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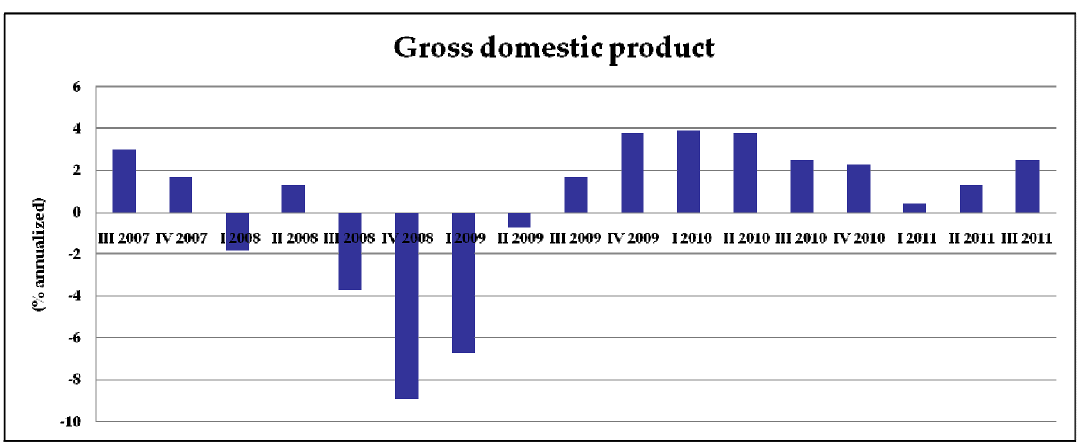
Advocacy Investing®

MERKEL'S BAZOOKA

- **The European leaders unveil a financial "Bazooka", but fail to impress the markets**
- **US 3Q11 GDP rises by 2.5%, reflecting gradually improved economic data**
- **Nevertheless, the Fed downgrades its medium-term forecast and stands ready to deploy more instruments**
- **The labor markets improve very slowly**
- **The major downside risks in the medium-term are a European recession and excessive US fiscal tightening**
- **A strong October market performance could extend to year-end**

The month of October ended on a positive note. First, European leaders, prodded by the IMF, the United States and Chancellor Merkel, have approved a significant program to alleviate the sovereign debt crisis. Second, the US economy reaccelerated in the third quarter of the year, albeit modestly. In combination, this led to a strong market rally in the last week of the month, the best week since 1987.

Fig. 1: <u>US GDP</u>



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Merkel's Bazooka meets Greek Confusion: The European leaders finally bowed to reality and agreed on the outlines of a sovereign debt package—Merkel's bazooka. The elements of the package are as follows: 1) an increase of the European Financial Stabilization Fund (EFSF) from €440 billion to €1 trillion; 2) a massive write-off of Greece's sovereign debt; and 3) allowing the use of the EFSF to recapitalize the European banks. These banks, which had initially agreed to a 21% reduction in the face value of their Greek debt holdings, were eventually forced to agree to a 50% cut. The deal represents a major victory for Chancellor Merkel and Germany, who had argued all along that the bondholders would not be bailed out. It also represents a victory for economic common sense. From the outset, it was clear that Greece was insolvent, and that kicking the can down the road was not a viable option. Nevertheless, the new European package is only in its preliminary stages, and will take weeks to take shape. In particular, the funding of the EFSF remains a key question, and will need contributions from major emerging market countries. Moreover, the Greek government threw a spanner in the works by announcing that it would put the austerity package to a referendum. While it is not exactly "back to square one", the unexpected Greek move has made the other tasks of the eurozone leadership—recapitalizing the banks and ring fencing the illiquid, but not insolvent European governments—more difficult. In recent developments, Greece, faced with a potential exit from the euro, has backed off from a disruptive referendum and is on the verge of forming a national unity government.

The Consumer Returns: After a dismal first half of the year (with economic output rising by 0.9%, annualized) and a bleak start to the third quarter, the economy rebounded somewhat in September, resulting in GDP growth of 2.5% (annualized) for 3Q11. While the rebound remains unimpressive, it has at the very least allayed fears of a double dip recession. The improved economic picture was driven by the acceleration in personal consumption expenditures (PCE, +2.4% annualized), as well as fixed investment (+13.7%). Furthermore, government expenditures stabilized and the fiscal drag faded. As a result, nominal GDP has returned to the pre-recession level of $13.35 trillion.

Not as Weak: Data releases continued to improve in September, especially in manufacturing. Industrial output was up 0.2% (month-on-month, m/m), durable goods ex-automobiles increased by 1.7%. While the Empire State survey remained negative, the Philadelphia Fed returned to positive territory (+8.7) after two negative months. Factory orders rose by 0.3% m/m, signaling strength in final demand. The Chicago PMI was down in October (58.4 vs 60.2), but still solidly over 50. The ISM-Manufacturing Index weakened to 50.8, but new orders ISM rose sharply. Personal income rose 0.1% (m/m), but PCE increased by 0.6% (the saving rate fell to 4.2%), while retail sales increased by 0.3%. The consumer confidence measures were mixed, with the Conference Board Index dropping to 39.8, while the University of Michigan-Reuters rose from 57.7 to 60.9. The "Beige Book" indicated that all 12 Federal Reserve districts showed modest increases in economic activity, led by manufacturing. ISM non-manufacturing was essentially unchanged at 52.9, but still above 50.

The housing market remains flat. According to the Case-Shiller 20-city index, house prices were unchanged in August. New home sales increased slightly, while existing home sales (a more significant indicator) fell. The Obama administration proposed new measures to allow home-owners with underwater mortgages to refinance more easily, but the impact of these changes on home prices is some way off. Nevertheless, construction spending has been inching up for the second month in a row. Despite record low mortgage rates, the demand for mortgages remains weak and refinancings are estimated to be less that $800 billion in 2011, down from $1 trillion the year before.

A Subdued Labor Market: High frequency labor market data (First-time Jobless Claims) have been pointing in the right direction, showing a steady level in the past few weeks of about 400,000, dropping to 397,000 in the first week of November. However the October payrolls number was still relatively low, with total non-farm payrolls rising by just 80,000—104,000, new private sector jobs were offset by 24,000 job losses in the government sector. Private sector jobs showed modest improvements across the board with the exception of construction. Moreover, data for the previous two months was revised upward by 102,000, leading to an average monthly job creation of 122,000 for the August-October period. Unemployment declined to 9% from 9.1%, weekly hours worked were unchanged at 34, and hourly wages rose by 0.3% (m/m). Long-term unemployment and part-time employment also fell. Overall, the data showed a slow and steady (but clearly insufficient improvement) in the labor market picture.

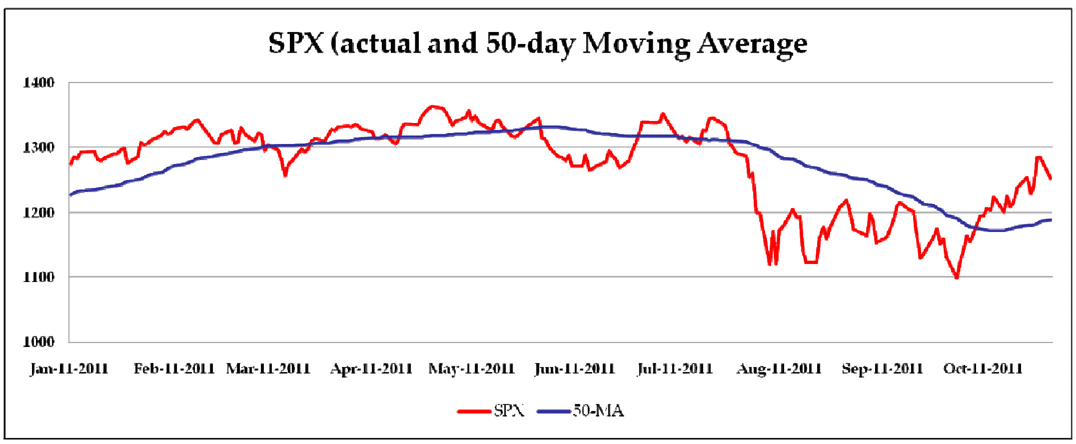
The Fed Downgrade: The Fed downgraded growth prospects in its semi-annual economic forecast after the latest FOMC meeting on November 2nd. GDP is now projected to grow by only 1.6-1.7% in 2011 and 2.5-2.9% in 2012, with growth not expected to return to over 3% until 2013. The unemployment rate is no longer expected to fall below 8.6% this year, but should fall to 7.8-8.2% by the end of 2012. While recognizing the slight improvement in economic conditions, the FOMC and Fed Chairman Bernanke reiterated that economic conditions remain weak with significant downside risks. Bernanke also reiterated that further stimulus measures would be considered down the road. Since 2008, the Fed has purchased $2.3 trillion in securities in two rounds of quantitative easing.

Commodities have rallied, with oil prices (WTI) up 22% to about $93/barrel since their recent lows in early September. Fortunately, this has not translated in higher gasoline prices as a result of a favorable US inventory situation.

The G-20 Meeting: The G20 leaders gathered in Cannes face difficult choices. The key issue will be containing the sovereign debt crisis. Moreover, the global economy is slowing down. The JPMorgan Global PMI did rise slightly to 50.5 in October, its first time over 50 since February, but the decline in the PMI in Europe and China indicates that stresses on the global picture continue. Meanwhile, most indicators in the eurozone are down, and it seems unlikely that the area will avoid another downturn in the months to come. More than ever, the G-20 needs active policy coordination. Unfortunately, the Cannes summit was overshadowed by short-term crisis management and ended without resolving any of the longer-term issues—the role of the IMF, financial help from the emerging markets, economic coordination and dealing with global inbalances.

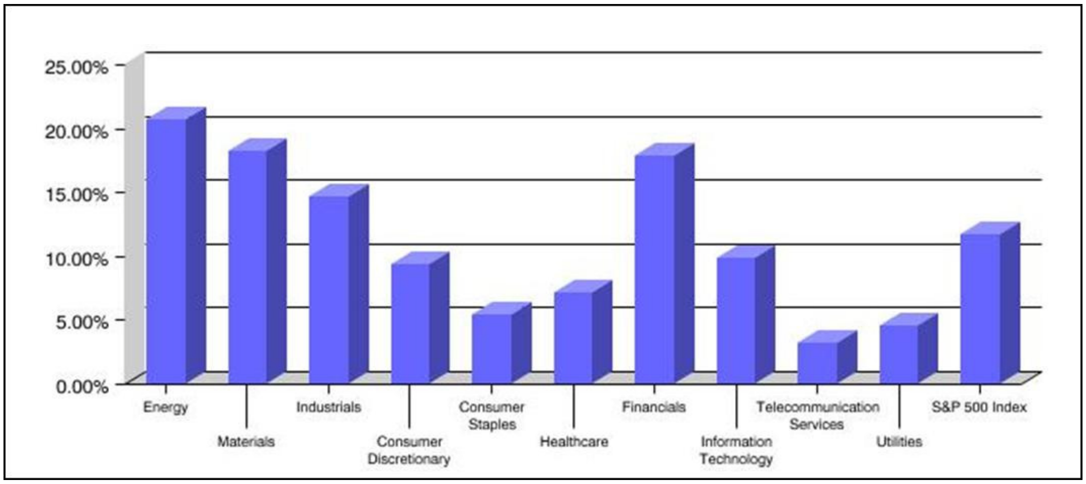
A Modest Forecast: While the data stream has improved, some of the elements of the improved 3Q11 performance may prove difficult to project into 4Q11. The economy is out of its mid-summer doldrums, oil prices are off their highs and the consumer has shown some degree of resilience. However, inventories are relatively high, and sustaining consumer spending might be difficult to maintain absent an improvement in the employment situation. Moreover, the economy faces two continuing headwinds. The first is the unresolved European crisis and the second is the threat of a significant fiscal drag in 2012. Nevertheless, we expect stronger business capital expenditures, a positive equity market and a steady growth of personal consumer expenditures to support growth of 2-2.5% (annualized).

Fig.2: S&P500 above 50-day Moving Average



The Troika of Worries: This term was coined by the business economist Ed Yardeni, referring to the eurozone, the United States and China. Markets rebounded from the deep pessimism of September on the strength of improved US data, strong 3Q11 earnings performance and yet another European package. The S&P 500 rose by 6.7% between October 3rd and the 30th, with only seven down trading days. A total of 220 companies out of the 295 S&P 500 reporting companies have exceeded forecasts, with aggregate profits rising by 19% (year-on-year). The improvement has been led by cyclical companies. Based on this sample, the S&P aggregate profit is at about $100/share, which leads to an average P/E of 12.4, significantly below its historic 15. Moreover, the S&P 500 has been trading above its 50-day moving average since the beginning of October, another sign of a strengthening rally. Under these circumstances, an S&P move to the 1.300-1,400 range by year-end is quite possible.

Fig.3: **S&P Sectors-October 2011**



The markets were unfazed by the apparent unraveling of the Greek bailout. Both US and European markets fell sharply after the announcement of the Greek referendum—later scotched by the Greek government—but have rebounded since. Moreover, it would seem that the main external market movers—a Greek default, the recapitalization of European banks and a sharp European slowdown—have already been priced into the markets. It is still too early to say that we have returned to a market trading on fundamentals and there could still be many potential pitfalls and surprises in store for us. We could very well be moving in that direction however, in which case we should see cyclical stocks return to center stage.

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October 2011 Economic Data

Data Releases

October 2011	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (3Q11, % Annualized)	1.3%	2.5%	2.5%	1.8%	
CPI (m/m) Sep	0.3%	0.3%	0.3%	0.0%	0.4%
Core CPI (% m/m) Sep	0.2%	0.2%	0.2%	0.0%	0.0%
Balance of Payments					
Exports (% m/m) (Jul)	3.6%				
Imports (% m/m) (Jul)	-1.1%				
Trade Deficit $ billion (Jul)	45.6	46.0	45.6	42.6	48.3
Current Account Deficit ($ billion) (2Q11)	118.0				
Industrial Production					
Empire State (Sep)	-8.82	-3.25	-8.48	-7.50	0.00
Philadelphia Fed (Sep)	-17.5	-9.8	8.7	-1.0	5.0
ISM-Mfg Sep	51.6	52.0	50.8	50.9	53.0
Chicago PMI (Sep)	60.4	58.0	58.4	56.0	60.4
Industrial Production (% m/m) Sep	0.2%	0.2%	0.2%	0.0%	0.4%
Durable Goods (m/m) Sep	-1.0%	-1.0%	-0.8%	-2.5%	0.5%
Durable Goods (y/y)	12.3%		-0.8%		
Durable Goods, ex transp (m/m)	-0.4%	0.5%	1.7%	-1.0%	1.7%
Durable Goods, ex Transp (y/y)	7.8%				
Inventories (m/m) Sep	0.4%				
Factory Orders (m/m) Sep	-0.1%	-0.2%	0.3%	-1.0%	0.5%
Services					
ISM non-mfg Sep	53	53.5	52.9	52.2	54.0
Consumer Spending					
Retail Sales (% m/m) Aug	0.3%	0.8%	1.1%	0.4%	1.6%
UMich Consumer Sentiment Sep	57.5	58	60.9	57	59.0
ConfBd Consumer Confidence (Jul)	46.4	48.0	39.8	40.0	50.0
Personal Income (m/m) (Jul)	-0.1%	0.3%	0.1%	0.1%	0.5%
Personal Income (y/y) (Jul)	4.3%		4.4%		
Consumer Spending (m/m) (Jul)	0.2%	0.3%	0.6%	0.1%	0.5%
Consumer Spending (y/y) (Jul)	4.9%		5.3%		
Housing Market					
Housing Starts ('000) Sep	658	590	658	585	643
New Home Sale ('000) Sep	296	312	312	285	312
Existing Home Sales (MM) Sep	5.06	4.93	4.91	4.75	5.25
Case Shiller-20 (m/m) Aug SA	-0.1%	0.0%	0.0%	-0.3%	0.2%
Case Shiller-20(y/y) Aug	-4.2%				-3.8%
Employment					
First Time Claims ('000) (1st Week Nov)	406	400	397	399	406
Non-Farm Payroll Oct	158,000	90,000	80,000	64,000	152,000
o/w Private Sector Oct	191,000	120,000	104,000	100,000	168,000

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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.