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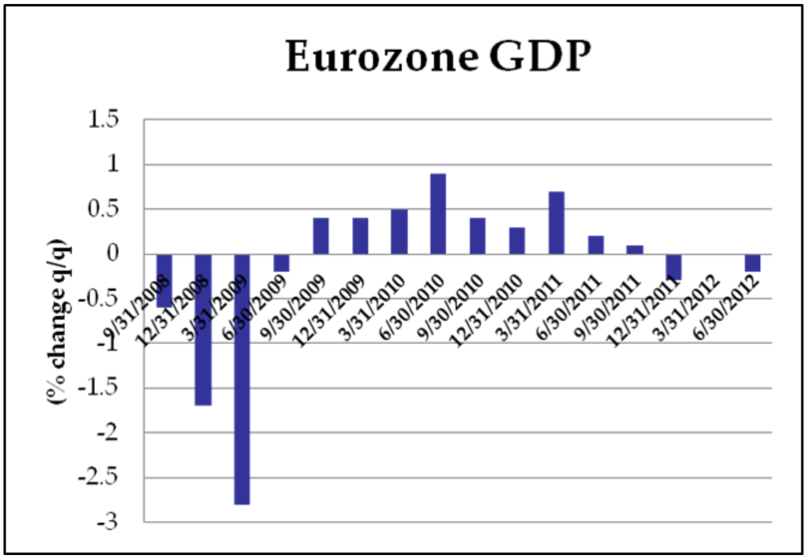
Advocacy Investing®

WAITING FOR SIGNOR DRAGHI

- **The European Central Bank (ECB) unveils a bazooka and commits to unlimited sovereign bond purchases**
- **Recent data on housing activities and prices provide a positive surprise**
- **Latest data releases in the United States improve somewhat, but the recovery remains tepid**
- **The economic weakness was reflected in the disappointing August payrolls number, which increases the odds of another round of quantitative easing by the Fed**
- **Significant political risks remain, but so far, the US economy seems to have weathered the global slowdown—but has yet to pull out of its rut**
- **Equity markets remain addicted to central bank easing as disconnect with fundamentals remains**

The Central Banks' Hour: The annual three-day Jackson Hole pilgrimage of central bankers and monetary experts, which finished on August 31st, gained even more significance than usual this year. All eyes were on the Chairman of the Federal Reserve Bank, Ben Bernanke. Bernanke did not disappoint, coming up with a forceful defense of quantitative easing. Bernanke started by expressing dissatisfaction with the anemic pace of both economic growth and job creation. He further stated that studies showed that three rounds of asset purchases had added 3% to output growth and led to the creation of 2 million jobs. Bernanke added that the benefits of the "non-traditional" monetary policy followed by the Fed outweighed its costs; that these costs were manageable; and that they should be pursued further as warranted by economic conditions—a strong hint at a third round of quantitative easing (QE-III). The disappointing August employment report has increased the likelihood of such an intervention, although the Fed is not expected to announce a QE-III before the US elections on November 6th.

Fig. 1: Eurozone in Recession



Mario Draghi, the President of the European Central Bank was unable to attend the Jackson Hole meeting, as he had his hands full with the on-going eurozone crisis. The summer lull in European markets has come to an end, and we expect a tumultuous "back-to-school" period. Economic data shows a eurozone sinking deeper into recession, with manufacturing shrinking for the 13th month in a row and unemployment rising to record levels. According to the latest ECB forecasts, the eurozone economy should contract by 0.4% in 2012 and only recover slowly in 2013.

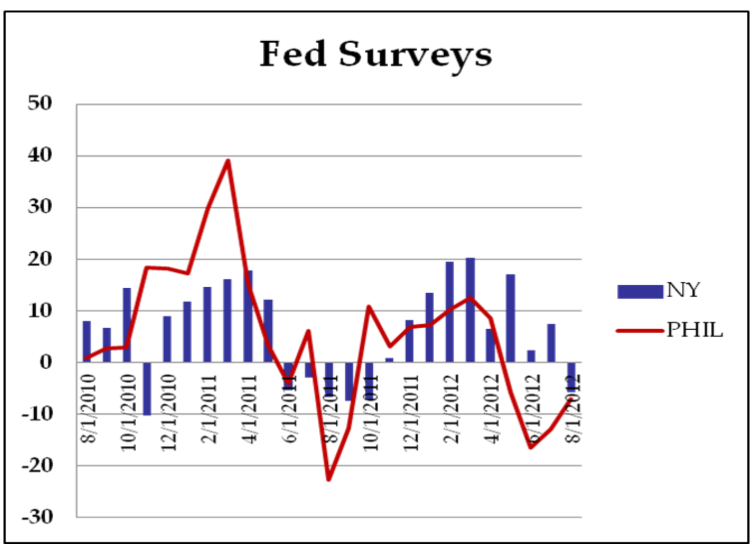
Once again, Europe faces a pivotal month in September, with series of key dates and events which will test the viability of the eurozone: the ECB September 6th meeting, the approval of further austerity measures in Greece, a ruling by the German High Court about the constitutionality of the eurozone bail-out fund on September 12th, and Dutch elections later in the month. The next hurdle is the deadline for the Greek government and legislature to approve further spending cuts of 2012 and 2014. A failure in this regard would significantly increase the likelihood of a Greek exit from the euro in the foreseeable future. The situation in Spain is equally worrisome, given the economic weight of the country in the eurozone. Insolvent regions are adding to the fiscal burden of the Spanish central government, and key questions regarding the European bailout of Spain remain unresolved.

Draghi Delivers: The ECB meeting was of particular importance, as the markets were seeing the event as a test of Draghi's promise to do all that the central bank can to save the euro. The ECB meeting delivered on that promise, and the European central bank committed itself to unlimited eurozone troubled sovereign bond purchases –the so-called Outright Monetary Transactions (OMTs). The ECB cited the need to "safeguard the monetary policy transmission mechanism in all countries of the euro area ….and address severe distortions in government bond markets which originate from, in particular, unfounded fears on the part of investors of the reversibility of the euro. Hence, under appropriate conditions, we will have a fully effective backstop to avoid destructive scenarios with potentially severe challenges for price stability in the euro area". The OMT program will be predicated on strict conditionality in the framework of the eurozone bailout mechanisms. Moreover, the devil is in the details, as we know too well!

As the saying goes, the prospect of hanging tends to concentrate the mind, and this is what seems to be happening to the eurozone core country leaders, who are now fighting to preserve the euro. The northern European countries are softening their positions and the political leadership is now closer to the ECB. Whether or not the ECB bond purchase program allows anything more than a short-term stabilization remains to be seen. Europe is also suffering a severe credit crunch as banks in the core country are slashing their exposure, in particular to the troubled periphery countries. Moreover, assuming a compromise is found for Greece (a debatable proposition in itself), Spain and Italy will continue to test the markets in the foreseeable future and the eurozone financial and economic crisis is unlikely to be resolved soon.

A Tepid Recovery Confirmed: The first revision of GDP in the United States showed that economic output increased by 1.7% (annualized) in 2Q12, up from the initial estimate of 1.5%.
According to government data, positive contributions from private consumption expenditures, non-residential investment and exports were offset by the contraction of both private inventories and state and local government spending.

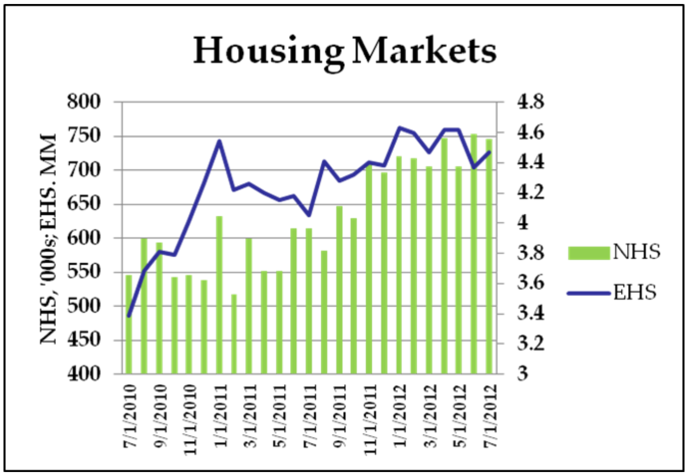
Fig. 2: <u>Manufacturing Slowdown</u>



The economy seemed to be on stronger ground as we entered 3Q12, with somewhat improved data releases for the month of July. Activity data was generally positive for July after two dismal months. However, the data remained mixed, and manufacturing seems to be faltering. Industrial production was up by 0.6% (month-on-month, m/m), factory orders increased by 2.8% m/m, and durable goods rose by 2.2% m/m. However, the forward-looking August industrial and manufacturing surveys were less reassuring--both the Empire State and Philadelphia Fed surveys remained in negative territory, the Chicago PMI was slightly down (to 53 from 53.7), and the ISM-Manufacturing index stayed under 50 for the third consecutive month. In contrast, the household sector also posted strong results: personal income and personal consumption expenditures were up by respectively 0.3% and 0.4% (m/m) and retail sales increased by 0.4% (m/m) for the first time in four months. Consumer confidence surveys also rebounded at the end of August, with the University of Michigan-Reuters index up to 74.3 from 73.5 in the first half of the month—although other consumer confidence measures still point south. The services sector showed some strength, as the ISM-Non manufacturing index rose to 53.7 in early September from 53 the previous month.

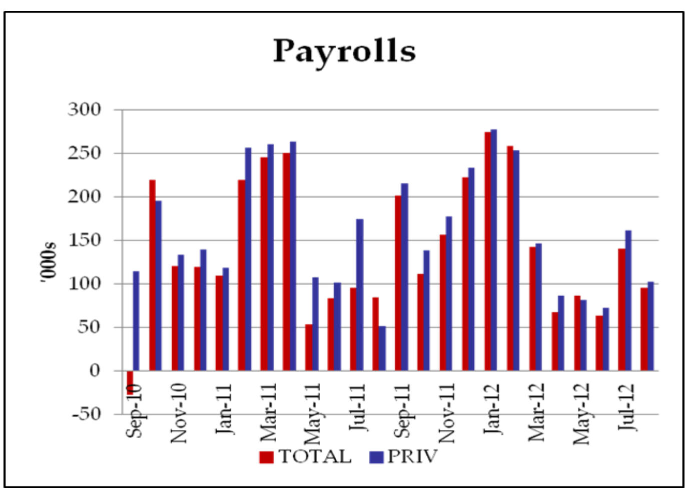
Green Shoots in the Housing Market: The housing market is showing unmistakable signs of recovery for the first time since the beginning of the recession. Both existing and new home sales are up, as are housing starts. More importantly, house prices have been on a sustained, albeit moderate upward path for the fifth month in a row, with the Case-Shiller 20-city price index gaining 0.9% m/m (and 0.5 % year-on year, y/y) in June. The improved housing market is due to two sets of factors, both cyclical and structural. On the cyclical side, low prices and low mortgage rates are leading to stronger demand. Furthermore, a strong rental demand for housing is feeding into strong demand from investors. Most of the price pressures are coming from the supply side, with housing inventories at a record low. Both government (Fannie Mae and Freddie Mac) and commercial banks have cut back on the sales of foreclosed properties, shifting instead to short sales. Moreover, the February 2012 agreement with the banks on foreclosures has resulted in an 11% drop in foreclosures (y/y) in 2Q12, and a 7% increase in foreclosed properties sale prices. Overall, these trends seem to be reaching a self-sustaining point, with ultimately positive results for both the housing market and the overall macroeconomic situation.

Fig. 3: <u>New and Existing Home Sales</u>



Oil Prices: Oil prices have climbed by 23.6% from their year-to-date (ytd) low of $77.8/barrel (bbl) on 6/21 to $96.2/bbl at the end of the first week of September (but still lower by 12% from their 2012 (ytd) peak in February. Major factors affecting the oil price surge have been the fall in crude inventories and the short-lived impact of Hurricane Isaac on oil production. With the summer driving season over and abundant supplies, oil prices are expected to decline into the $85-90 range within the next few weeks. Furthermore, higher oil prices have not had a major impact in the past few months on consumer behavior, as we saw consumer expenditures actually rise during July, a month of sharp increases in oil prices.

Fig. 4: <u>Disappointing Payrolls</u>



Payrolls Slump: Despite some promising indications, the August payrolls number was disappointing, with only 96,000 new jobs (compared to market expectations of 125,000). Moreover, the previous months' number was revised downwards by 31,000, bringing the 3-month average down to 100,000. Private sector job creation fell from a revised 141,000 to 103,000, but the ravage in government payrolls slowed down. Most significantly, employment in manufacturing was down by 15,000, reflecting the weakness of the sector. The unemployment rate (based on a separate households' survey) fell from 8.3% to 8.1%, but the drop reflected a further decline in the participation rate to 63.5%, a cyclical low. Weekly hours worked fell by 0.1 to 34.4 hours, hourly earnings were stagnant, as a consequence, the payrolls' earnings proxy rose by a mere 2% (annualized). The employment situation's sharp deterioration was all the more unexpected since, high-frequency data had stabilized in the past few weeks, with first-time jobless claims down to 365,000 in the first week of September. All in all, after two noisy data months, the August numbers seem to confirm a steadily eroding economy.

Risky Business: The problems that have dogged the G-3 economies (United States, Europe and Japan) for the past few years continue to ail the global economic scene. While strong growth in China and major emerging markets managed to offset the G-3 economic weakness for most of 2010 and 2011, these economies are themselves now suffering a slowdown, especially in manufacturing. The JPM Global Manufacturing PMI has fallen to 48.1 in September from 48.3 in the previous month, and global unemployment is on the rise.

In a nutshell, the G-3 economies are suffering a self-reinforcing combination of deficient aggregate demand and excessive public debt. In this context, the eurozone crisis poses the greatest risk to the global economy, which will also be buffeted by the Chinese slowdown. Moreover, there remain significant political risks and uncertainties. The greatest political risk is the outcome of the US presidential and congressional elections. Any of the four potential outcomes—an across-the board Republican sweep, a Romney or Obama victory with a divided Congress, or a re-elected Obama facing a Republican Congress-- poses risks and opportunities of their own. The secretive, yet complicated, political transition in China also poses political and policy risks on its own, as it is delaying a needed stimulus program in the face of a sharper-than-expected economic slowdown.

The second half of the year does not seem to offer much relief, with the economy facing stronger headwinds:

- The latest data confirms a significant slowdown in a manufacturing sector buffeted by weakening international trade and inventory adjustment
- The disposable income gains of households are likely to be eroded by higher food prices
- The US corporate sector is facing a slump in profits, which is not conducive to either higher capital expenditures (which have slowed down year-to-date) or hiring
- The "fiscal cliff" uncertainty is not likely to be resolved before the election
- Problems in the global economy will continue to act as a brake to faster recovery

On the positive side, forceful central bank action should continue to offer some degree of support for the economy. Moreover, we are seeing signs of more policy activism in the major emerging markets, with some positive results. Furthermore, China is likely to move on a stimulus program in the fourth quarter. Finally, the mending of the housing sector could inject some degree of dynamism in the economic outlook. These factors should prevent a slide back into recession, but that is about as optimistic as we can be. The economy is clearly stuck in a rut, weighed down by the on-going eurozone economic crisis and political risks. Under these conditions, we cannot expect the economy to grow at more than 1.5-2.0% in 2H12 despite its remarkable resilience so far, with some potential for acceleration in early 2013.

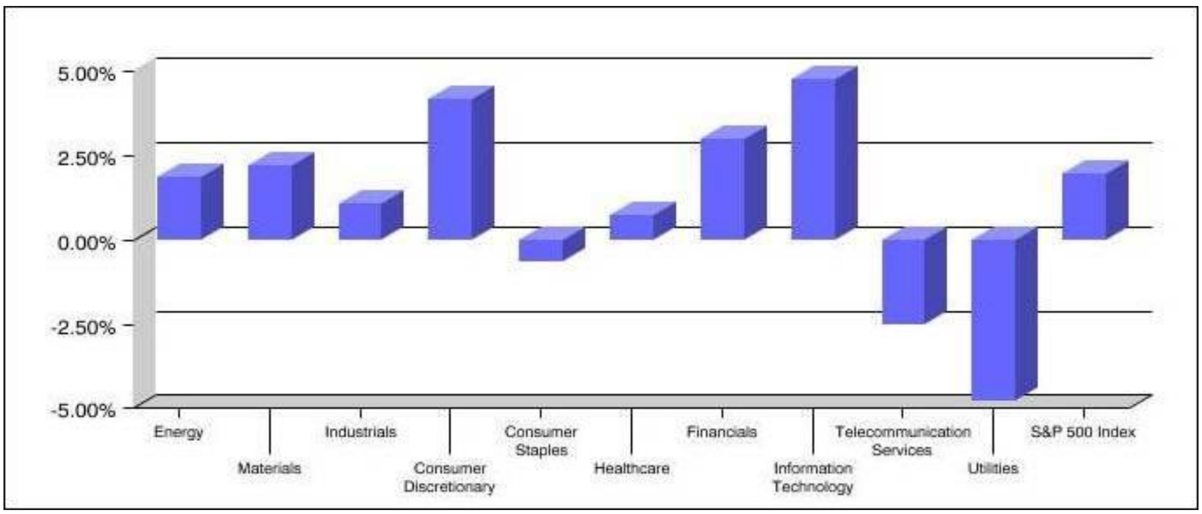
Addicted to Quantitative Easing: The stock market has been on an upswing since reaching a 2012 ytd low on June 4th. Since that time, the S&P500 has jumped by 9.5% (to end-August) and has been above 1,400 since August 7th. However, a measure of market weakness is the low P/E ratio, which remains in the 15-16 range.

Table 1: <u>QE Addiction</u>

	S&P500	Materials	Energy
During QE-I (Nov 2008-Jun 2010)	+36.8%	+82.7%	+48.2%
Between QE-I and QE-II	-10.5%	-8.7%	-14.1%
During QE-II (Nov 2010-Jun 2011)	+19.1%	+21.4%	+36.5%
After QE-II	+11.4%	-9.3%	+14.7%

Since the beginning of the financial crisis, equity markets have become increasingly addicted to quantitative easing (Table 1). We see an increased divergence between market performance and economic, as well as business fundamentals. U.S. corporate profits fell by 5.3% year-on-year in 2Q12, to an annualized $1.648 trillion (-1% on a quarter-to-quarter basis). Overall, profits fell in 1H12 after several years of healthy growth. Yet, the S&P500 rose by 6.7% over the first half of the year. The main offset to the weak fundamentals has been the extra-easy monetary policy and several rounds of quantitative easing by central banks. This addiction was clearly illustrated by the jump in stock market indices that followed the ECB announcement, with the S&P500 reaching a 4-year high of 1,422 on September 7th—and a further rise to 1,433 on September 11th.

Fig. 5: S&P500 30-day (August) Sectoral Performance



In the short-term, while all sectors benefitted on a 3-month basis, the month of August saw a swing back to cyclical sectors. Over the next few weeks, we can expect a sustained level of event risk and market volatility, with no major changes in market fundamentals. Most of the gains in the index in the past few months have been the result of improvement in the P/E ratio, with little lift from earnings—which are expected to remain depressed in 2H12. Under these circumstances, the S&P500 should remain in the 1,400-1,475 range, but without clear macroeconomic signals, it is unlikely to move beyond that level.

August 2012 Economic Data

August 2012	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (2Q12, % Annualized) 1st estimate	1.5%				
CPI (m/m) July	0.0%	0.2%	0.0%	0.0%	0.2%
Core CPI (% m/m) July	0.2%	0.2%	0.1%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) (Jun)	0.3%		0.8%		
Imports (% m/m) (Jun)	-0.8%		-1.5%		
Trade Deficit $ billion (Jun)	$48.00	$47.50	$42.9	$45.50	$48.50
Current Account Deficit ($ billion) (4Q11)					
Industrial Production					
Empire State (Aug)	7.39	7.0	-5.85	-2.0	9.0
Philadelphia Fed (Aug)	-12.9	-5.0	-7.1	-16.5	0.0
ISM-Mfg Jul	49.8	50.0	49.6	45.5	50.0
Chicago PMI (Aug)	53.7	53.0	53	51.0	54.5
Industrial Production (% m/m) Jul	0.1%	0.5%	0.6%	0.3%	1.1%
Durable Goods (m/m) Jul	1.6%	1.9%	2.2%	-1.0%	7.0%
Durable Goods, ex transp (m/m)	-2.2%	0.4%	-0.4%	-0.8%	1.0%
Inventories (m/m) June	0.3%				
Factory Orders (m/m) Aug	-0.5%	2.0%	2.8%	-0.4%	2.8%
Services					
ISM non-mfg Sep	52.6	53.0	53.7	51.5	53.5
Consumer Spending					
Retail Sales (% m/m) Jul	-0.7%	0.3%	0.8%	0.0%	0.4%
UMich Consumer Sentiment (2d half Aug)	73.6	73.5	74.3	73	75.0
ConfBd Consumer Confidence Aug	65.9	65.8	60.6	63.0	66.0
Personal Income (m/m) Jun	0.3%	0.3%	0.3%	0.3%	0.4%
Consumer Spending (m/m) Jun	0.4%	0.4%	0.4%	0.2%	0.4%
Housing Market					
Housing Starts ('000) Jul	754	750	746	695	785
New Home Sale ('000) Jul	359	362	372	340	400
Existing Home Sales (MM) Jul	4.37	4.50	4.47	4.30	4.65
Case Shiller-20 (m/m) SA Jun	0.9%	0.4%	0.9%	0.2%	1.0%
Case Shiller-20(y/y) Jun	-0.7%	0.0%	0.5%	-1.5%	0.5%
Employment					
First Time Claims ('000) (1st week Sep)	377	370	365	365	380
Non-Farm Payroll (Jul)	141,000	125,000.00	96,000	70,000	177,000
o/w Private Sector (Jul)	162,000	134,000.00	103,000	80,000	177,000

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.