

**Title: Advocacy Investing<sup>®</sup> Portfolio Strategies, Issue 35**  
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**Date: March 19, 2012**

## Advocacy Investing<sup>®</sup>

### THE HANGOVER, PART II

- **Third consecutive strong payrolls report in February**
- **Consumer confidence on the rise despite higher gasoline prices**
- **Greece reaches a landmark agreement with private creditors**
- **Markets continue on a bullish path**
- **Despite positive developments, recovery remains tentative and subject to considerable downside risks**
- **Over the next few months, the greatest threat is geopolitical—the ongoing nuclear crisis with Iran**

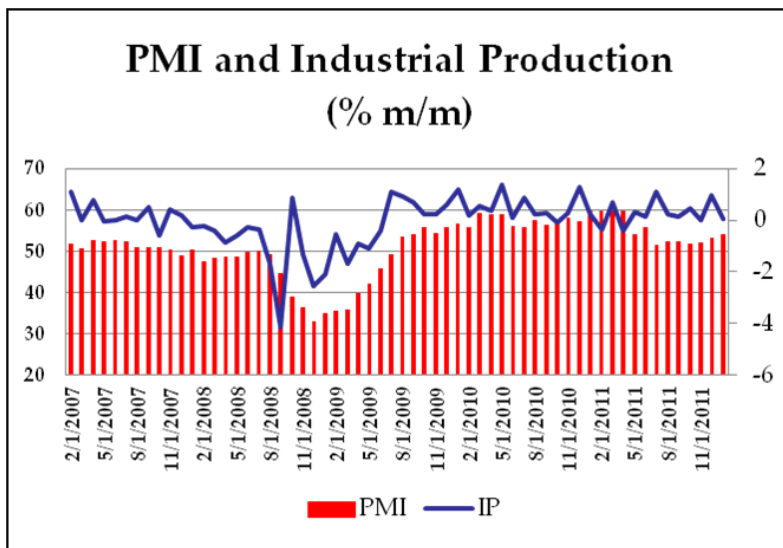
***An Economy on the Move:*** The continued flow of positive data releases is underscoring a burgeoning recovery. This is reflected in the upward revision of the estimate for 4Q11 economic growth from 2.8% to 3.0% (annualized). This change reflects an upward revision in personal consumption expenditures and non-residential fixed investment, as well as a lower trade deficit.

Survey data for the industrial sector continue to indicate a positive trend in manufacturing. Both of the Empire State and Philadelphia Fed indicators (respectively at 13.53 and 10.2) increased, having remained in positive territory for four consecutive months; the Chicago Purchasing Managers' Index (PMI) rose to 64 and the Institute of Supply Management (ISM) manufacturing index declined slightly to 52.4. However, the January data on industrial activity is more mixed: industrial production was flat, durable goods fell by 4.0% month-on-month (m/m), while factory orders declined by 1.0%. While exports continue to grow at a steady clip (+1.4% m/m) in January, the trade deficit also widened as imports rose even faster (+2.1%). On the household side, higher gasoline prices have yet to dent a surge in consumer confidence. The Conference Board's Consumer Confidence Index rose to 70.8 in February—its highest level in 4 years, while the University of Michigan-Reuters Consumer Sentiment measure increased to 75.3. Personal income increased by 0.3% m/m and personal consumption expenditures rose by 0.2% m/m. The service sector showed buoyancy, with the ISM-non-manufacturing index increasing from 56.8 to 57.3. Consumer credit also registered its second monthly

increase in January. All in all, we have a picture of a cautiously optimistic consumer, gradually opening up the purse strings.

The housing market seems to have stabilized, with the three main indicators (existing home sales, new home sales and housing starts showing slight increases in January, albeit at low levels. However, the Case-Shiller 20-city price index showed another decline (minus 0.4% m/m, minus 3.8% year-on-year, y/y) in December.

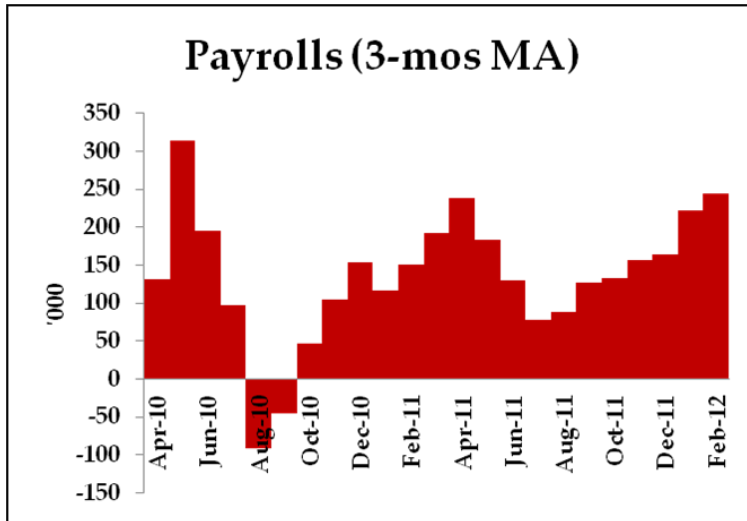
**Fig. 1: Industrial Sector Dynamics**



**Good News in Labor Markets:** The high-frequency labor statistics continue to point to an improving employment situation. While the latest weekly (March 8) Initial Jobless Claims rose slightly to 362,000 from 354,000 the previous week, the 4-week moving average remained constant at about 375,000. Moreover, this number has been below the critical 400,000 benchmark for 16 consecutive weeks. The February payrolls report underscored the sustained improvement in the employment situation. Payrolls increased by 227,000 in February (private payrolls were up by 233,000), and the previous two months numbers were revised upwards by 61,000. This data brings the three-month average to 245,000 (251,000 for the private sector). Manufacturing was up by 31,000 and private services by 209,000. Employment in construction and retail declined by respectively 13,000 and 7,000. Payrolls in the public sector fell by 6,000, indicating that the period of massive job losses in the public sector might be over. Weekly hours worked stayed constant at 34.5 and hourly earnings increased by 0.1%, bringing the (annualized) income proxy (hours times hourly earnings) up by 5%. The improved labor market conditions also resulted in a rise in the participation rate to 63.9% from 63.7 in January. The separately conducted households' survey showed that the unemployment rate remained unchanged at 8.3%, (largely due to the rise in the labor supply). An encouraging statistic was the shift to full-time

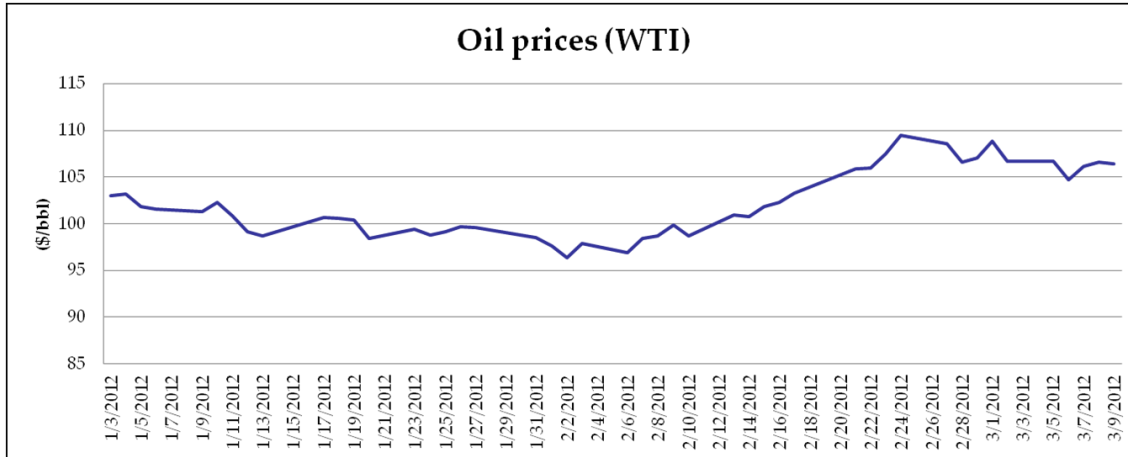
work as the number of part-time positions fell significantly. In combination, higher payrolls and lower initial jobless claims are evidence that the improvement in the employment situation is sustained and broad-based.

**Fig. 2: Improving Payrolls**



**The Iran Premium:** Oil markets are at the center of global policy concerns. Oil prices have reached what seems to be a new plateau of \$105-110/barrel (\$/bbl, West Texas Intermediate, WTI) in early March, approximately 15% higher than the 4Q11 average. Two factors are behind the oil price increase, one positive and one negative: faster growth in the United States and stronger demand from emerging markets, in particular India and China on one hand; and the rise in geo-political tensions on the other. However, an analysis of the global oil markets indicates that the physical markets are well supplied. Global oil demand was flat in 2011 at 85.8 million barrels per day (mbd), while supplies rose by 1.3 mbd to 89.6 mbd, with both non-OPEC and OPEC production increasing. In particular, OPEC production, which was temporarily reduced in 2Q11 by the events in Libya, recovered by an average of 1 mbd to 30.5 mbd by 4Q11. Moreover, U.S. crude oil stocks have reached their highest levels in five years. Meanwhile, US crude oil imports have fallen sharply, and the US became a net products exporter in 2011.

**Fig. 3: Oil Prices: A New Plateau**



Therefore, much of the rise in oil prices is in reaction to the rise in geopolitical tensions with Iran. Oil markets have always been characterized by multiple equilibria, with the price of oil being driven by “paper barrels”. From this point of view, oil markets are anticipating a worsening supply/demand balance in the coming months, driven by a potential European Union (EU) embargo on Iranian oil (which could be in place in 2H12), as well as conflict-driven supply interruptions.

Iran has threatened to retaliate by cutting off oil supplies to the EU. Moreover, with the crippling financial sanctions in place, as well as political pressures from the US and its allies, Iran has increasingly had problems selling its oil. While Saudi Arabia has pledged to add supplies to the markets as needed, its excess capacity is now estimated at about 1-1.5 mbd—all other OPEC members are producing at capacity. With little capacity to spare, an effective embargo on Iranian oil would lead to the loss of at least 1 mbd of oil supplies. In addition, Iran has responded to the threat of military action by Israel and/or the United States by threatening to attack oil facilities in neighboring countries. All in all, these factors have added an estimated \$15-20/bbl “Iran premium” to oil prices. Should there be military action, oil prices are certain to spike significantly higher.

While crude oil supplies remain high, gasoline production in the US has been adversely affected by a lack of refining capacity. As a result, gasoline prices are on the rise at a time when they should be seasonally at their lowest level, early March. Retail gasoline prices are now up roughly 30 cents from their end-year 2011 level. (It is estimated that every cent in gasoline price hikes costs the US households \$1 billion.)

**A Global Slowdown:** The global economic date is mixed, but overall tends in the direction of a slowdown. The eurozone economic output shrank by 1.7 % annualized) in 4Q11, However, the two largest eurozone economies, German and France, managed to maintain a modicum of growth, while Greece, Portugal, Spain, Italy and the Netherlands slipped into recession. The JPMorgan Global PMI

ended a 3-months upswing, falling slightly to 51.1 in February. However, these trends were somewhat offset by the strength of the JPMorgan All-Industry Global PMI (which includes services) jumping to a 12-month high of 56.5--a sign of a broadening of the base for economic recovery. Furthermore, concerns about economic overheating have led the Chinese government to reduce its medium-term growth forecast from over 10% to 7.5%.

***Greek Debt Swap in Place:*** The Greek debt saga reached an important turning point on March 8<sup>th</sup>, when most of the private sector bondholders agreed to swap their holdings of Greek debt for new bonds at a 53.5% discount (on a total of €206 billion). This agreement triggers the collective action clauses, which essentially forces all bondholders to abide by the terms of the agreement. The exception is the European Central Bank, which will exchange its debt at par. The Greek rescheduling will allow the release of another tranche of European Union monies. This will give some breathing space for the embattled Greek government, but is only a first step in resolving the European sovereign debt problem, which so far has been met with self-defeating savage budget cuts.

***Resilience and Risks:*** While the economic data and in particular the payroll numbers point to a continually improving economy, the global backdrop is one of a generalized slowdown and both systemic risks (the European sovereign debt crisis) and event risk (military conflict and oil supply disruptions).

In the US itself, we see a mixed picture.

- The US manufacturing recovery, which began last fall, is showing signs of slowing down, in part a response to weaker global demand.
- Rising incomes and sharply improved consumer confidence bode well for a more sustained recovery in consumption expenditures. However, personal disposable income rose in real terms by only 2% last year, and is not expected to grow much faster this year. Households remain very cautious, with the savings rate holding at about 4.5% of disposable income, as well as evidence of continued deleveraging.
- With no new action at the Federal level expected on the economy in this an election year, there will be a residual fiscal drag from federal spending.
- The budget travails of state and local governments seem to have abated somewhat with rising revenues, brightening their fiscal outlook and reducing fiscal drag.
- The widening trade gap could be a drag on economic growth.

For the first time in many years, we are seeing significant geopolitical risks affecting the growth picture. Even if a military conflict with Iran can be avoided, the United States and the West face a difficult balancing act: how to balance the sanctions on Iranian oil without imperiling the global economy. An oil price spike will have both direct and indirect effects on the US economic recovery--directly through the additional cost of fuel, and indirectly through its impact on Europe, financial

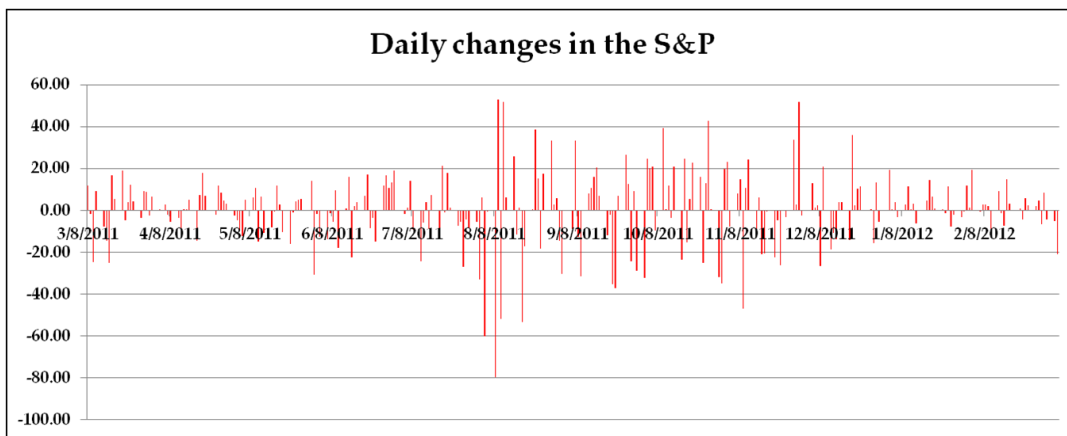
markets and consumer and business confidence. The magnitude of the impact is difficult to gauge, it would depend crucially on both the size and duration of any spike in oil prices resulting from Iran's response to the sanctions.

Overall, the US economy remains resilient, but the upside remains elusive and we have yet to see a tipping point. My central scenario remains a US economy growing at 2-3% over the year, with unemployment falling to under 8% by 4Q11.

***It's the Liquidity, Stupid!*** Equity markets have been on a strong bull run since the beginning of the year, with the S&P500 reaching its highest level since mid-2008 on March 2<sup>nd</sup>. Overall, the S&P500 has been up on 28 out of the 42 trading days in the first two months of the year. Concerns over global growth and the impending Greek debt swap led to a large correction on March 5<sup>th</sup>, with the S&P500 declining by 1.5%. However, markets responded positively to the Greek debt deal, and the S&P500 rebounded to end flat over the first week of March.

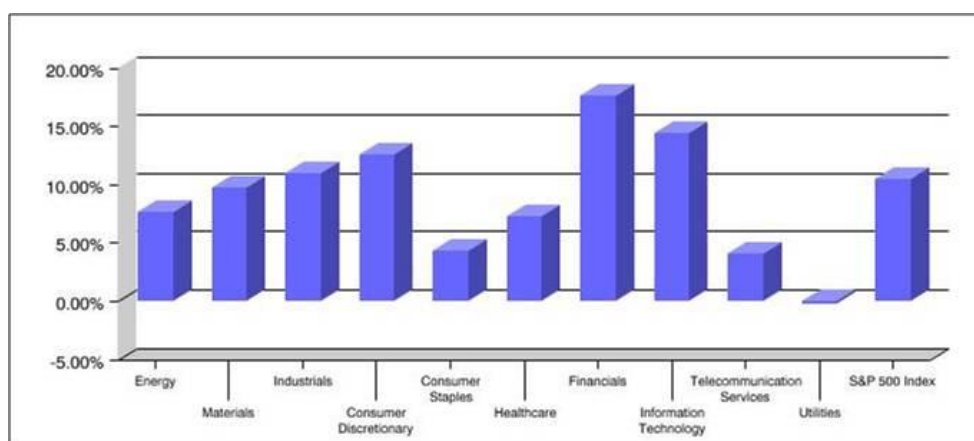
While the U.S. economic news has been improving, the economic performance remains subpar, hardly enough to sustain the strong recovery we have seen in the equity markets. With weak economic fundamentals, the markets seem to be driven by the massive liquidity injections we continue to see from the key central banks. As a case in point is the €500 billion of three-year credits provided by the European Central Bank (ECB) in its recent auction (bringing the total to over €1 trillion), which led to a rally in financial shares in Europe. The generous liquidity provision by the ECB has staved off the danger of a European banking collapse, but the banking fundamentals, particularly in Europe, remain weak. To varying degrees in both the United States and Europe, banks face fragile funding conditions, widening credit spreads, increased regulatory burdens and more difficult operating conditions. With this in mind, the S&P is considering downgrading about 100 financial institutions.

**Fig. 4: The S&P in 2012-More Ups than Downs**



The pattern for equity markets in the past few months has been to increase in a stepwise fashion. Currently, the S&P500 seems to be holding at a step of 1,350 to 1,400 and should be able to sustain that level over the short term. Over the medium term, the markets will continue to be buffeted by two forces. The upside will be limited by continued deleveraging at the corporate and household levels and mediocre economic growth. The downside will be somewhat protected by central banks action. The end result is likely to be one of market spurts followed by pauses and occasional corrections.

**Fig. 5: S&P500 three-month Sectoral Performance**



The three-month sectoral performance of the S&P500 is consistent with an economic recovery scenario: a good performance by cyclical sectors. The best performances were registered by Information Technology, Energy and Consumer Discretionary. The improvement in Financials most probably reflected the receding of the fear factor surrounding the Greek crisis, as well as the improvement in the economy. These patterns are expected to be maintained over the medium term.

## February 2012 Economic Data

Data Releases Feb 2012	Prior	Consensus	Actual	Min	Max
<b>Macroeconomy</b>					
GDP (4Q11, % Annualized)	2.8%	2.8%	3.0%	2.6%	3.1%
CPI (m/m) Jan	0.0%	0.3%	0.2%	0.1%	0.4%
Core CPI (% m/m) Jan	0.1%	0.2%	0.2%	0.1%	0.3%
<b>Balance of Payments</b>					
Exports (% m/m) (Jan)	0.4%		1.4%		
Imports (% m/m) (Jan)	1.6%		2.1%		
Trade Deficit \$ billion (Jan)	\$48.80	\$48.40	\$52.60	\$46.90	\$50.80
Current Account Deficit (\$ billion) (3Q11)	\$124.72		\$110.28		
<b>Industrial Production</b>					
Empire State (Feb)	13.48	14.8	13.53	10.0	18.0
Philadelphia Fed (Feb)	7.3	9.5	10.2	7.5	13.9
ISM-Mfg Feb	54.1	54.6	52.4	54.0	55.5
Chicago PMI (Feb)	60.2	61.0	64	58.0	62.0
Industrial Production (% m/m) Jan	1.0%	0.7%	0.0%	3.0%	1.2%
Durable Goods (m/m) Jan	3.3%	-0.7%	-4.0%	-2.1%	0.5%
Durable Goods (y/y)	17.1%		8.1%		
Durable Goods, ex transp (m/m)	2.1%		-3.2%		
Durable Goods, ex Transp (y/y)	6.7%		5.7%		
Inventories (m/m) jan	0.3%	0.5%	0.4%	0.0%	0.8%
Factory Orders (m/m) Jan	1.1%	-1.6%	-1.0%	-2.2%	0.5%
<b>Services</b>					
ISM non-mfg Feb	56.8	56.0	57.3	54.5	58.0
<b>Consumer Spending</b>					
Retail Sales (% m/m) Jan	0.1%				
UMich Consumer Sentiment Feb	72.5	73	75.3	71	76.0
ConfBd Consumer Confidence (Jul)	61.5	64.0	70.8	62.0	67.0
Personal Income (m/m) (Jan)	0.5%	0.5%	0.003	0.2%	0.8%
Personal Income (y/y)	4.6%		3.6%		
Consumer Spending (m/m) (Jan)	0.0%		0.2%		
Consumer Spending (y/y)	4.0%		3.8%		
<b>Housing Market</b>					
Housing Starts ('000) Jan	689	675	699	640	736
New Home Sale ('000) Jan	324	315	321	310	355
Existing Home Sales (MM) Jan	4.38	4.69	4.57	4.50	4.82
Case Shiller-20 (m/m) DecSA	-0.7%	-0.4%	-0.5%	-0.6%	0.0%
Case Shiller-20(y/y)	-3.8%	-3.7%	-4.0%	-4.1%	-3.0%
<b>Employment</b>					
First Time Claims ('000) (1st Week March)	351	354	362	345	360
Non-Farm Payroll (Feb)	284,000	204,000	227,000	180,000	275,000
o/w Private Sector Feb	285,000	220,000	233,000	195,000	285,000

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