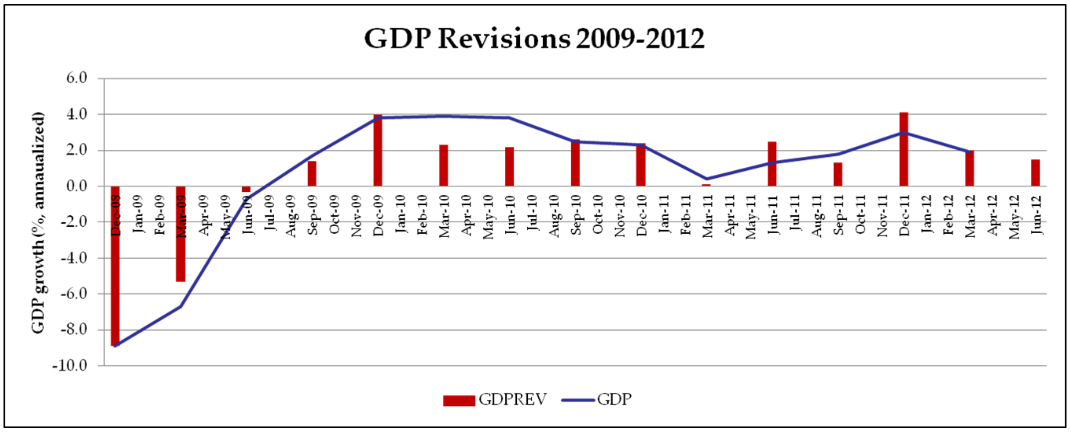
Advocacy Investing®

THE RAIN IN SPAIN…

- **Sharp loss of momentum…**
- **..but, a positive surprise on the July payrolls may indicate some bounce**
- **The eurozone financial crisis continues to be the major downside risk…**
- **… but deep policy divisions prevent a quick solution to the problem**
- **No clear trend in the economy, expected to continue to perform below potential**
- **The Fed and the European central Bank (ECB) stand ready to act**
- **The markets holding at high levels despite the onslaught of bad news**

Economic growth slowdown: The Bureau of Economic Analysis (BEA, US Department of Commerce) released its first estimate of 2Q12 growth. The economy grew at an anemic 1.5% annualized rate, its slowest pace since 3Q11. The growth number for 1Q12 was revised upwards from 1.9% to 2.0%. A faltering consumer was the main reason for the slowdown in growth, while government continued to be a drag. The BEA also revised past GDP numbers all the way back to 1Q09. The revisions indicate that the 2008-09 recession was not as severe as earlier reported (GDP fell by 4.7% between Dec 2007 and June 2009, not 5.1% as estimated earlier), but also that the recovery was slower (GDP rose by only 2.4% in 2010, down from a reported 3%).

Fig. 1: A Slower Recovery



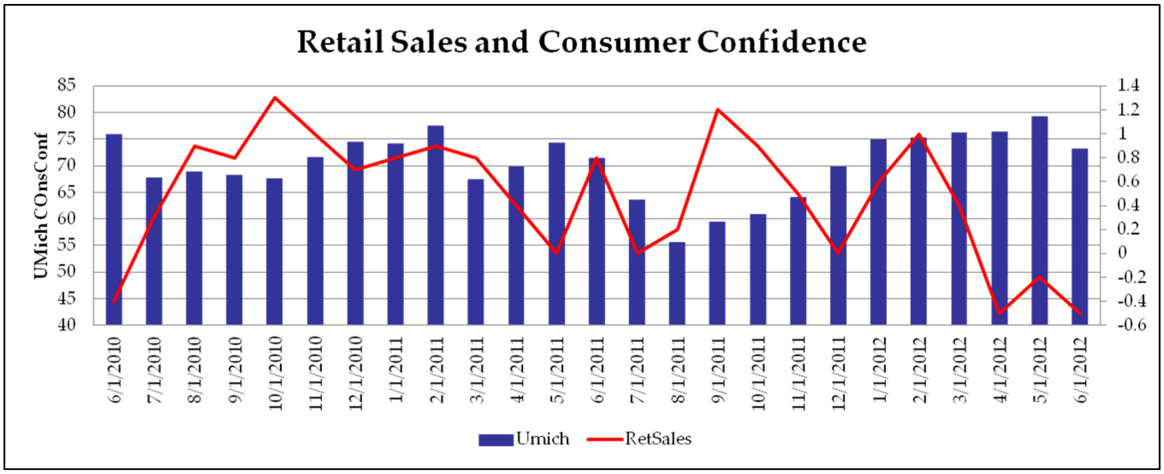
This subpar economic performance, which points to a significant loss of momentum, is also reflected in the July economic data releases. The picture on the household sector is mixed. The July University of Michigan-Reuters measure of consumer confidence fell to 72.3 in the second half of July from 73.5—and a peak of 79.3 in May 2012--while retail sales declined by 0.5% month-on-month (m/m), the third consecutive monthly decline. Nevertheless, there was some improvement at the end of the month, with the Conference Board measure of consumer confidence rising from 62.7 at the end of June to 65.9, and personal income up 0.5% (m/m) in June. However, personal consumption expenditures were flat in June, reflecting a rise in the savings rate to 4.5% from 3.5% at year-end 2011.

Table 1: GDP Growth Composition

Date	Mar-11	Jun-11	Sep-11	Dec-11	Mar-12	Jun-12
Private Consumption	3.1	1.0	1.7	2.0	2.4	1.5
Gross Private Investment	-5.3	12.5	5.9	33.9	6.1	8.5
Government	-7.0	-0.8	-2.9	-2.2	-3.0	-1.4

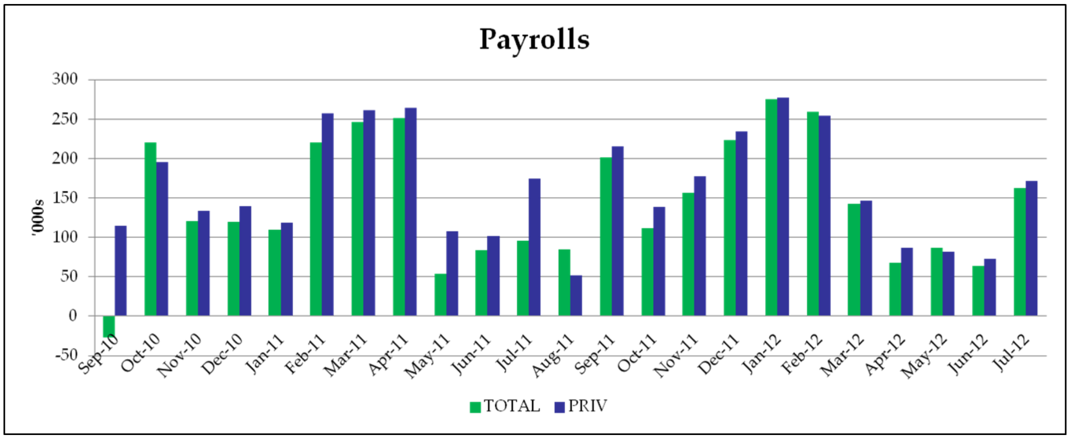
Both surveys and realizations indicate continued weakness in industry and manufacturing. Industrial production rose by 0.4% m/m while factory orders fell by 0.5% m/m. Durable goods increased by 1.6% m/m in June, mostly on the strength of transportation—ex-transportation, they fell by 1.1%. The forward-looking surveys were weak: the Empire State index rose to 7.39, and the Philadelphia Fed remained negative (although less so) at minus 12.9. The Chicago PMI rose unexpectedly to 53.7 from 52.5 the previous month, but the ISM-Manufacturing index remained below 50 (49.8) in July, for the second month in a row. Services, however, continued to expand, with the ISM-Nonmanufacturing index rising to 52.6 from 52 in the previous month.

Fig. 2: A Cautious Consumer



An unexpected jump in payrolls: The job markets provided a welcome positive surprise. Payrolls in July expanded by 163,000, significantly above the June result (which was revised downwards to 64,000), as well as above the market consensus of 100,000. Private payrolls expanded by 172,000. The job gains were across the board: manufacturing was up by 25,000 and private services by 148,000. The job gains in July bring the three-month moving average up to 105,000 (from 73,000 in June). Hours worked remained stable at 34.5, and hourly wages rose by 0.1% (m/m). The unemployment rate, which is derived from the household survey, showed a slight deterioration from 8.2% to 8.3%, and the participation rate also fell slightly to 63.7%. At the same time, high-frequency data indicates some stabilization. First time jobless claims in the last week of July rose slightly to 365,000, but the 3-month moving average trend has been downwards in the past few weeks. Moreover, despite the negative economic news, this statistic has not been worsening and remains under 400,000. However, we should not read too much into the much-improved payrolls report. It indicates at best a shift from the slowing economic momentum towards stabilization at a below-trend cruising speed. At this pace, jobs growth merely keeps up with population increases, we need a doubling of that pace to make a serious dent in the unemployment rate and two or three months of improved data to confirm the shift in trend.

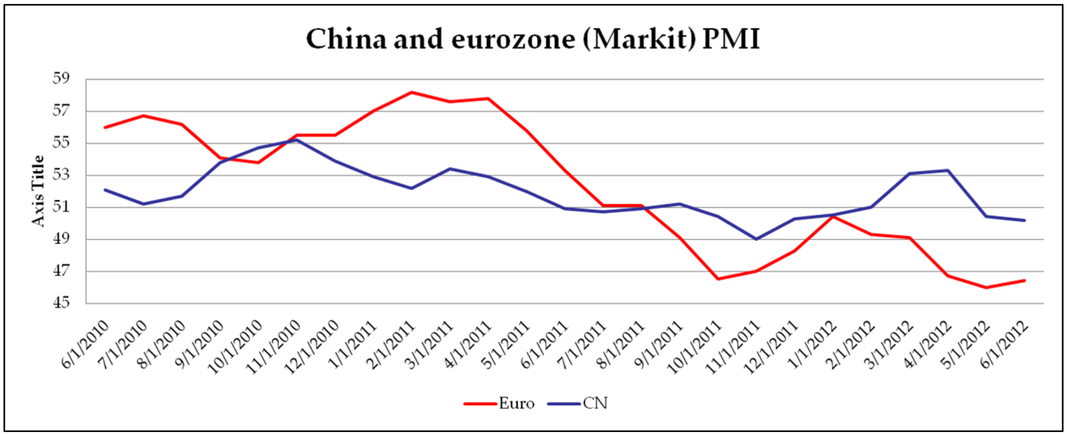
Fig. 3: Payrolls



The European Albatross: The economic outlook is dominated by increasingly negative developments in Europe, which threaten to drag down the US into recession. A deceptively calm period in the past few weeks has come to an end in Europe, with new and unexpected layers of crisis emerging as events unfold. The situation in Spain is rapidly deteriorating. What started as a bailout program for the country's "Caja's" (Savings and loans companies) is morphing into a full blown sovereign debt crisis. A €100 billion European rescue package for Spain's banks and the additional austerity measures introduced by the Spanish government failed to impress financial markets, which pushed Spanish bond yields to danger zone levels of almost 8%. The situation has now been complicated by the need to bail out heavily indebted Spanish regional and local governments. At the same time, talks between the EU and the Greek government are hitting an impasse, putting in doubt the next much needed disbursement of funds to Greece and raising the specter of a partial Greek default.

The economic news out of Europe is equally negative. The eurozone is now sinking into its second recession since 2008, with the economic slowdown that began in the periphery now spreading to the core countries. Industrial output in the eurozone was down in July for the 11th consecutive month, and the forward-looking eurozone Markit PMI remained below 50. The UK is in a much sharper-than-expected recession, with GDP down 0.7% (annualized) in 2Q12.

Fig. 4: Global Slowdown



Citing the rising uncertainty for the eurozone outlook, the negative consequences of a potential Greek exit from the euro and the massive cost of bailing out Spain and possibly Italy—costs that would have to be borne by the northern tier countries—Moody's downgraded the outlook of three out of the four remaining eurozone AAA countries (Germany, Netherlands and Luxembourg) to "negative"—only Finland was spared.

Recent talks have yielded some progress on reaching common ground among European governments in planning greater banking, financial and fiscal integration, though these same governments are not moving fast enough to address the urgent issues facing the union. The election of a Socialist president and government in France has only served to highlight the deep differences between Germany and northern European countries on one hand and France and southern Europe on the other. Nevertheless, there seems to finally be some degree of panic emerging in Brussels, Frankfurt and Berlin, which was reflected in the recent statements by the main European leaders. Mario Draghi, the European Central Bank president, has stated that the ECB stands ready to do all within its mandate to salvage the euro. The markets interpreted his comments as a signal that the central bank stands ready to purchase Spanish (and if needed Italian) government bonds. The German Chancellor Angela Merkel and the French President Francois Hollande have added their voice to the chorus, promising to take all steps necessary to save the euro.

European bond markets responded positively to these commitments, and we have seen Spanish and Italian bond yields drop sharply in the last days of July. However, the policymakers will be judged by their acts, not words, and bond markets will remain edgy for the foreseeable future.

Has Housing Reached a Bottom? Housing seems to be on an improving path, although the data there is mixed. The FHA housing price index rose by 0.8% (m/m) in May, up by 3.8% year-on-year (y/y). Housing starts increased. Existing home sales declined, but that was due in part to a decline in the inventory of homes and homeowners expectations of higher prices. New home sales also fell in June from a 10-month high in May to 350,000. On the other hand, the Case-Shiller 20 city price index rose by a strong 0.9% m/m in May, the 4th consecutive monthly increase-with price rises in 18 out of the 20 cities.

Buying Time: Central banks cannot fix structural economic problems; neither can they substitute for fiscal policy. All they can do is buy time for policymakers. Moreover, both the Fed and the ECB have reached the limits of conventional central bank intervention—benchmark interest rates are close to zero—and the effectiveness of quantitative easing declines with each new round. Nevertheless, in the absence of credible economic policies beyond self-defeating austerity, the monetary authorities remain the only game in town. Coincidentally, both the Fed and the ECB had monetary policy meetings in the last week of July.

The Fed: In line with market expectations, the Fed did not announce any major initiatives at its July 30-31 FOMC meeting. The FOMC acknowledged that the economic picture had deteriorated and restated that the Fed stood ready to take additional steps. In the meantime, the Fed will continue its "Operation Twist" (extending the maturity of its portfolio by simultaneously selling short-term and buying long-term government securities), and its existing policy of reinvesting principal payments from its holdings of agency debt and mortgage-backed securities into additional agency mortgage-backed securities. So, there was no new quantitative easing announced for the time being, just monitoring of the situation.

The ECB: In the absence of decisive action by the eurozone to address its problems, the burden of crisis management is on the ECB, especially since Draghi committed himself to a major expansion of the role of the central bank. Draghi took on a gamble, and needs to convince financial markets that he has the policy tools required to dampen the sovereign debt problems of the largest European debtors. His main tool, the direct purchase of sovereign bonds, has been opposed by Germany. The alternative would be to transform the European Stabilization Mechanism, the main bailout fund—into a bank and buy its bonds. In either case, the ECB would end up monetizing the debt of the eurozone periphery countries. Nevertheless, Draghi disappointed the markets, which were expecting decisive action by the ECB at its August 2 meeting. Instead, under pressure from the Bundesbank, the ECB merely stated that it stood ready to take strong action. But even that commitment would be conditional upon the countries having a credible economic plan and access to funds from the European Financial Stabilization Fund (EFSF), after which the ECB would proceed to purchases of bonds in the secondary markets. The markets remained unconvinced.

An Oil Boost: Oil prices have been volatile, reacting to event risk. The slowing global economy, the European recession and concerns over US growth have pushed oil prices down, while supplies are abundant. Brent crude remained under $100/barrel (bbl) for most of the month of June, and at around $104/bbl at the end of July, is still 12% below its 2012 peak. West Texas (WTI) crude has mostly been under $90/bbl, a 19% drop from its 2012 high at the end of February. In the face of unchanged demand and supply conditions and subdued geo-political risks, oil prices (WTI) are expected to remain volatile in the $85-95/bbl range over the next few weeks.

A Trendless Economy: The economic recovery is anemic and doesn't seem to be trending in either direction for the time being. The world is facing a synchronized slowdown driven by three factors: 1) both the United States and Europe are on an austerity diet; 2) the banking systems in both areas are not functioning—if anything, credit is shrinking in Europe; and 3) there is a lack of global economic coordination at a time when it is badly needed.

Moreover, the medium-term economic outlook is weighed down by several factors: a worsening of the European sovereign debt and financial crisis; the slowdown of the Chinese economy; the rise in geo-political risks in the Middle East; and the potential for a "fiscal cliff" next year in the Unites States. On top of this, the most severe drought in the US since the 1930s is expected to have negative impact on inflation, further squeezing the US households. Nouriel Roubini, (aka Dr. Doom), a famously pessimistic economist, has dubbed this confluence of factors a "perfect storm" that should lead to another recession in 2013. Another influential market analyst, Pimco's Mohamed el-Erian, warns that the US economy might be slowing to a stall speed.

The European financial crisis remains the dominant concern as it continues to destroy wealth and drives down business and consumer confidence worldwide. Weak consumer and business confidence and stubbornly high unemployment have resulted in a softening of demand in the past three months, a softness that is expected to continue in the near term, at least until we get better employment numbers. Nevertheless, there are some mitigating factors to the economic pessimism:

- Oil prices remain low
- The expenditure cuts and tax increases of the so-called "fiscal cliff" are going to be gradual. Moreover, it is likely that a compromise will be reached regardless of who occupies the White House and the Capitol next year
- The Fed is likely to intervene more forcefully in the near future with additional monetary stimulus
- European leaders, who have committed themselves to saving the euro, will have little choice but to avoid a full-blown crisis in either Greece or Spain
- Despite an expected slowdown, emerging markets are still in good shape and have ample room for both fiscal and monetary stimuli. Moreover, Chinese industrial production is inching upwards, a sign that the economy is back on track.

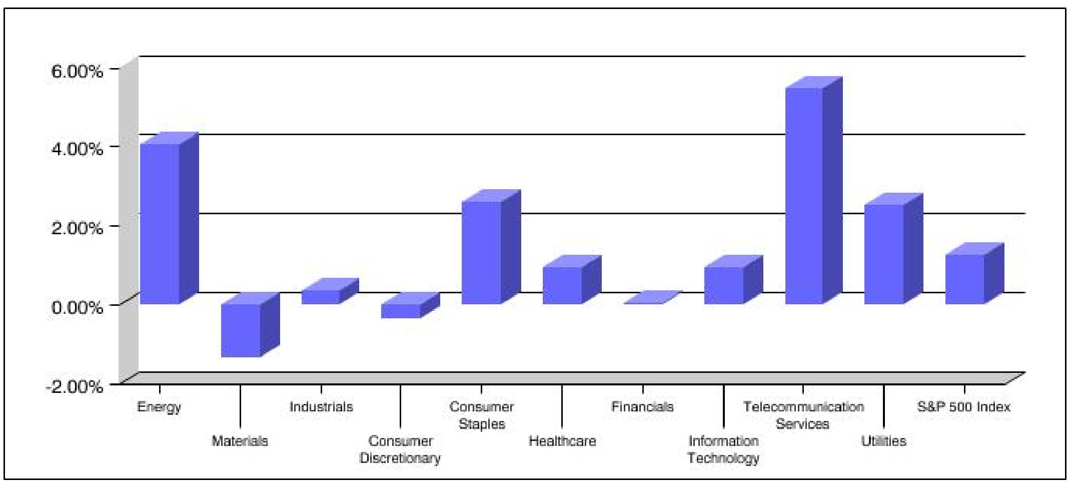
So, while our analysis indicates that muddling through continues to be the main scenario, there are no obvious game-changing factors on the upside. The U.S. economy has shown a surprising degree of resilience, but does not seem to be able to exit from a crawling pace of economic growth.

A Perfect Storm? Equity markets have been hard to fathom. On one hand, they are suffering from a bad case of economic blues, remaining extra-sensitive to event risk. On the other, the major indices are clinging stubbornly to key benchmark levels, while the divergence between valuations and macroeconomic fundamentals has widened significantly--how can we justify a DJIA of 13,000-plus while US growth is anemic, Europe is in recession and 2Q12 earnings are disappointing?

Global and U.S. shares were initially walloped by the stream of bad news from Europe's crisis countries and evidence of a weakening US economic outlook. Nevertheless, the S&P500 has been on a saw-tooth rising trend since hitting a 2012 low of 1,278 on June 2, gaining 8.4% to 1.385 by the end of July.

Second quarter earnings have been mixed--bell-weather stocks such as UPS and Apple being hit by below-expectation earnings, while others such as Caterpillar showing strong earnings performance. However, while 73% of the S&P companies releasing results have met or beat (more modest) expectations, earnings have been flat in 2Q12, and are expected to remain so in the next few months. For one thing, the global slowdown has hit the bottom line of US multinationals, from which foreign operations provide 50% of earnings.

Fig. 5: <u>S&P 30-day Sectoral Performance (July)</u>



The sectoral performance is very volatile, although defensive stocks have generally fared better. Financials are particularly vulnerable, as are luxury goods. With no clear macroeconomic or market game changer, the strategic position should remain defensive until at least after the November election.

July 2012 Economic Data

Data Releases					
July 2012	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (2Q12, % Annualized) 1st estimate	2.4%		1.5%		
CPI (m/m) June	-0.3%	0.0%	0.0%	0.0%	0.5%
Core CPI (% m/m) June	0.2%	0.2%	0.2%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) (May)	-0.2%		0.9%		
Imports (% m/m) (May	-1.6%		-0.7%		
Trade Deficit $ billion (May)	$50.6	$48.70	$48.70	$42.50	$51.50
Current Account Deficit ($ billion) (4Q11)					
Industrial Production					
Empire State (Jul)	2.29	4.5	7.39	-8.0	6.0
Philadelphia Fed (Jul)	-16.6	-8.0	-12.9	-15.0	-2.0
ISM-Mfg Jul	49.7	50.1	49.8	48.5	51.5
Chicago PMI (Jul)	52.9	52.5	53.7	49.0	54.3
Industrial Production (% m/m) Jun	-0.2%	0.3%	0.4%	-0.1%	0.5%
Durable Goods (m/m) Jun	1.6%	0.6%	1.6%	-1.4%	2.1%
Durable Goods (y/y)	4.6%	5.1%	8.0%		
Durable Goods, ex transp (m/m)	0.8%	0.2%	-1.1%	-0.7%	1.1%
Durable Goods, ex Transp (y/y)	3.6%	4.1%	3.1%		
Inventories (m/m) June	0.3%	0.3%	0.3%	0.0%	0.5%
Factory Orders (m/m) Mar	0.5%	0.7%	-0.5%	-0.5%	1.1%
Services					
ISM non-mfg Feb	52.1	52.0	52.6	51.5	53.0
Consumer Spending					
Retail Sales (% m/m) Jun	-0.2%	0.2%	-0.5%	-0.2%	0.4%
UMich Consumer Sentiment Jul	73.2	73.5	72	70	76.5
ConfBd Consumer Confidence Jul	62.7	61.5	65.9	59.0	65.0
Personal Income (m/m) Jun	0.3%	0.4%	0.5%	0.2%	0.5%
Consumer Spending (m/m) Jun	-0.1%	0.1%	0.0%	0.0%	0.3%
Housing Market					
Housing Starts ('000) Jun	711	745	760	720	800
New Home Sale ('000) Apr	382	370	350	358	385
Existing Home Sales (MM) Jun	4.62	4.65	4.37	4.60	4.79
Case Shiller-20 (m/m) SA May	0.7%	0.5%	0.9%	0.0%	0.8%
Case Shiller-20(y/y) May	-1.9%	-1.4%	-0.7%	-2.6%	0.6%
Employment					
First Time Claims ('000) (Last Week Jul)	357	370	365	340	380
Non-Farm Payroll (Jul)	84,000.00	100,000.00	172,000	70,000	165,000
o/w Private Sector (Jul)	73,000.00	110,000.00	172,000	80,000	180,000

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.