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## Advocacy Investing<sup>®</sup>

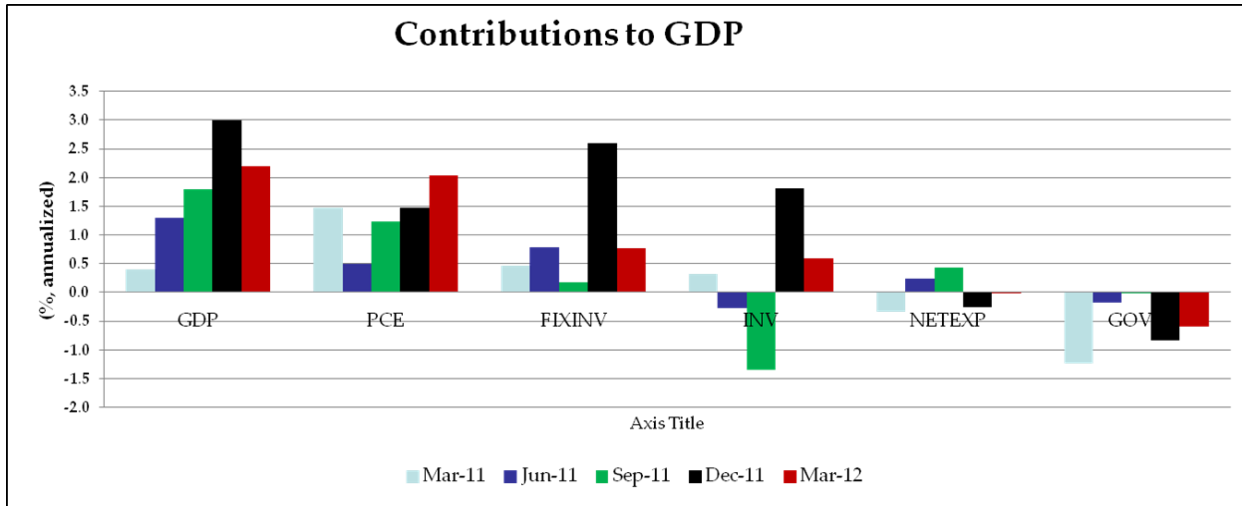
### IF IT'S APRIL, IT MUST BE EUROPE

- 1Q12 GDP growth disappoints
- The European financial situation deteriorates once again as markets focus on Spain
- Electoral shifts in Europe have intensified political risks
- Will Greece be forced out of the euro?
- The data releases stream is mixed, points to a slowing manufacturing sector
- Sluggish labor markets underscore economic slowdown
- The US economy faces stronger headwinds in the second half of the year

***In the past two years, April has been marked by eurozone economic and financial shocks, and it seems that this year will be no exception.*** Ill winds of recession and sovereign debt crisis are blowing once again over the Atlantic, potentially putting a serious damper on the United States fledgling recovery.

The preliminary estimate for 1Q12 GDP shows that the economy decelerated from 3% to 2.2% growth between the last quarter of 2011 to the first quarter of 2012 (Caution! This estimate is subject to two revisions in the coming months). The acceleration in personal consumption expenditures, residential investment and net exports was offset in large part by a smaller contribution from inventory buildup, as well as by continued drag from shrinking government expenditures at both federal and local level. Fixed non-residential investment actually shrank for the first time in eight quarters.

**Fig. 1: Sectoral Contributions to GDP**



**Softer Data:** The data releases show resilient households, but a stuttering manufacturing sector casts a shadow on the strength of the recovery. Disposable income and personal consumption expenditures rose by respectively 0.4% and 0.3% (month-on-month) in March, and despite still-high gasoline prices and uncertain employment prospects, both the University of Michigan-Reuters and the Conference Board consumer confidence measure remained high. We face a different story on the industrial and manufacturing side, where the data show a significant deceleration. Survey data are still positive, but pointing downward: the Empire State index down from 20.21 in March to 6.26 this month; the Philadelphia Fed index also down from 12.5 to 8.5 and the Chicago PMI declining from 62.2 to 56.2. However, the ISM-Manufacturing index bucked the trend and increased from 53.4 to 54.8. Industrial production flat lined in both February and March. Factory orders in March saw the biggest decline in three years, falling by 1.5% (m/m). Overall, capital spending was soft, especially in tech expenditures.

**Payroll disappoint again:** April payrolls came in at +115,000, below market expectations for the second month in a row. The disappointing data for April was offset in part by upward revisions for the previous two months (+54,000). This brought the average monthly job creation rate for the first four months of the year to 200,000. The unemployment rate (based on a separate household survey) fell from 8.2% to 8.1%, but that was the result of a further reduction in labor job participation from 63.8% to 63.6%. Manufacturing gained only 16,000 jobs, the slowest in 5 months, while retail jobs increased by 30,000. Government payrolls shrank by 15,000. Both hours worked and hourly wages remained flat. This loss of momentum in the past two months had been already reflected in the high-frequency data, with the first time jobless weekly claims number reversing a 16-week favorable trend and climbing in the first three weeks of April. While these claims remained under 400,000 and fell at the end of the month, the positive trend experienced in the past few months was clearly interrupted.

While April numbers have generally been subject to upward revisions, the second month of disappointing labor market data points to a softening of economic trends.

**A Difficult Global Economy:** Global manufacturing data was mixed. The eurozone PMI was down (still under 50), and the Chinese PMI was up. The JPMorgan Global Manufacturing PMI was up slightly in April, to 51.4, driven by strength in the US and China, which offset a decline in the eurozone and the UK.

**Those \*\*\*\* Europeans!** The eurozone remains unsettled after a relatively quiet two months, with new concerns about Spain and a rise in political risk. Recent data showed that both the UK and Spain officially are in recession (as defined by two consecutive quarters of economic contraction). Moreover, the severe austerity program introduced by the new conservative government of Prime Minister Rajoy failed to impress the markets. Yields on Spanish bonds rose sharply once again as financial markets feared that Spain, the fifth largest economy in the eurozone, could become the next victim of the European financial crisis. Eurozone unemployment reached a 15-year high of 10.8%. Political risks have also risen as we are seeing a broadening resistance against the tough austerity medicine pushed by Germany. Increasingly, economists, policy-makers and the political classes are seeing that Europe is caught in a vicious circle of austerity, economic contraction and rising debt. Furthermore, the European debt crisis will not be resolved without a return to growth.

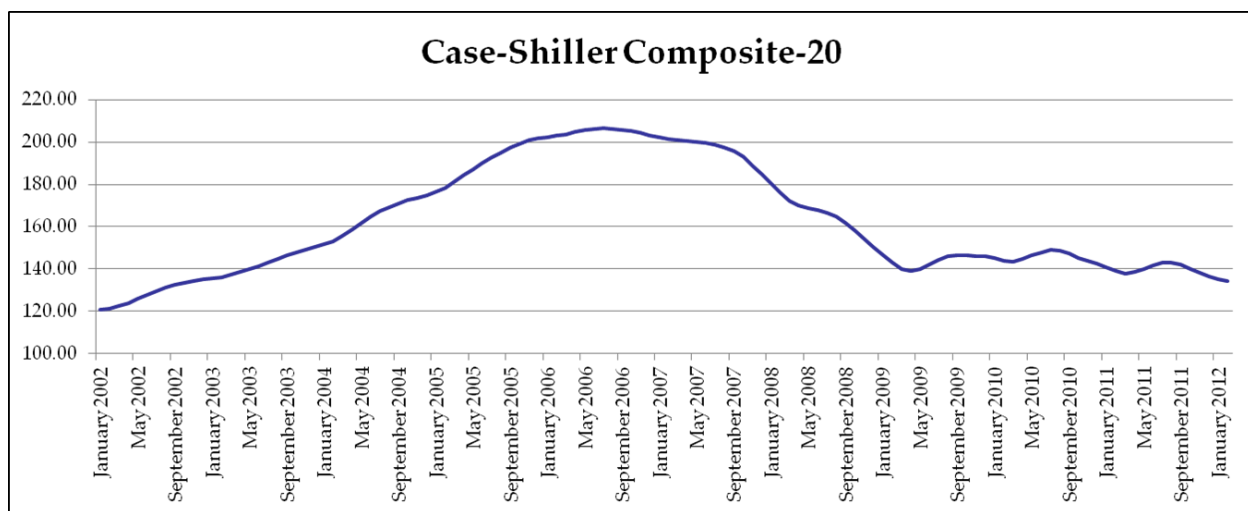
**No to Austerity!** This realization is being reflected in the political shifts we are witnessing, with two elections held last Sunday (France and Greece) delivering a strong vote against austerity. In France, the Socialist candidate Francois Hollande defeated the conservative President Sarkozy. This is the first time the Socialists have won the presidency since 1988 (and only the second time since the onset of the Fifth Republic in 1958). In Greece, the majority socialist party PASOK was handed a stinging defeat, coming in third place behind Syriza, a new anti-austerity leftist coalition. Furthermore, the two main parties, PASOK and the conservative New Democracy, saw their share of the vote drop to one-third. French president-elect Hollande lost no time in pledging to fight the austerity programs backed by Germany. Hollande's first international test will be the G-8 Camp David Summit to be held on May 18<sup>th</sup>-19<sup>th</sup>, only days after his inauguration.

Even the Dutch government, one of the most fiscally responsible ones in Europe, fell as a result of a dispute between the coalition partners over new austerity measures. The dramatic shifts in political power mean that we are entering a period of increased political risk and uncertainty. While the tilt towards growth has found new favor among economists and policy-makers, the financial markets' reaction remains to be seen.

**No-Surprises from Ben:** The April 25<sup>th</sup> meeting of the Federal Open Market Committee (FOMC) did not yield any surprises. The Fed's view of the broad economic trends remains unchanged from the previous meeting--moderate growth, gradual decline in unemployment and high downside risks.

Nevertheless, the Fed upgraded its 2012 economic growth projection by 0.2% to 2.4-2.9%, with growth returning to 3.0%-plus by 2013 and 2014. While some of the FOMC members feel that confident enough about growth to talk about a monetary tightening, the majority voted to keep short-term rates down in the 0-25 basis points range to the end of 2014. However, there was no talk of extending “Operation Twist” beyond its end-June deadline.

**Fig. 2: Housing Prices**



**Signs of Life:** The housing market is showing some signs of life. While sales of both new and existing homes remained flat in March, the Case-Shiller price index showed a slight gain in February, the first in ten months. Moreover, we are seeing some structural shifts in the market, with a decline in foreclosure sales (so-called OREOs, which fell by 14% in 4Q11) and a rise in short sales (up by 12% in the same period). The \$25 billion settlement reached between the banks and the government over foreclosures could be helpful in reducing the number of distressed properties (March foreclosures are down by 30% year on year, y/y).

**Oil price pressures have lessened** as a result of ample supplies, weak demand and the lessening of tensions with Iran. However, the oil markets remain very volatile as prices respond quickly to equally volatile economic news. Nevertheless, oil prices have stabilized around \$105/barrel (West Texas Intermediate), and had stayed above the \$100 mark since mid-February, falling under \$100 on May 5<sup>th</sup>—a four-month low of about \$96.00. While this stabilization is welcome economic news, oil prices will remain downwardly sticky, and \$95-100 seems to be the “new-normal” range for WTI.

**Loss of Momentum:** After a strong start in the first two months of the year, the US economy seems to be marking time as external headwinds become more intense. The main elements of the economic forecast remain the same as in previous months:

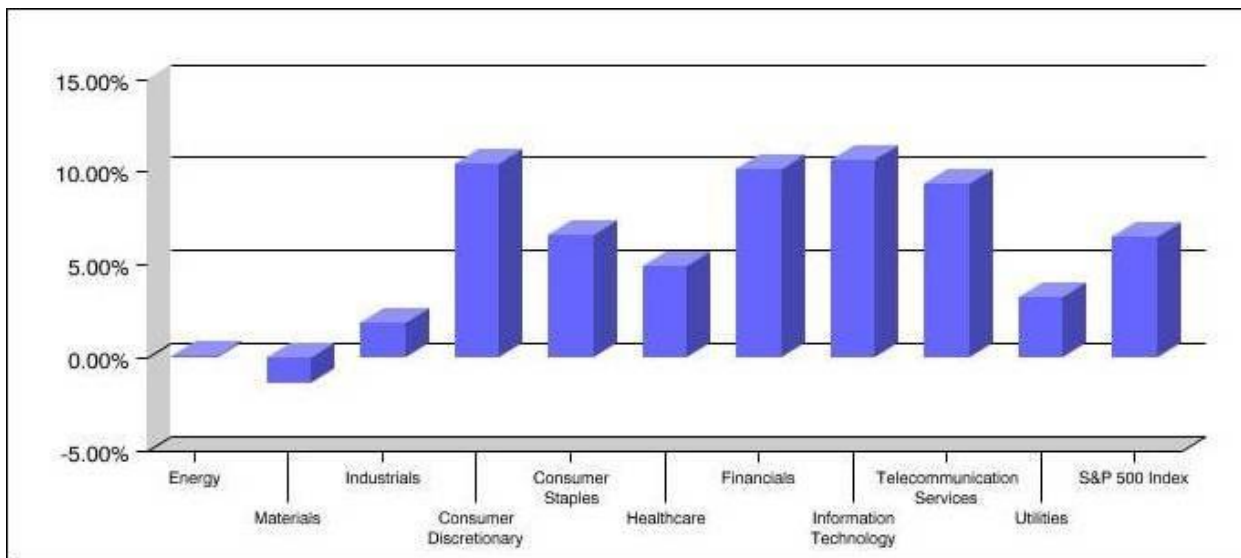
- Headwinds from the crisis in Europe have intensified
- The global economy is slowing down
- Manufacturing and inventory buildups, which went to overdrive in 1Q12, have shown signs of slowing down as the global economy softens
- Despite high unemployment, the steady improvement in labor markets and the bottoming out of the housing cycle are fuelling improved consumer confidence. These trends should sustain moderate growth in private consumption expenditures

While the economy remains resilient, the balance of risk is tilted towards the negative. Nevertheless, we do not necessarily see a repeat of the negative shifts of the past two Aprils, as each year presents different challenges and opportunities. For one thing, the US economy is in a much stronger position, gasoline prices are unchanged from their levels a year ago, and we do not have to cope with the impact of a tsunami. Moreover, emerging markets seem to be recovering. The major challenge will be to cope with any potential European financial shock in the next few weeks. In the longer term, the US economy is facing this fiscal “cliff” of approximately \$500 billion (3% of GDP) in 2013 with the expiration of the both the payroll and the Bush tax cuts. With these points in mind, our central forecast is for economic growth of 2-2.5% over the next two quarters.

**Markets Decoupled:** The markets have held their ground despite the darkening of the economic horizon. The S&P500 fell by about 4.5% from its end-March high of 1419 by mid-April, but has been hovering around 1,400 in the first week of May and the DJIA has clung to 13,000 for most of the month. However, April saw the S&P500 fall below its 50-week moving average for the first time since December 19, 2011, although it managed to return to a higher level by the end of April. Cyclical stocks lost the most ground in the month of April, but have done better on a 90-day basis.

The major driver of the resilience of the US equity markets—which has also been the case for major foreign markets—has been positive earnings surprises. For the 357 out of 500 companies in the S&P500 reporting 1Q12 profits, earnings were up 6.9%, significantly higher than earlier market expectations (which projected a flat quarter). The good news is that 70% of the S&P500 reporting companies beat expectations. The bad news is that most of the earnings buoyancy came from foreign markets. Moreover, some of the earnings drivers in the Financials sector, which has done exceptionally well in the past few months, are not likely to be repeated. Higher capital requirements and the sharp contraction in global M&A, IPOs and bond underwritings should lead to a more subdued picture in that sector.

**Fig. 3: S&P Sectoral 90-days Performance (4/30/2012)**



Markets showed morning-after forbearance in the face of the French and Greek election results, dropping only modestly. While the FaceBook IPO might provide some short-term dynamism to the markets, the best-case scenario is for a market plateau in the next few weeks as we are back to a wait-and-see stance by investors. Political risks are likely to dominate in the short-term, until we get a clear view of the political and policy shifts in Europe.

## April 2012 Economic Data

April 2012	Prior	Consensus	Actual	Min	Max
<b>Macroeconomy</b>					
GDP (4Q11, % Annualized)	3.0%	2.5%	2.2%	2.8%	3.6%
CPI (m/m) Mar	0.3%	0.3%	0.3%	0.1%	0.5%
Core CPI (% m/m) Mar	0.2%	0.2%	0.2%	0.1%	0.2%
<b>Balance of Payments</b>					
Exports (% m/m) (Feb)	1.5%		0.1%		
Imports (% m/m) (Feb)	2.1%		-2.7%		
Trade Deficit \$ billion (Feb)	\$52.5	\$51.70	\$46.0	\$48.50	\$54.50
Current Account Deficit (\$ billion) (4Q11)	\$124.10				
<b>Industrial Production</b>					
Empire State (Apr)	20.21	18.0	6.56	10.0	22.7
Philadelphia Fed (Apr)	12.5	12.0	8.5	5.0	15.5
ISM-Mfg Mar	53.4	53.0	54.8	52.0	54.6
Chicago PMI (Mar)	62.2	60.8	56.2	58.0	62.9
Industrial Production (% m/m) Mar	0.0%	0.1%	0	-0.20%	0.7%
Durable Goods (m/m) Feb	2.2%				
Durable Goods (y/y)	12.2%				
Durable Goods, ex transp (m/m)	1.6%				
Durable Goods, ex Transp (y/y)	9.5%				
Inventories (m/m) Feb	0.7%				
Factory Orders (m/m) Mar	1.1%	-1.6%	-1.5%	-2.5%	0.5%
<b>Services</b>					
ISM non-mfg Feb	56	56.0	53.5	54.0	62.0
<b>Consumer Spending</b>					
Retail Sales (% m/m) Mar	1.0%	0.3%	0.8%	0.1%	0.7%
UMich Consumer Sentiment Mar	75.7	75.8	76.4	74	78.0
ConfBd Consumer Confidence (Apr)	69.5	69.7	69.2	66.9	72.5
Personal Income (m/m) Mar	0.3%	0.3%	0.4%	0.1%	0.5%
Personal Income (y/y)	3.3%		3.4%		
Consumer Spending (m/m) Mar	0.9%	0.4%	0.3%	0.2%	0.7%
Consumer Spending (y/y) Mar	4.3%		4.0%		
<b>Housing Market</b>					
Housing Starts ('000) Mar	694	700	654	675	738
New Home Sale ('000) Feb	353	318	328	305	335
Existing Home Sales (MM) Mar	4.6	4.62	4.48	4.50	4.72
Case Shiller-20 (m/m) SA Feb	-0.1%	0.1%	0.2%	-0.3%	0.2%
Case Shiller-20(y/y) Feb	-3.9%		-3.5%		
<b>Employment</b>					
First Time Claims ('000) (1st Week May)	392	378	365	365	385
Non-Farm Payroll (Mar)	154,000	165,000.00	115,000.00	105,000	244,000
o/w Private Sector (Mar)	166,000	178,000.00	130,000.00	105,000	246,000

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