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By: Karim Pakravan, Ph.D.

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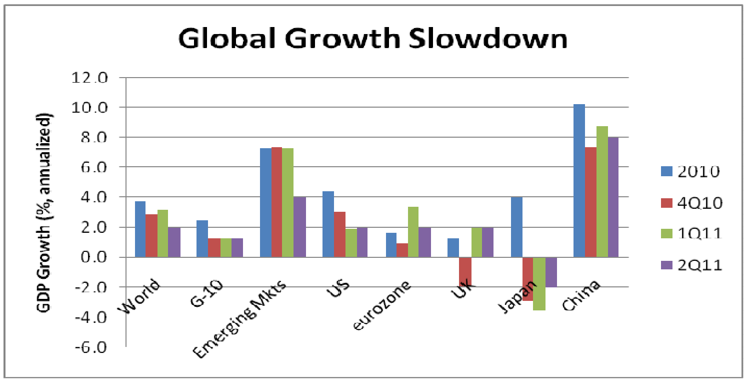
Advocacy Investing®

A LOSS OF MOMENTUM

- **Disappointing payroll data for the second consecutive month**
- **Global manufacturing growth falters in 2011, but seems to be regaining strength**
- **European debt crisis goes unabated as all 3 major debtors are downgraded to junk status**
- **Debt ceiling talks at an impasse**
- **With no clear trend or growth engine in the US economy, downside risks to the forecast are on the rise, although a double dip recession is unlikely**
- **Nevertheless, markets remain resilient, with the 12,000 level for the Dow holding**

The US economic recovery is soon to reach the 2-year point, but there is still little to celebrate. The final GDP revision puts 1Q11 economic growth at 1.9% (annualized), making this the weakest recovery since the Great Depression—although total output has regained its pre-recession levels. Policy paralysis has emerged as the major threat to the US and global economy. In the United States, the debt ceiling impasse continues as both parties dig in their positions despite warnings from economists across the political spectrum. In Europe, deep policy disagreements over a second rescue package have worsened the sovereign debt crisis and spooked global financial markets. However, there seems to be light at the end of the tunnel on both fronts. In Greece, the European Union agreed to extend new funds after the Greek parliament approved another austerity package, and European banks are moving towards a technical rescheduling with a tentative agreement to extend the maturities on about 70% of the €13.2 billion of Greek sovereign debt held by the banks that will be maturing over the next 2 1/2 years.

Fig 1: Global Growth Slowdown



The global economy at a turning point: Most indicators show a slowdown in global manufacturing. JPMorgan's Global PMI registered a fourth consecutive month of decline, falling to 52.2 in June from 52.7 the previous month. Emerging markets industrial production has faltered in East Asia, and the Chinese PMI was slightly down for May as the monetary tightening measures of the Chinese central bank start having an effect. At the same time, the recession in the eurozone periphery is dragging down European manufacturing performance at a time when growth is slowing in the core. As a result, we expect eurozone output growth to slow to about 1.5-2.0% (annualized) in both 2Q11 and 3Q11 from 3.4% in 1Q11. In particular, Germany is likely to come down from its record 6.1% growth rate achieved in 1Q11 to around 2.0%. Chinese growth should slow down to about 8-8.5% from the 12.4% reached in 4Q10.

A Slight Improvement: Dismal data readings in the beginning of June gave way to some improvement at the end of the month. The main area of weakness remains the consumer. Falling consumer confidence (reflected in both the University of Michigan/Reuters and the Conference Board Surveys) fell sharply in July to a 2-year low. While personal income was up by 0.5% month-on-month (m/m) in May, retail sales fell by 0.2% m/m and personal consumer expenditures were flat. The manufacturing surveys (Empire State and Philadelphia Fed) released earlier in the month were both in negative territory, but both the Chicago PMI and the ISM-Manufacturing published later in June showed a strong rebound. The positive trend in manufacturing was also reflected in an improved number for factory orders, up by 0.8% m/m in May. The Empire State survey for July, while still in negative territory, showed a much smaller contraction.

Housing Markets Mixed Data: for the first time in many months, housing market data releases showed a modest improvement. Housing starts and new home sales were all up, beating expectations, while existing home sales fell. The Case-Shiller 10 cities index increased by 0.8% m/m in April after months of decline.

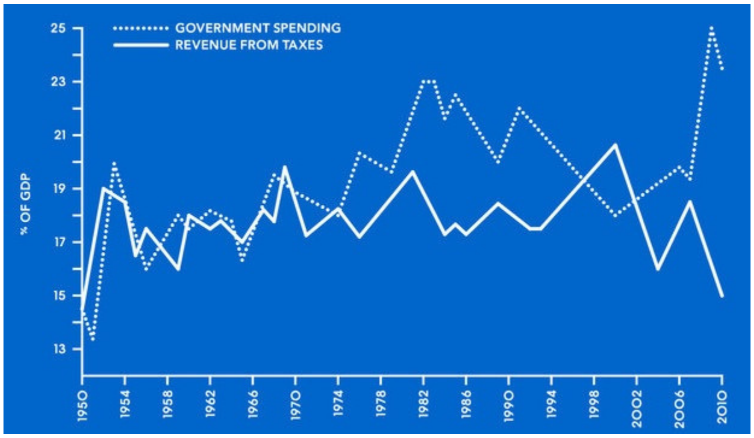
Not A Pretty Picture: For the second month in a row, we are faced with a dismal jobs report. Despite an improvement in high frequency labor market data and other positive signs, the June payroll number showed a meager 18,000 increase, with a sharp downward revision of the May number from 54,000 to 25,000. While the continued large cuts in government payrolls (minus 39,000 in June for a two-month total reduction of 87,000) played an important role, the labor market exhibited across-the-board weakness. Private payrolls rose by 57,000 for the month; manufacturing and private business rose modestly, while mining, construction and financial services all declined. Weekly hours worked fell by 0.1 hours to 34.3, hourly wages stagnated, and unemployment—which is based on the separate household survey—rose from 9.1% to 9.2%. Nevertheless, the high-frequency data continued to show improvement, with the first time unemployment claims dropping for the second consecutive week to 405,000 in the week of July 11.

Running out of bullets: The statement issued by the FOMC after its June 21-22 meeting reflected a decidedly gloomier view of the US economy. The FOMC sees lower-than- expected growth and higher-than-expected unemployment over the medium term. Since the beginning of the year, the Fed has downgraded its estimate of 2011 growth from almost 4% to about 3%, and now projects unemployment to fall to around 7% only by 2013. Moreover, in a tacit admission that there is little more that monetary policy can achieve, the Fed is not expected to introduce new monetary stimulus measures now that QE II has expired. However, the zero interest rate policy is to be maintained for the foreseeable future.

Oil Shock and Awe-briefly: The oil and commodity markets were in retreat over the past few weeks, with oil prices (WTI) down about 5% in the first half of June to around $95/barrel (bbl). When the early June OPEC meeting failed to increase oil quotas, the developed countries engineered a concerted intervention in the oil markets, announcing a 60 million barrel release of crude and products from their strategic reserves (of which 30 million barrels would be contributed by the US). This concerted action took oil markets by surprised, causing oil prices to drop by another $5, to around $90/bbl. This action, taken at the beginning of the summer driving season, should provide some relief to US consumers. However, the impact has been short-lived, and oil prices are back up above $96/bbl. Furthermore, the expectation of higher growth and limited oil supplies could lead to a tightening of oil markets by the end of 3Q11. Oil prices averaged $98.5/bbl in 1H11, 22% higher than in 2H10, and are forecast to be in the $95-100 range in 4Q11.

Debt ceiling talks: With less than a month to go before a technical default, both parties are under significant pressure from Wall Street to reach an agreement, and as the saying goes, “cooler heads” are expected to prevail. There is a broad agreement among economists that a failure to raise the debt ceiling would have serious consequences in both the medium and long term, and at the very least, on the so far rock-solid credibility of the US government with foreign creditors. Even Alan Greenspan weighed in on the debate. There is also a broad consensus on two more issues. First, you cannot reduce the deficit in the medium term without raising revenues.

Fig.2: <u>The Fiscal Chasm</u>



Second, deep spending cuts at a time of economic uncertainty are not advisable. The two parties continue negotiations on raising the Federal debt ceiling, with August 2 as the deadline. A failure to raise the debt ceiling will not however have immediate consequences from a technical point of view. The Treasury faces two major interest and principal repayment dates in the short term, August 15th and November 15th. Meeting the August payments will require some creative accounting and juggling, but should not be an issue. The real impact would be felt through an immediate negative bond markets' reaction leading to sharply higher interest rates and an equity markets reversal if the impasse continues beyond November. In the meantime, the rating agencies have raised the ante, with both Moody's and Standard & Poors threatening to downgrade the US sovereign debt rating if an agreement on raising the debt ceiling is not reached on time.

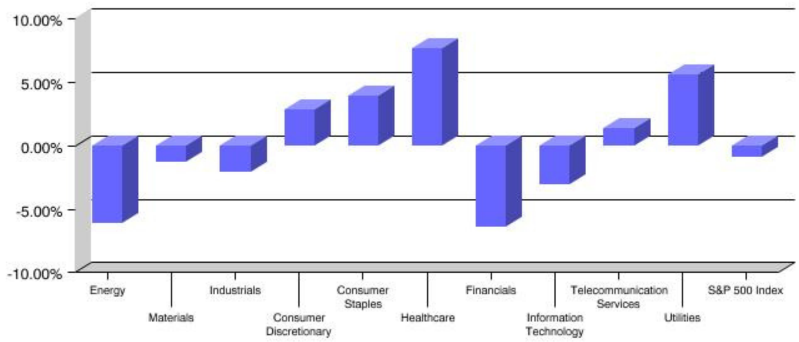
Economic Outlook: The dismal June payrolls report confirms that the economy is still struggling to regain momentum after several months of strong headwinds. Clearly, both the consumer and the business sector have experienced a weak second quarter, and the emerging virtuous cycle of improved consumer confidence, higher consumption, output and employment gains has not gained traction. At issue is whether the 1H11 slowdown is the bottom of the cycle or the beginning of a trend. Some of the headwinds experienced in the first half are expected to wane. A stabilizing of oil prices, albeit at a relatively high level, is a plus for consumer confidence. At the same time, the rapid post-tsunami recovery in Japanese manufacturing capacity and production is starting to ease the bottlenecks in the global supply chain. German manufacturing has shown a strong rebound in May, renewing confidence in the perception that global manufacturing has bottomed out. Chinese industrial production growth data for June have been strong. In combination with an end in inventory adjustment, this is expected to result in a stronger manufacturing output recovery. However, more than ever, the US recovery will be affected by external factors largely out of its control--the European sovereign debt crisis—as well as the domestic political gridlock. Each of these factors has a major impact on the country's economic prospects through the global financial markets. Moreover, with no clear engine for growth in 2H11, downside risks have risen. The consensus forecast for 2011 has been revised downward from 2.7% last month to 2.5%, which implies modest acceleration of economic growth to about 3-3.5% in 2H11 from 2% in 1H11.

A Market Seesaw: the market narrowly missed a technical correction, as the Dow fell by 9.3% between May 2 and June 15. However, gloom and doom over the on-going Greek tragedy and the stream of disappointing economic releases seems to be offset by continued faith in the consensus view of a stronger economic recovery in 2H11. As a result, while the major indices fell, the Dow managed to defend the 12,000 level. With the threat of an imminent Greek default removed (or at least postponed for a few months) in late June, the equity markets came back with a roar in the last two weeks of the month, only to be walloped again in the second week of July after the publication of the dismal payrolls report on July 8. This was followed by a 4-day winning streak in the week of July 11. The S&P however, remains above its 200-day moving average level. The last time it fell below its 200-day moving average was mid-May last year, which marked the beginning of a 3 1/2 month bear market that bottomed at the end of August 2010. However, in that case, the S&P 500 dropped about 18% before starting to recover at the end of summer. A similar correction this year would leave the S&P500 at around 1,100 by the middle of 3Q11, an unlikely event at this stage.

The bond markets seemed to shrug off both the end of QE II and the debt ceiling impasse. The 10-year yield actually fell by 55 basis points between April 8th and June 17th, dropping below 3%. Since then, it has continued to trade in a range close to that level. The AAA-10 year spread has widened somewhat, reflecting a higher risk premium, but the AAA-BBB spread has been stable. Appearances can be deceptive though and bond markets are known to react suddenly and violently, so the threat of a sudden market adjustment remains.

The US equity markets performance continues to be marked by an apparent divergence in asset prices and economic performance. Investors may be willing to return to a less defensive position after weeks of cutting back on their exposure to equity markets, both directly and through mutual funds. It would seem that investors are suffering from schizophrenia, bouncing between a focus on strong earnings and continued doubts about the economic recovery's staying power. In fact, a recent Bloomberg survey of Wall Street analysts finds expectations of a strong year ahead for corporate profits, with earnings growth projected to return to its 51-year annual average of 6.9%. Furthermore, revenues per share could reach $100/share this year, up 17% from 2010. Moreover, the S&P500 is trading at a multiple of 13.5, still below its 10-year average.

Fig. 3: **3-month Sectoral S&P500 Performance (end-June)**



The market's schizophrenic attitude reflects the fact that we are not experiencing a standard business cycle, but rather a protracted adjustment to what PIMCO's el-Erian has dubbed the "new normal". Larry Summers has warned that this "new normal" could be protracted stagnation a la Japan, but that is not my base case scenario. In such a market, the best advice would be to stay tactically defensive. At the same time, continue to avoid sectors likely to remain weak in the longer term, i.e. financials.

June 2011	Prior	Consensus	Actual	Min	Max
Macroeconomy					
Leading Indicators (m/m) Jun	-0.30%	0.2%	0.8%	-0.5%	0.5%
GDP (1Q11, % Annualized)	1.8%				
CPI (m/m) May	0.4%	0.0%	0.2%	0.0%	0.3%
Core CPI (% m/m) Jun	0.2%	0.2%	0.3%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) (Apr)	4.6%		1.6%		
Imports (% m/m) (Apr)	4.9%		-0.5%		
Trade Deficit $ billion (Apr)	46.8	$49.0	43.7	$46.5	$51.0
Current Account Deficit ($ billion) (1Q11)	113.3	112.0	119.3		
Industrial Production					
Empire State (May)	11.88	14.0	-7.8	3.8	18.1
Philadelphia Fed (May)	3.9	9.0	-7.7	0.0	19.8
ISM-Mfg	53.5	52.0	55.3	51.0	55.0
Chicago PMI (May)	56.6	53.0	61.1	49.5	61.1
Industrial Production (% m/m) May	0.0%	0.2%	0.1%	0.0%	0.4%
Durable Goods (m/m)	-2.7%	1.5%	1.9%	-1.0%	5.5%
Durable Goods (y/y)	6.4%		9.0%		
Durable Goods, ex transp (m/m)	-0.4%		0.6%		
Durable Goods, ex Transp (y/y)	8.2%		7.2%		
Inventories (m/m)					
Factory Orders (m/m)	-0.9%	1.0%	0.8%	-0.3%	1.0%
Services					
ISM non-mfg (Mar)	54.6	54.0	53.3	51.2	55.0
Consumer Spending					
Retail Sales (% m/m) (Apr)	0.3%	-0.3%	-0.2%	-1.3%	0.0%
UMich Consumer Sentiment (Jun)	71.8	71.8	71.5	71	73.0
ConfBd Consumer Confidence	61.7	62.0	58.5%	55.0	66.7
Personal Income (m/m) (May)	0.3%	0.4%	0.3%	0.1%	0.5%
Personal Income (y/y) (May)	4.4%		4.2%		
Consumer Spending (m/m) (May)	0.3%	0.0%	0.0%	-0.2%	0.3%
Consumer Spending (y/y)	0.048		4.7%		
Housing Market					
Housing Starts ('000) (May)	541	547	560	530	560
New Home Sale ('000 May)	326	305	319	288	345
Existing Home Sales (MM) (May)	5.00	4.75	4.81	4.60	5.10
Existing Home Sales (% change. m/m) May					
Case Shiller-10 (m/m) Apr SA	-0.6%		0.8%		
Case Shiller-10 (y/y)	-3.6%		-3.1%		
Employment					
First Time Claims ('000) (July 14)	427	405	405	395	415
Non-Farm Payroll (Jun)	25,000.00	105,000.00	18,000.00	65,000.00	160,000.00
o/w Private Sector (Jun)	73,000.00	125,000.00	57,000.00	100,000.00	183,000.00

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.