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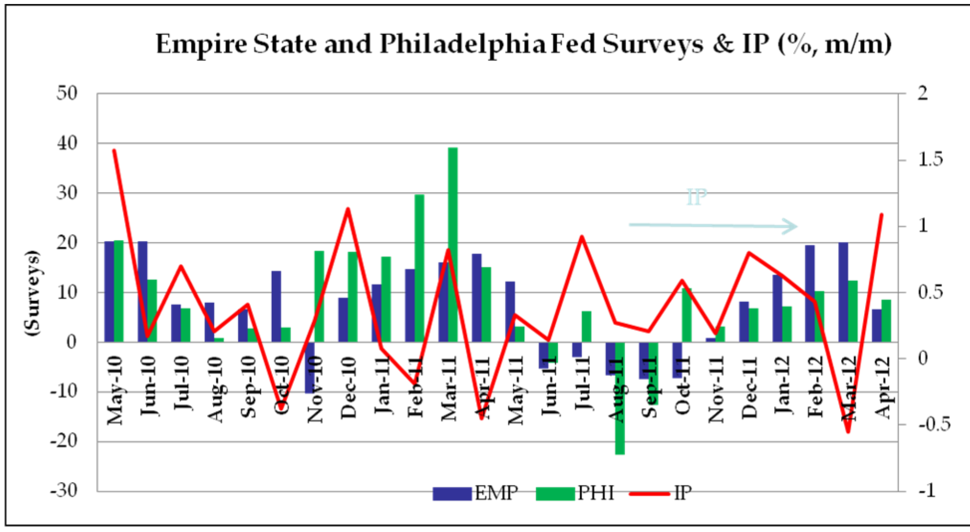
Advocacy Investing®

THE FEAR FACTOR

- **The eurozone's make or break moment**
- **Is the likely "Grexit" another Lehman moment?**
- **Economic indicators point south once again**
- **Sharp reversal in US employment situation**
- **The US economy's loss of momentum could dampen further the tepid recovery**
- **Investors overwhelmed by fear push "safe" yields to historic lows**

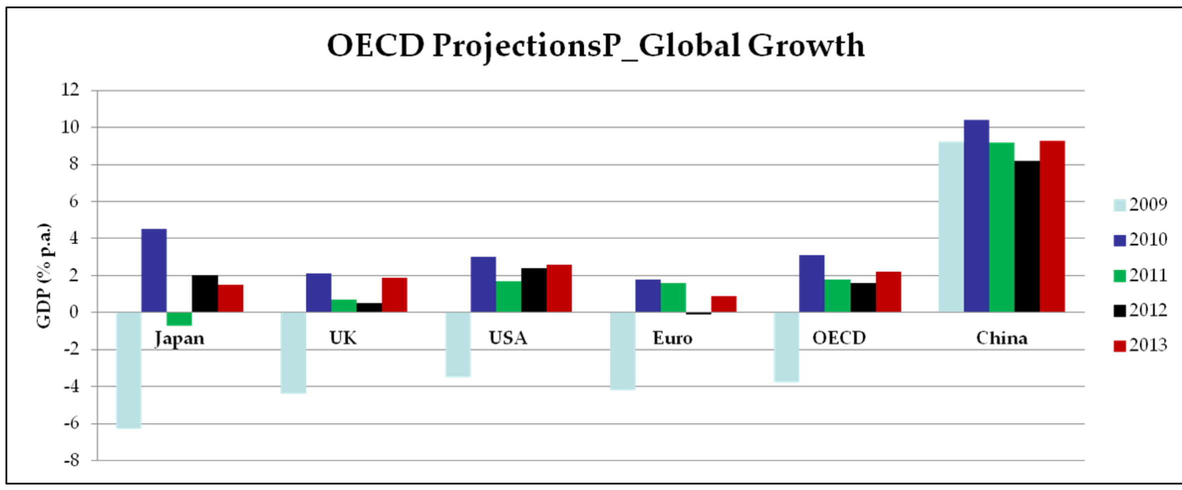
Negative Global Developments: The US economy is once again dragged down by negative global developments. The latest data releases show that we are experiencing a sharper-than-expected loss in momentum. Real GDP growth for 1Q12 was revised downward from 2.2% (annualized) to 1.9%. This loss in momentum is especially felt in industrial production and manufacturing sectors, which had provided the economy with a strong stimulus in the first months of the year. Survey data, while generally still in positive territory, underscored this slowdown. The Empire State index rose to 17.09 in May from 6.56 in April. In contrast, the Philadelphia Fed index fell into negative territory. The Chicago PMI fell sharply to 52.5, the lowest level since September 2009, and the Manufacturing ISM fell slightly to 53.5. Industrial production rose by 1.1% (month-on-month, m/m), but durable goods fell by 6.3% m/m. Factory orders were down 0.6% (m/m), the third consecutive monthly decline. The ISM Non-manufacturing delivered a positive surprise, rising to 53.5 from 53.3. Nevertheless, the consumer seems to be holding. Personal income rose by 0.2% (m/m), while personal consumption expenditures (PCE) increased by 0.3%. However, consumer confidence indices were mixed (up for the University of Michigan-Reuters index, down for the Conference board), which could indicate a negative shift in consumer behavior.

Fig. 1: Industry Surveys



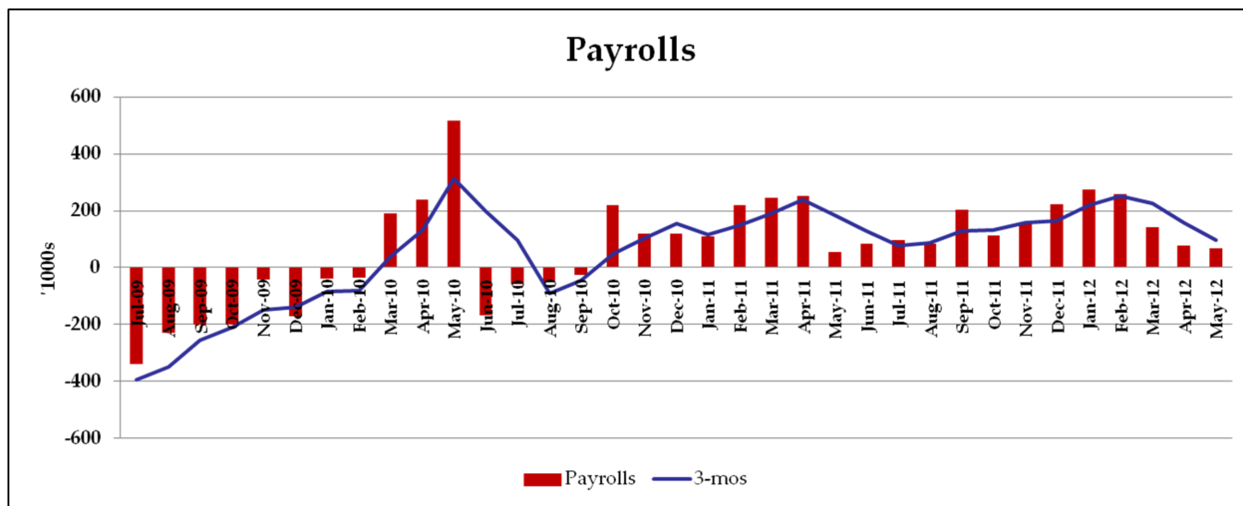
The housing markets continue to stabilize, with increases registered in both new and existing home sales in April. Moreover, the Case-Shiller 20-city home price index rose by 0.1% (m/m), the best performance since December 2010.

Fig. 2: Global Economic Performance and Forecasts



Challenging Employment Picture: The labor markets are challenging. High-frequency data show continued stagnation, as weekly first-time jobless claims were flat at around 370,000 for most of May and rose to 383,000 in the last week of the month. The slowdown was confirmed by the May monthly payroll data, which increased by a disappointing 69,000 (private payrolls increased by 82,000), significantly below even the low end of market expectations. In another worrisome sign, April payrolls were revised downward by 38,000, to 77,000, resulting in a monthly average of under 100,000 for the past three months, about half of the average pace over the previous three months. Manufacturing increased by 12,000 and private business services by 97,000. Construction fell by 28,000 and government by another 5,000. Weekly hours worked fell by 0.1, to 34.4 hours, while average hourly earnings rose by 0.1%. In combination, the earnings proxy has increased by only 1.5% (annualized) in the past two months, down from 5.6% in 1Q12. The unemployment rate, which is based on a separate household survey, inched up from 8.1% to 8.2%--in part due to a recovery in the labor participation rate.

Fig. 3: <u>Employment Picture</u>



Global Slowdown: The global scene is extremely challenging for the United States, with the world being weighed down by the combined effect of the global economic slowdown and the renewed sense of crisis in the eurozone. The eurozone economy was flat in 1Q12, and is expected to have slipped into recession in 2Q12. Chinese industrial production is contracting, as underscored by a below 50 PMI—overall, the country's economy is slowing down from the double-digit growth levels of the past few years; output growth in 1Q12 was estimated at 8.5%, and could fall to 7.5% in 2Q12. Other major BRICs are either slowing down (India), or in recession (Brazil).

Commodities and Oil Markets Respite: Commodities have fallen to their lowest level in 8 months in response to the global slowdown. The consumer benefitted from lower oil prices in the past few weeks. Oil prices (West Texas Intermediate, WTI) continued to retreat, falling by 25% from its high of almost $110 to under $84 at the end of May, making it officially a bear market, and Brent has fallen under the $100 mark. Falling demand, abundant supplies—excess supply is estimated at 500,000 barrels/day-- and a muting of geopolitical risks have contributed to what could be the main welcome news of a difficult May.

Another Lehman Moment? Europe is at the center of global concerns. In its latest semi-annual report on the global economy, the Organization for Economic Cooperation and Development (an official economic advisory body which gathers data from the 34 most developed countries on the world) stated: *"the global economy is gradually gaining momentum, but the recovery is fragile, extremely uneven across different regions and could be derailed by the crisis in the euro area".* The Greek political crisis has raised the ultimate question: are we seeing the unraveling of 60 years of European integration, or the beginning of a deeper union? The eurozone sovereign debt crisis seems to be going through the classic stages of shock-anger-denial-acceptance. As we speak, we are in the last two phases and facing the unthinkable, the exit of one, and possibly more countries from the single currency. As things stand today, Greece is facing another election in June, an election which is likely to strengthen the anti-austerity coalition. At the same time, the core European powers, France and Germany, are struggling to reconcile structural reforms and the urgent need to relaunch economic growth. Meanwhile, Spain is facing a major banking crisis and needs to recapitalize several of its ailing banks to the tune of tens of billions of euros.

Another Greek default and its exit from the euro (which the Financial Times has dubbed the "Grexit"!) are almost certain, and banks and governments across Europe are preparing for that eventuality. The problem will be to keep contagion from spreading to other countries, in particular Spain. Both of these issues (an orderly Grexit and refinancing the Spanish banks) will require massive amounts of money, as well as a consistent message from the core countries.

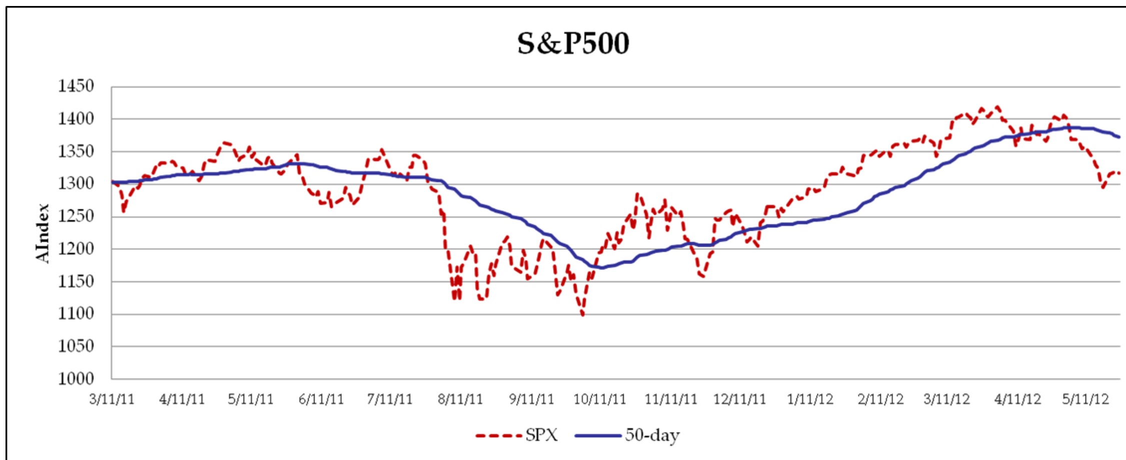
A Greek exit and default would have a major depressing impact on Greece itself, pushing most companies and banks to the brink of insolvency. Under these circumstances, European banks would also take a major, albeit manageable hit. Managing a semi-orderly exit would require ringfencing and recapitalizing the Greek banks, minimizing the impact on European banks and rewriting all Greek contracts in a new currency. Moreover, another Greek debt restructuring will not spare the official creditors (who hold 63% of Greece's €260 billion debt) this time around. Ultimately the eurozone has the means and the financial firepower to contain the damage, but preventing contagion will require additional steps by the core countries, the European Central Bank, as well as the IMF.

Fiscal Cliff Warnings: The government sector has been a major drag on the economy, with spending shrinking at an annualized pace of 4% in the past two quarters. This drag could continue in the near term. Moreover, there are fresh warnings about the 2013 "fiscal cliff" by the non-partisan Congressional Budget Office (CBO). As discussed in earlier issues of the newsletter, the United States is facing a fiscal "cliff" in 2013 as a result of the combined effects of the expiration of the Bush tax cuts and the automatic cutbacks under the Budget Enforcement Act of 2011. According to the recent projections of the Congressional Budget Office, the cliff would cut the fiscal deficit in FY 2013 (starting in October 2013) by an estimated $560 billion (4% of GDP) to 3.9% of GDP, and could cause the economy to contract by 1.3% in 1H13. Even if the CBO scenario represents an extreme case, the dire projections are a wake-up call to Congress and the Administration to come together to deal with the problem. There are indications that the two parties are moving to a potential agreement, and a "cliff" effect could be averted.

Loss of Momentum Could Intensify: The US economy has lost some momentum in the second quarter of the year, but remains on track for a tepid recovery, with significant downside risks resulting from the unresolved eurozone stresses. While the US and the rest of the world are bystanders in the unfolding European drama, the US economy could suffer from the crisis, directly through the loss of export markets, as well as indirectly through the negative impact on equity markets and consumer confidence.

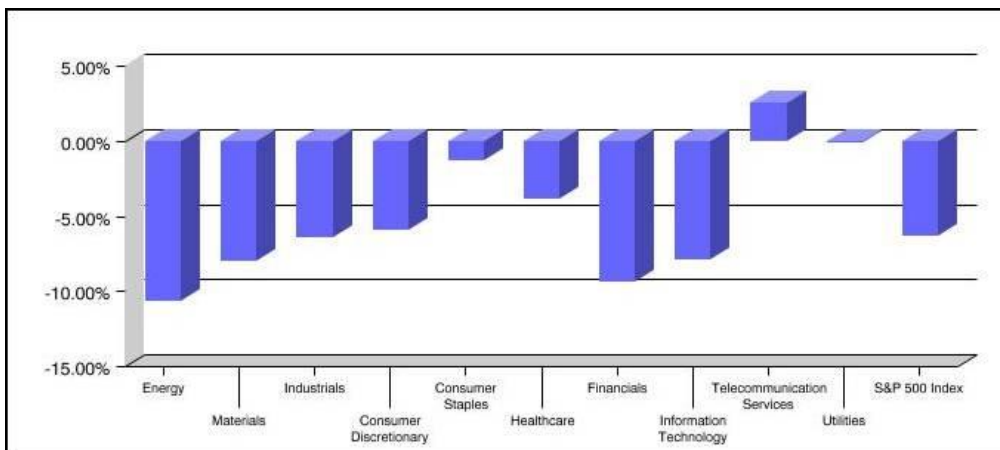
The US economic trajectory over the next few months is fraught with uncertainty. The good news is that private consumption is holding its ground—but for how long? We are also likely to see both the Fed and the ECB providing insurance. In the face of economic weakness, the Fed should extend its quantitative easing (Operation Twist) beyond its scheduled end in July, while the ECB will find a way to support the eurozone banking system. Moreover, major emerging markets, in particular China and Brazil, have already introduced modest stimulus measures, and we are likely to see other major central banks outside the US and Europe providing monetary support. However, there are limits to what monetary policy can do. Under such conditions, assuming European policymakers manage to calm market fears, we should see a downward ratcheting of US growth prospects to 1.5-2.0% from 2.0-2.5%, but we would avoid a double-dip recession.

Fig. 4: S&P500 Below 50-day Moving Average



Heading for the Exits: The markets were hammered in May by the combined effects of the Greek crisis and the failed Facebook IPO. Investors heading for the exits made May the worst month since last November for the S&P500, which fell by 6.7% from its April 30 high of 1,413, although it managed to remain above 1,300 for the month—only to fall below that level in response to the weak employment report on June 1. With both retail and institutional investors shunning equity markets, volatility has increased once again. The VIX index rose from a 2012 low of 14.26 at the end of March to a high of 25.10 on May 14. Since then, it has declined somewhat, although it remains in the low 20s. Investors, rush to safety has resulted in US 10-year yields falling to around 1.62%, the lowest levels since 1946, as well as a further decline in German Bunds yields—to negative yields for some maturities.

Fig. 5: S&P500 Sectoral Performance (90-days to May 31, 2012)



The first quarter saw a recovery in corporate profits, up 14.7% from a year earlier. However, the second quarter of the year is likely to be a difficult one for corporations, which have shown reluctance to publish any earnings guidance in the face of high macroeconomic instability. Nevertheless, the market consensus is for record average earnings per share of $105 for the S&P in 2012. The markets have already discounted a Greek exit from the euro, but remain uncertain about the potential impact of such an exit. The focus is now on Spain, which is struggling with a potentially massive bank bailout. This will translate to a market driven by macroeconomics (mainly US data releases) and policy risks (what will Merkel do?). Moreover, with all the main asset categories (equities, commodities, alternative investments) moving downwards in unison, there is no possibility to diversify risk by shifting portfolios.

The market is thinly traded, weak and subject to confusion. The S&P500 has traded so far this year at 12.9 times earnings vs. 15.9 times in February 2011, indicating deep bearish sentiments, while at the same time forecasting record earnings. The answer in this market is to stay put and defensive, but maintain an opportunistic stance.

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May 2012 Economic Data

Data Releases May 2012	Prior	Consensus	Actual	Min	Max
Macroeconomy					
GDP (4Q11, % Annualized) 1st revision	0.0%		1.9%		
CPI (m/m) Apr	0.0%	0.0%	0.0%	-0.1%	0.4%
Core CPI (% m/m) Mar	0.2%	0.2%	0.2%	0.0%	0.2%
Balance of Payments					
Exports (% m/m) (Mar)	0.3%		2.9%		
Imports (% m/m) (Mar	-2.8%		5.2%		
Trade Deficit $ billion (Mar)	$45.4	$49.50	$51.80	$45.00	$52.00
Current Account Deficit ($ billion) (4Q11)					
Industrial Production					
Empire State (Apr)	6.56	10.0	17.09	2.0	15.0
Philadelphia Fed (Apr)	8.5	10.0	-5.8	5.0	13.0
ISM-Mfg Mar	54.8	54.0	53.5	51.0	54.5
Chicago PMI (Mar)	56.2	56.1	52.4	55.0	60.0
Industrial Production (% m/m) Apr	-0.6%	0.5%	1.1%	0.0%	0.9%
Durable Goods (m/m) Apr	-3.7%	0.5%	0.2%	-1.4%	2.6%
Durable Goods (y/y)	1.8%		6.9%		
Durable Goods, ex transp (m/m)	-0.8%	0.7%	-0.6%	-0.2%	1.5%
Durable Goods, ex Transp (y/y)	5.4%		6.3%		
Inventories (m/m) Apr	0.6%	0.4%	0.3%	0.2%	0.7%
Factory Orders (m/m) Mar	-2.1%	0.1%	-0.6%	-0.5%	0.5%
Services					
ISM non-mfg Feb	53.5				
Consumer Spending					
Retail Sales (% m/m) Mar	0.7%	0.1%	0.1%	-0.3%	0.8%
UMich Consumer Sentiment May	77.8	77.8	79.3	76	79.5
ConfBd Consumer Confidence May	68.7	69.7	64.9	67.5	72.0
Personal Income (m/m) May	0.4%	0.3%	0.2%	0.1%	0.4%
Personal Income (y/y)	2.8%		2.8%		
Consumer Spending (m/m) May	0.2%	0.3%	0.3%	0.1%	0.5%
Consumer Spending (y/y) May	3.8%		3.8%		
Housing Market					
Housing Starts ('000) Apr	699	690	717	641	730
New Home Sale ('000) Apr	332	335	343	325	355
Existing Home Sales (MM) Apr	4.47	4.66	4.62	4.50	4.85
Case Shiller-20 (m/m) SA Mar	0.2%	0.3%	0.1%	-0.2%	0.7%
Case Shiller-20(y/y) Feb	-3.5%		-2.6%		
Employment					
First Time Claims ('000) (Last Week May)	373	370	383	367	377
Non-Farm Payroll (May)	77,000.00	150,000.00	69,000	95,000	206,000
o/w Private Sector (May)	87,000.00	164,000.00	82,000	100,000	209,000

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.

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