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Advocacy Investing®

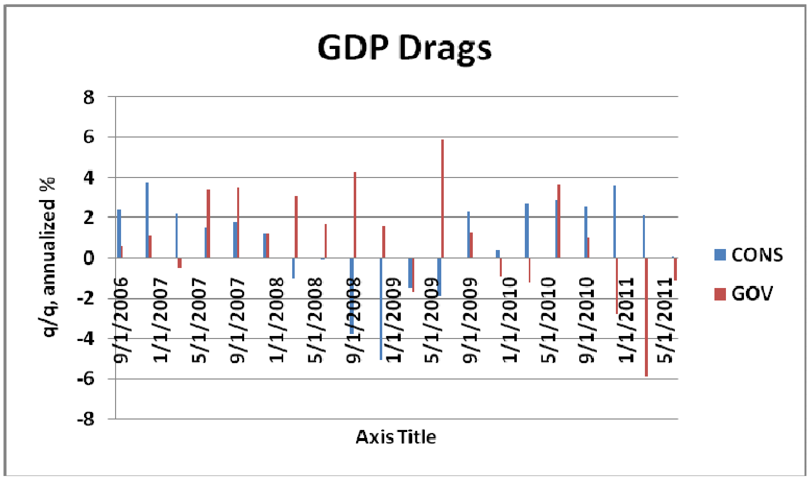
LOSS OF CONFIDENCE

- ***The US loses its AAA rating***
- ***The US economy is in a stall***
- ***Broad-based loss of confidence feeds into a vicious circle of low investment, consumption and unemployment***
- ***Global equity markets in a downward and self-reinforcing spiral***
- ***The European sovereign debt stresses spread to Spain and Italy***
- ***Panicked investors trigger technical correction***
- ***At best, we face another quarter of sub-standard growth; at worse, another recession***

The US economy is under severe stress as it enters the third quarter of the year. The negative impact of several months of mixed-to-negative data has been compounded by the dizzying Congressional debate over raising the debt ceiling and its messy resolution. A default might have been avoided, but damage done by this manufactured political crisis to investor confidence around the world will be felt across the spectrum and could be long-lasting.

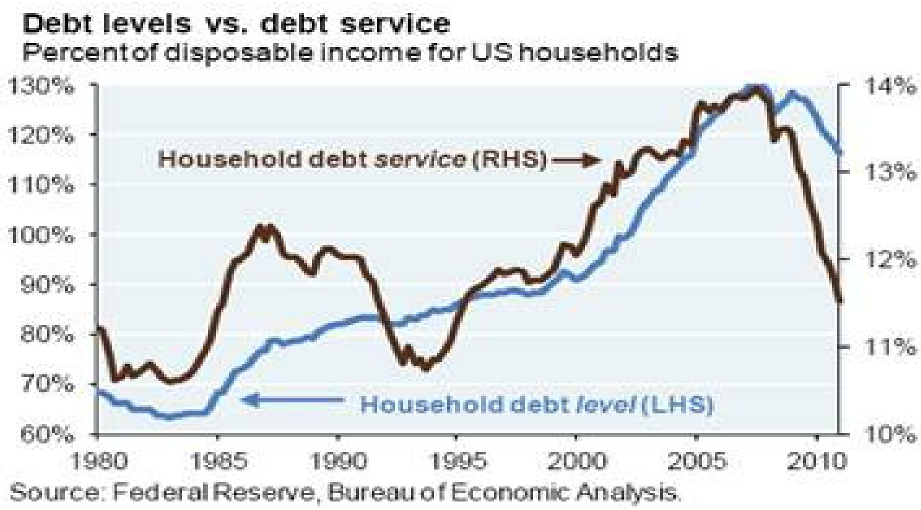
A Better-forgotten First Half: The latest GDP release confirmed the dismal economic performance over 1H11. Economic output grew by a mere 1.3% (quarter-on-quarter, q/q, annualized) significantly less than the 1.8% market consensus expectation. Furthermore, the output growth number for 1Q11 was revised downwards from 1.9% to 0.4%, resulting in 1H11 growth of 1%. There was weakness across the board, but the main drivers of the slowdown were sagging consumer expenditures and public sector contraction. Within the national accounts, the consumer contribution grew by barely 0.1% in 2Q11 from a high of 3.6% in 4Q10, while government expenditures—combined federal and local—fell by almost 6% in 1Q11 and 1.1% in 2Q11. With a widening trade deficit, net exports also became a drag on the economy. This challenging picture comes against a backdrop of global weakness. The JPMorgan Global All-Industry PMI (which includes goods and services) showed a slight improvement in July, but is still consistent with a decelerating global economy—global output rose by less than 2% in 2Q11.

Fig.1: GDP Drags: The Consumer and the Government



The Fading Consumer: Weak labor markets, high commodity prices and continued deleveraging by households have taken their toll on consumer confidence. The University of Michigan/Reuters survey showed consumer confidence falling to a 27-month low of 63.7. While personal income rose by a modest 0.1% month-on-month (m/m) in June, personal consumption expenditures fell unexpectedly by 0.1% m/m –the third consecutive monthly decline. In another sign of soft demand, auto sales in June fell year-on-year by 2.9% to 11.5 million vehicles after dropping by 10.4% in May.

Fig.2: Households Retrenchment

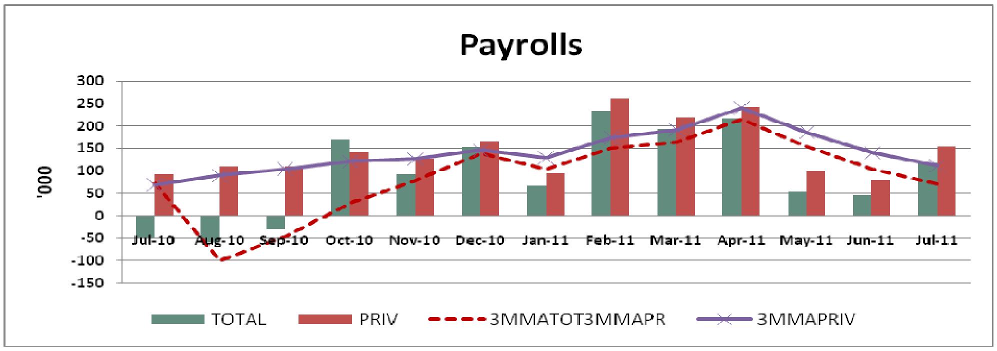


Manufacturing Stall: manufacturing was the bright spot of the economic recovery in 4Q10 and 1Q11. However, the sector has shown signs of a sharp slowdown both at the global and US level. The JPMorgan Global PMI fell for the 5th consecutive month to 50.7 in July, uncomfortably close to the "stall" benchmark of 50. While the Chicago PMI Index remained in the positive zone, the ISM-Manufacturing fell to a 2-year low of 50.9, well below market expectations. The weak manufacturing numbers are not surprising, as industries continue to run down inventories in the face of shrinking global demand. Durable goods expenditures fell, while industrial production rose by 0.2% m/m. Factory orders also declined by 0.8% m/m in June after a small gain in May, mostly as a result of the contraction of durable goods' expenditures. Overall, the Fed's Beige Book indicated a slowing economy in 8 out of the 12 Federal Reserve districts. The services sector also showed signs of weakness, with the ISM-nonmanufacturing Index dropping to 52.1 in July from 53.3 in the previous month.

The housing market remains stagnant at low levels of activity. While housing starts rose, new and existing home sales are significantly below normal levels of activity, and the Case-Shiller 10 city index shows barely budging prices.

Payrolls Improve: the July payrolls provided a rare glimpse of good news, with an above-expectations increase of 117,000. Moreover, the May and June totals were revised upwards by 56,000. Private sector jobs increased by 154,000 in July, with a June upward revision to 108,000. Government jobs continued to decline, falling by a total of 71,000 in June and July. While hours worked were unchanged, hourly wages were up by 0.4%. In parallel, we have seen the weekly first-time jobless claims decline to around 400,000, the benchmark for a drop in the unemployment rate. The unemployment rate edged down from 9.2% to 9.1%, but most of the improvement came from a fall in labor force participation.

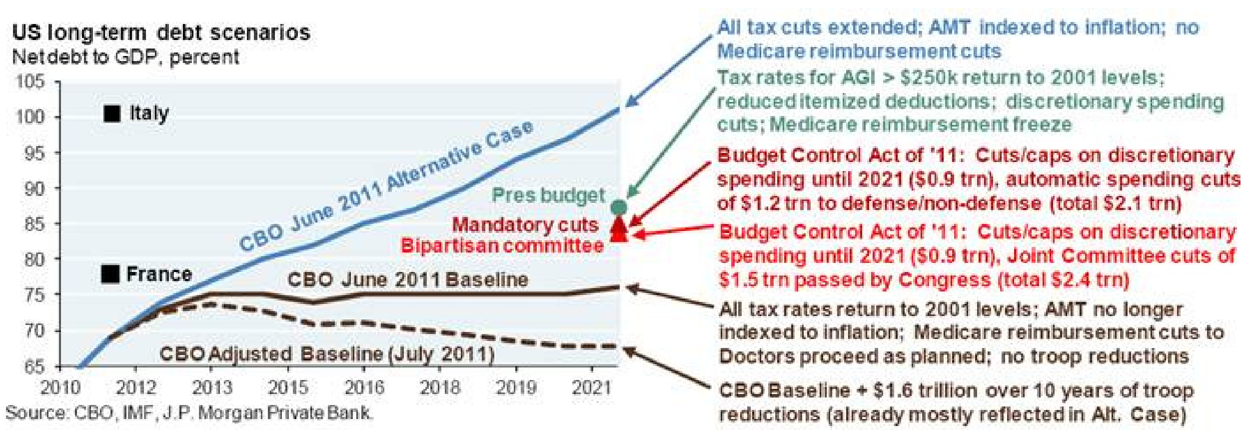
Fig.3: Payrolls



Fixing the Debt-Ceiling, losing the AAA: after weeks of fruitless wrangling, it took a 500-point drop in the Dow Jones Industrial Index in the last week of July to wake up Congress to the dangers of brinkmanship. (Interestingly enough, the bond markets remained calm despite the crisis, with the 10-year yield remaining under 3%). The final deal signed into law by President Obama just before the August 2 deadline) met with broad political dissatisfaction, but was necessary to avert a default. Nevertheless, serious damage was done to the United States and its global political leadership. In the words of Christine Lagarde, the newly-appointed head of the International Monetary Fund: "…there was always a positive bias towards the United States, towards Treasury bills. The events of the past weeks are probably chipping into that positive bias". The only saving grace for the dollar and the US Treasury is that in the face of on-going sovereign debt travails across the G-10 countries, the US financial markets maintain an edge with foreign investors.

The deal raises the debt ceiling by $2.1 trillion, sufficiently to cover deficits to January 2013. Spending is to be cut by about $0.9 trillion over the next ten years. In addition, a special Congressional bi-partisan commission will be formed to find ways to cut a further $2.4 trillion, with its recommendations subject to a simple up-or-down vote by Congress. However, compared to the January 2011 projections by the Congressional Budget Office (CBO), the sum total of these cuts are insignificant, representing about 5% of total 2011-2021 outlays and one-third of projected fiscal deficits over the same period. The reality is that the only real deficit reduction mechanism is faster growth. As a reference, tax receipts rose by 86% over the 1992-1999 period of rapid economic growth, and a further 25% over 2000-2008 despite the Bush tax cuts.

Fig.4: <u>Debt Dynamics</u>



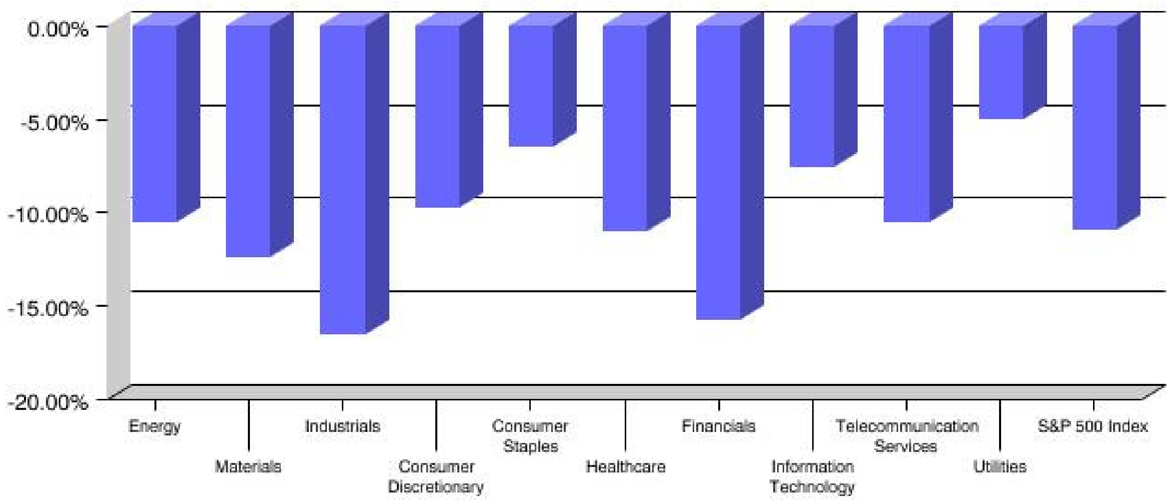
The economic impact of the spending cuts on economic growth is unclear at this moment, largely because we have little information on either the timing or the nature of these cuts. Based on early indications, it seems that the budget deal is back-loaded and will have minimal macroeconomic impact in 2011 and 2012. The flawed debt ceiling deal failed to impress the markets. Equity markets continued their sharp contraction and yields on long-dated Treasuries fell. The downgrade of the US sovereign rating by Standard & Poors from a AAA to AA+ on Friday August 5 was expected. The loss of the US gold-plated creditworthiness will be felt over time in the form of lower demand for US government security and ultimately somewhat higher interest rates. Moreover, the spectacle of a dysfunctional Washington establishment has impaired the world's confidence in the ability of the US to deal credibly with its major challenges and offer much-needed leadership on global issues.

A Challenging Picture: While the economy showing increasing signs of stalling, the US government has embarked on a path of austerity. Moreover, monetary policy is running out of tools, and can at best have a modest impact on a putative economic recovery. Twice in the past 18 months was the economy on the verge of a breakthrough and twice the breakthrough was aborted. The first time was when the Greek crisis hit in April-May 2010, and the second time when a combination of fiscal and sovereign debt in problems in Europe and the United States in the past spring have thrown a wrench in the works.

All of the engines of growth in the United States seem to have stalled or reversed themselves in 2Q11. Weaknesses in housing, employment, business and consumer confidence have come on top of fiscal austerity at both federal and state levels and continued household deleveraging. The only positive factor has been the sharp drop in oil prices, which have fallen to around $85/ bb. In combination, these factors have led most economists to downgrade their growth projections for 2H11. Martin Feldstein, a senior member of Business Cycle Dating Committee of the National Bureau of Economic Research (NBER) has raised the probability of a recession in the next few months to 50%, others to 20-30%. While the latter outcome is likely to be avoided, we will probably see growth of 1.5-2.5% in 3Q11. All eyes are now of the Fed to maintain a modified QE-II by shifting more assets to the long-end of the curve. A weak economy could also lead the Obama administration and Congress to renew the payroll tax cut of 2011, which would offset some of the fiscal tightening by injecting approximately $112 billion in the economy. The US ratings downgrade will be another blow to business and consumer confidence. Ultimately, we need to transform the vicious circle of economic stagnation, low consumer spending and low investment to a virtuous one, but the task is seemingly more difficult by the day.

Self-Fulfilling Fears? Having barely emerged from the debt ceiling saga with a loss of 6.2% for the Dow, the markets were assailed with negative economic news, ping-ponging between the twin fears of a US recession and concerns over a spreading of the European sovereign debt crisis to big players—Italy and Spain. Moreover, European, Asian and American equity markets have entered a vicious circle of mutually reinforcing down cycles. By Thursday August 4, the US equity markets was officially in a technical recovery, with the Dow having lost 10% since from its high of 12,724 on July 21. The S&P500 has broken through its 200-day moving average to below 1,200-- some technical analysts have been projecting a fall to the resistance level of 1,120.

Fig. 5: S&P500 Sectoral (3-months to 8/5/11)



Underlying the sharp losses in the equity markets is a loss of confidence of the public and the markets in the G-10 country in their governments' ability to deal with their economic and financial problems. The eurozone's political institutions seem to have been a "euro short and a day late" in their efforts to tame the sovereign debt crisis. The ink was hardly dry on the latest Greek bailout when the focus of the markets turned their concerns on Italy and Spain. In the US, the debt ceiling fiasco has underscored the dysfunction in Washington. Furthermore, markets are skeptical of the debt ceiling deal and concerned about its macroeconomic consequences. The glimmer of good news from the labor markets was not sufficient to halt the market panic and we are now in dangerous territory, with the market fears of another US recession and a major European debt crisis becoming self-fulfilling. These negative expectations are reflected in the sharp drop in US Treasury yields, with the 10-year yield falling under 2.5%.

When in panic mode, the investors question everything. Earning releases for 2Q11 have generally been positive—S&P 500 earnings were up and beat expectations-- but there is some question about their sustainability. Will governments be able to stave the bleeding? What about monetary policy? In this environment, to the extent that they are not fleeing equities, investors have turned to the defensive sectors. The question is now, what can turn the markets around? The focus will be on any evidence of a recovery after two miserable quarters, so once again we have to turn to the high-frequency data releases.

Data Releases

July 2011	Prior	Consensus	Actual	Min	Max
Macroeconomy					
Leading Indicators (m/m) Jun	0.8%	0.3%	0.3%	0.1%	0.6%
GDP (2Q11, % Annualized)	0.4%	1.9%	1.3%	1.0%	1.3%
CPI (m/m) Jun	0.2%	-0.2%	-0.2%	-0.3%	0.0%
Core CPI (% m/m) Jun	0.2%	0.2%	0.3%	0.1%	0.2%
Balance of Payments					
Exports (% m/m) (May)	1.6%		-0.5%		
Imports (% m/m) (May)	-0.5%		2.6%		
Trade Deficit $ billion (May)	43.6	$42.7	50.2	$41.5	$45.0
Current Account Deficit ($ billion) (1Q11)	119.3				
Industrial Production					
Empire State (Jul)	-7.8				
Philadelphia Fed (Jul)	-7.7	5.0	3.2	-4.8	10.0
ISM-Mfg	55.3	55.3	54.3	50.9	52.0
Chicago PMI (Jun)	61.1	61.1	58.8	56.5	62.5
Industrial Production (% m/m) Jun	-0.1%	0.4%	0.2%	0.1%	0.6%
Durable Goods (m/m)	1.9%	1.0%	-2.1%	-1.9%	1.5%
Durable Goods (y/y)	9.2%		7.6%		
Durable Goods, ex transp (m/m)	0.7%		0.1%		
Durable Goods, ex Transp (y/y)	7.4%		7.1%		
Factory Orders (m/m)	0.6%	-1.0%	-0.8%	-1.7%	0.7%
Services					
ISM non-mfg (Mar)	53.3	53.0	52.7	52.1	55.5
Consumer Spending					
Retail Sales (% m/m) (Jun)	-0.2%	0.0%	0.1%	-0.3%	0.1%
UMich Consumer Sentiment (Jul)	63.8	64	63.7	61.5	65.0
ConfBd Consumer Confidence (Jul)	57.6	57.0	59.5		
Personal Income (m/m) (Jun)	0.2%	0.2%	0.1%	-0.2%	
Personal Income (y/y) (Jun)	5.0%		5.0%		
Consumer Spending (m/m) (Jun)	0.1%	0.1%	-0.2%	-0.1%	0.2%
Consumer Spending (y/y)	4.7%				
Housing Market					
Housing Starts ('000) (Jun)	549	575	629	550	600
New Home Sale ('000 May)	319	321	312	309	342
Existing Home Sales (MM) (May)	4.81	4.90	4.77	4.80	5.20
Case Shiller-10 (m/m) May SA	0.4%		0.1%		
Case Shiller-10 (y/y)	-3.5%		-3.6%		
Employment					
First Time Claims ('000) (Aug 4)	401	403	400	388	400
Non-Farm Payroll (Jul)	46,000	75,000	117,000	25,000	125,000
o/w Private Sector (Jul)	80,000	108,000	154,000	60,000	150,000

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