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Advocacy Investing®

THE CLIFFS OF FALL

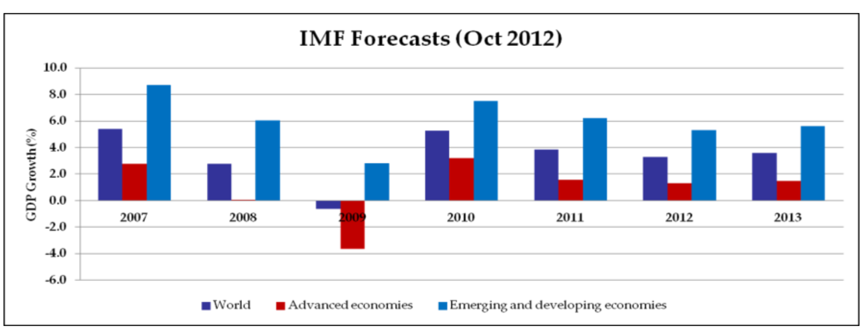
"O the mind, mind has mountains; cliffs of fall
Frightful, sheer, no-man-fathomed."

Gerald Manley Hopkins (1844-1889)

- **A weak global economic environment**
- **US 2Q12 GDP revised downwards**
- **A mixed picture for the US economy, but a positive surprise in September payrolls**
- **Central banks open-ended stimulus (or promise thereof) continues**
- **Europe struggles with mounting popular unrest in the face of austerity**
- **Markets continue to defy gravity**

One month after significant action on quantitative easing by the major central banks and less than one month until the US presidential and congressional elections, the markets are once again focusing on the weak global economic fundamentals, the continued risks posed by Europe and the rapidly approaching deadline for the US fiscal cliff, all of which have provided fuel for market volatility.

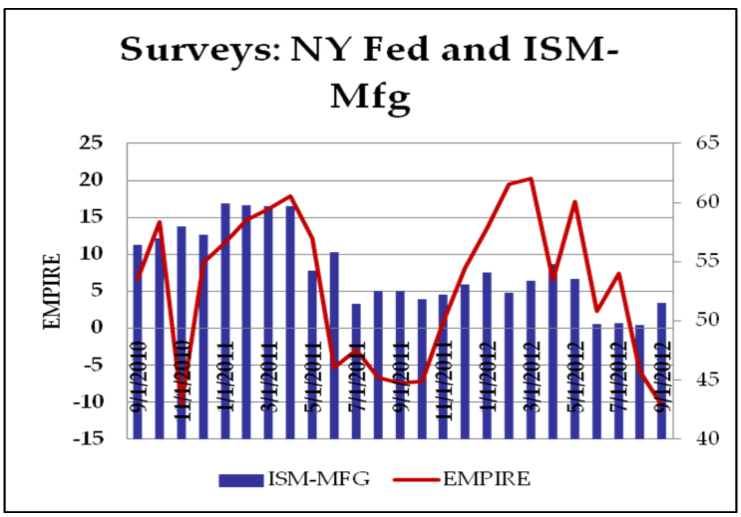
Fig. 1: IMF Forecast



The global economy continues to slow down, with Europe and China being the major areas of concern. In Europe, all indications are for a deepening recession, while in China, the extent of the slowdown seems to be much greater than reflected in the official data with the economy expected to grow by about 7-8% in each of this year and next, compared to an average of 9.7% per year in 2008-2011. The IMF's semi-annual economic projection, released on the eve of the IMF/World Bank Annual Meeting in Tokyo, presents a gloomier picture than in its April 2012 projections, with world GDP growth revised downwards to 3.3% (from 3.6%) in 2012, and not much better (3.6%) in 2013. The developed countries are expected to grow by only 1.3% this year and 1.5% next year.

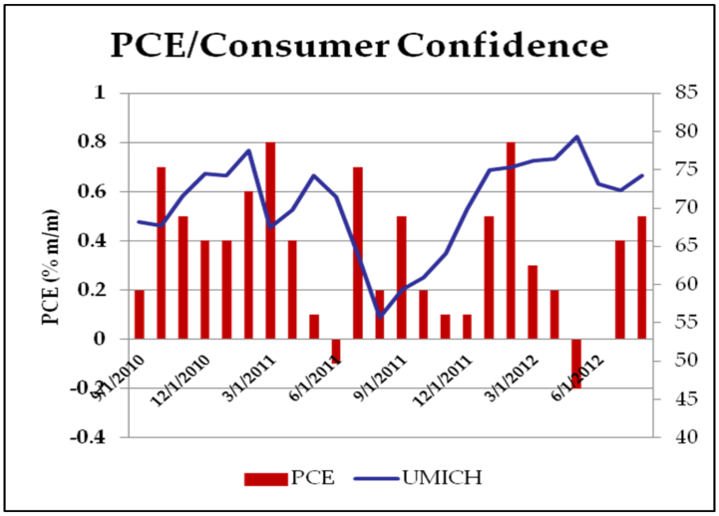
The second (downward) revision of 2Q12 GDP numbers underscored the economy's weak economic performance. Output growth was revised downwards to 1.3% (annualized) from 1.7%, with lower numbers across the board—consumer spending, investment and net exports.

Fig. 2: <u>Industry Surveys</u>



A Mixed Picture: The economy in 3Q12 does not look much better, although there are some bright spots. In fact, the US data releases reflect three distinct trends. First, we are seeing a continued improvement on the consumer side. Surveys of consumer confidence have been generally on the upside (Conference Board index up to 71.3 at the end of September from 61.3 a month earlier, but the Reuters-University of Michigan fell slightly in the second half of September). August retail sales were up 0.9% month-on-month (m/m), for the second month in a row, and private consumption expenditures gained 0.5% m/m. High frequency data also indicated a firming of consumer demand. At the same time, personal income rose only marginally (0.1% m/m), while most of the 0.5% m/m increase in personal consumption expenditures came from higher gasoline prices.

Fig. 3: **Consumer Confidence and Private Consumption**



Second, the slide in manufacturing continues, reflected both in surveys and actual output. The main reason behind this weakness is the European recession and the Chinese slowdown, which are having an impact all along the logistic chain. The Empire State activity index worsened to -10.41, while the Philadelphia Fed index improved, but remained negative. Industrial production fell by 1.2% in August, durable goods orders (driven by a sharp fall in the aircraft sector) declined by 13.1% (m/m). The Chicago PMI, which encompasses both manufacturing and services, fell to below 50 (49.7) for the first time since September 2009. However, the ISM-Manufacturing jumped to 51.5, ending a three-month contraction and the PMI-Manufacturing (Markit) remained above 50. Factory orders declined by 5.2% in August, but most of the fall was due to a drop in military and aircraft orders, and orders for other capital goods rose by 1.1%. In contrast, the automobile sector continues on its very strong trajectory. Auto sales in September reached 14.9 million (annualized) the highest level since March 2008. In 3Q12, automobile sales reached 14.5 million (annualized), only marginally lower than the record 15.3 million reached in 1Q08. Overall, the sector has been growing at around 10% per year for the past three years, and should even accelerate further as disposable income improves.

Third, continued improvements in the housing market, albeit at a slower pace. The Case-Shiller 20-city price index rose by 0.4% (m/m) in July, the sixth consecutive monthly price rise, and was up 1.2% on a year-on-year (y/y) basis. Housing starts and existing home sales were up, while new home sales increased only marginally. Furthermore, the rising house prices have allowed more households with underwater mortgages to be made whole once again. Anecdotal evidence on pick-up truck sales, (which are highly correlated to construction activity), seem to confirm the improving trends.

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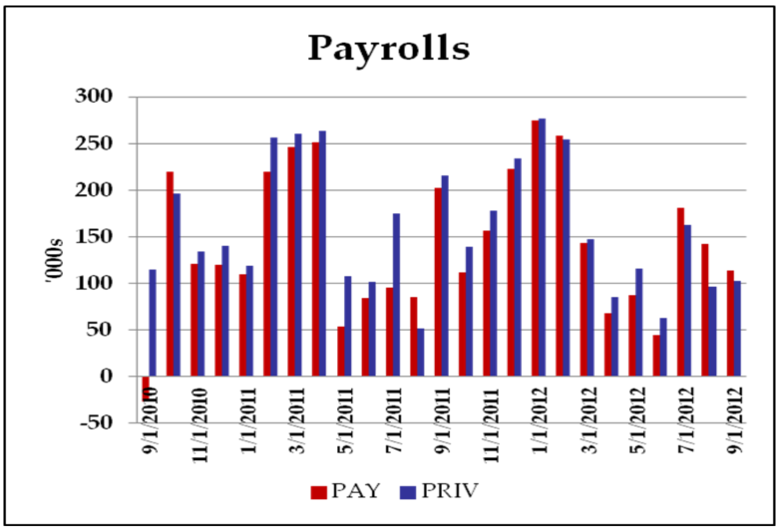
Despite turmoil in the Middle East, oil prices (West Texas Intermediate, WTI) were down from their August peak of $96/barrel (bbl) to under $90/bbl, largely as the result of falling global demand (China and Europe) and high levels of supply from both OPEC and non-OPEC. Oil prices are expected to hover around $90/bbl over the balance of the year.

Fig. 4: Payrolls



October Surprise: The labor market has been waiting for a positive surprise, which it got in October. According to the Bureau of Labor Statistics (BLS), the economy added 114,000 jobs in September. In addition, the BLS revised upward the July and August numbers by an aggregate 86,000, bringing the three month moving average for the third quarter to 121,000. In addition, the unemployment rate, which is derived from a separate household survey, fell to 7.8% from 8.2%. Most importantly, this improvement occurred as the labor force actually increased in size after two months of decline. Most of the job increases in September came from private services (+ 114,000) and government (which increased both in August and September after a long period of decline). The goods-producing sector lost 10,000 (manufacturing down 16,000). Finally, average hours worked increased by 0.1 to 34.5, and hourly earnings rose sharply by 0.5% (m/m). This brings the annual income proxy growth up to 4.3%. With the recent upward revision of 2012 payroll numbers by the Bureau of Labor Statistics (BLS), employment has returned to January 2009 levels. While this is an important psychological landmark, we are still short of the numbers needed for faster economic growth. First time jobless claims have been stable at around 365 thousand in the past few weeks. Challenger-Gray data show that while planned layoffs are slightly up in September, they still are 71% lower than a year ago. While the labor market seems to have improved, we are still a far cry from the 250,000 monthly job additions needed to significantly bring unemployment down.

US Deleverage: Recent Federal Reserve data shows that the U.S. economy continues to deleverage. Total debt in the US economy has dropped sharply from 359% of GDP in 2008 to 329% at the end of 2Q12. Consumer debt has declined from $12.7 trillion at the end of 2008 to $11.4 trillion at the end of 2Q12, and household net worth is up from $51.2 trillion to $62.7 trillion over the same period. This structural change could provide support for a faster recovery when the overall financial and macroeconomic picture improves.

Europe Faces more Turmoil: Under pressure from Germany, the Greek government has introduced more spending cuts. The Spanish government has done the same. However Europe faces a turbulent October, as public protests against austerity measures are flaring up again in Spain, Greece and Portugal. At the same time, the Madrid government, which has been forced to bail out several of the country's regional governments, is facing a political challenge from Catalonia, the largest region, which is threatening to secede.

Work continues at the eurozone level on a European level banking regulatory system, but deep differences remain. This has delayed the bailout of the Spanish banks, which are in need of about $76 billion dollars of additional capital, as shown by the recently completed stress tests. Meanwhile, Germany continues to push for a Eurozone level fiscal pact.

In its October World Economic Outlook report, the IMF has singled out the strong austerity measures followed by European governments as problematic and excessive. The Greek and Spanish governments in particular are in a downward spiral of budget cuts, worsening recession and further budget cuts. By now, it should be clear that such remedies cannot be effective, but the policy divide between Germany and other Northern European countries on one hand and the troubled eurozone periphery and France on the other remains.

Central Banks Vigilance: The Fed surprised markets at its September 12th-13th FOMC meeting by introducing a third round of quantitative easing (QE-III). Prior to the FOMC meeting, the consensus was that the Fed would only announce a further QE intention and wait until after the election to implement the policy. However, the FOMC statement included strong language by the Fed about the necessity of additional stimulus measures in the face of faltering economic growth. In addition to extending the zero interest rate policy from end-2014 to mid-2015, the Fed extended its "Operation Twist" to end-2012, continuing its purchases of longer-term government securities to the tune of $45 billion per month. QE-III will involve an open-ended commitment to purchase $40 billion a month in mortgage-backed securities until the job situation improves. The open-ended easing offered by the Fed reflects Bernanke's deep concerns about the structural impact of high levels of long-term unemployment. Bernanke recently reiterated his concern about the long-term economic impact of high unemployment and the need to continue monetary stimulus.

The Fed action came at the same time as major easing moves by the European Central Bank and the Bank of Japan. The ECB committed itself to unlimited eurozone troubled sovereign bond purchases—the so-called Outright Monetary Transactions (OMTs). The Bank of Japan significantly expanded its purchases of long-term government debt.

While the ECB announcement of its new policies calmed markets in September, it has yet to buy any debt. The OMT was made conditional upon the country in question applying to the European Stabilization Mechanism (ESM), which would mean agreeing to an economic stabilization and structural change program. So far, no country has applied, and the new program remains untested. In particular, Spain has resisted applying for an ESM program, as the government fears that it will have a negative psychological impact.

Uncertain Times: The economy remains plagued by uncertainty. Recent surveys of US CEOs show that the majority of the US corporations are postponing investment and hiring decisions until the issue of the looming fiscal cliff is resolved. Moreover, the outlook for large corporations is further clouded by the European financial crisis and China's sharp economic slowdown. The fiscal cliff is expected to cut $667 billion (4.3% of GDP) from the FY2013 federal budget. Such massive cuts could push the economy into recession.

There are some factors offsetting this doom and gloom. First, regardless of the result of the US election, Congress and the White House will be under strong pressure from the business community to resolve the fiscal cliff problem. There is already movement afoot in the Senate in this regard, and a compromise solution is likely. Second, consumer confidence has recovered somewhat, and demand remains stronger than expected. Falling oil prices will ease the pressure on the households' pocketbooks. Finally, the recovery in the housing markets and a resilient stock market are both contributing to a positive wealth effect.

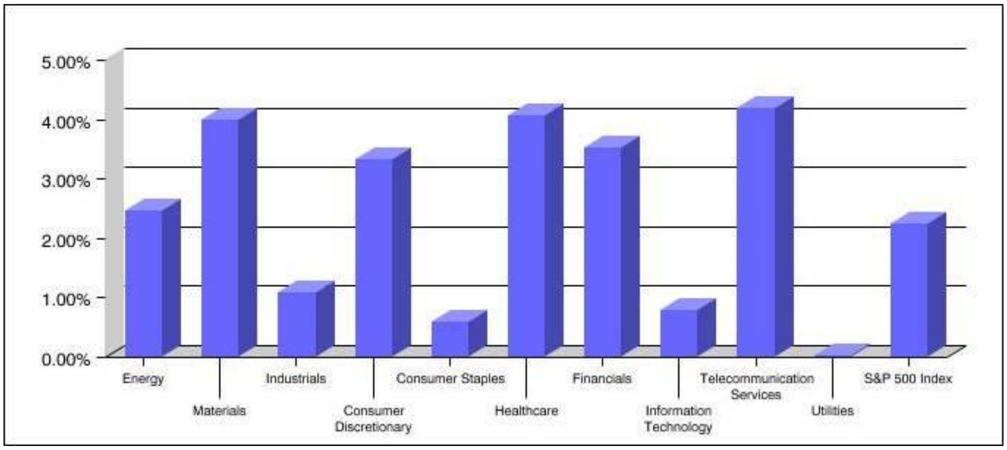
Nevertheless, all these positive factors can only provide a floor to the economy, and the overall picture still adds up to weak economic growth of 1.5-2% over the next one of two quarters. In the longer run, faster growth will depend on global factors, in particular Europe and China.

Defying Gravity: The equity markets had a choppy September. The S&P500 reached an almost five-year high of 1,465 on September 19th, but then lost ground. Overall, the index dropped for 7 of the 19 trading days of the month. Since then, the index has recovered somewhat, ending 3Q12 6% higher than the end of 2Q12, and 31% higher than the end of 3Q11. The markets continued their recovery in the first week of October, with the S&P500 gaining a further 1.6% over that time period, ending the week at 1,460, its highest level since the end of 2007.

The market rally in 3Q12 was driven by the cyclical sectors, although all sectors did benefit, showing that investors continue to be sustained by hope. As stated before, once the US election is over, the

White House and Congress are likely to move to resolve the fiscal cliff, which would give new impetus to investment and hiring plans.

Fig. 5: S&P 30-day sectoral Performance



Will markets continue to defy gravity? That is the key question. As we enter 3Q12 earnings season, we will get some of these answers. Surveys indicate that the markets expect profits for the S&P500 will total $154.7 billion in 2012 (+8% over 2011)--including $37 billion in 3Q12 (down 1.7%). Financial companies (13% of total S&P500 earnings) have had a particularly strong performance this year. Despite the uncertainties, and against all odds, the markets seem to continue to believe in an economic recovery. Over the next few weeks, we expect the S&P500 to continue trading solidly in the 1,425-1,475 range.

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September 2012 Economic Data

September 2012	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (2Q12, % Annualized) 1st estimate	1.7%	1.7%	1.3%	1.5%	2.0%
CPI (m/m) August	0.0%	0.6%	0.9%	0.2%	0.9%
Core CPI (% m/m) July	0.1%	0.2%	0.1%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) (Jul)	0.8%		-1.0%		
Imports (% m/m) (Jul)	-1.5%		-0.8%		
Trade Deficit $ billion (Jul)	$41.9	$44.30	$42.0	$39.70	$47.10
Current Account Deficit ($ billion) (2Q12)	$133.6	$125.0	$117.4	$120.0	$134.0
Industrial Production					
Empire State (Sep)	-5.85	-2.0	-10.41	-10.0	5.0
Philadelphia Fed (Sep)	-7.1	-4.0	-1.9	-10.0	
ISM-Mfg Sep	49.6	49.7	51.5	48.0	50.6
Chicago PMI (Sep)	53	53.5	49.7	50.2	54.0
Industrial Production (% m/m) Aug	0.5%	0.1%	-1.2%	-1.0%	0.3%
Durable Goods (m/m) Aug	3.3%	-5.0%	-13.1%	-9.4%	-1.1%
Durable Goods, ex transp (m/m)	-1.3%	-0.2%	-1.6%	-1.9%	0.7%
Inventories (m/m) Aug	0.1%	0.5%	0.8%	0.1%	0.6%
Factory Orders (m/m) Aug	2.6%	-6.0%	-5.2%	-10.0%	-1.2%
Services					
ISM non-mfg Sep	53.7	53.5	55.1	52.0	54.7
Consumer Spending					
Retail Sales (% m/m) Aug	0.6%	0.8%	0.9%	0.3%	1.5%
UMich Consumer Sentiment (2d half Sep	79.2	79	78.3	75	81.5
ConfBd Consumer Confidence Sep	61.3	64.8	70.3	61.5	68.0
Personal Income (m/m) Aug	0.1%	0.2%	0.1%	0.1%	0.3%
Consumer Spending (m/m) Aug	0.4%	0.5%	0.5%	0.3%	0.8%
Housing Market					
Housing Starts ('000) Sep	733	768	750	740	780
New Home Sale ('000) Aug	374	380	373	365	400
Existing Home Sales (MM) Aug	4.47	4.55	4.82	4.45	4.61
Case Shiller-20 (m/m) SA Jul	0.9%	0.9%	0.4%	0.2%	1.9%
Case Shiller-20(y/y) Jun	0.5%				
Employment					
First Time Claims ('000) (1st week Oct)	363	370	376	364	375
Non-Farm Payroll (Jul)	142,000	113,000.00	114,000	75,000	162,000
o/w Private Sector (Jul)	97,000	130,000.00	104,000	100,000	165,000

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.