U.S. MARCHING ALONG — EUROPE STILL UNDER STRESS

FEAR SELLS … SUBSCRIPTIONS

Zacks Investment Research recently circulated a memo that made light of a few of the scarier headlines that had recently been circulated by a number of disingenuous prognosticators:

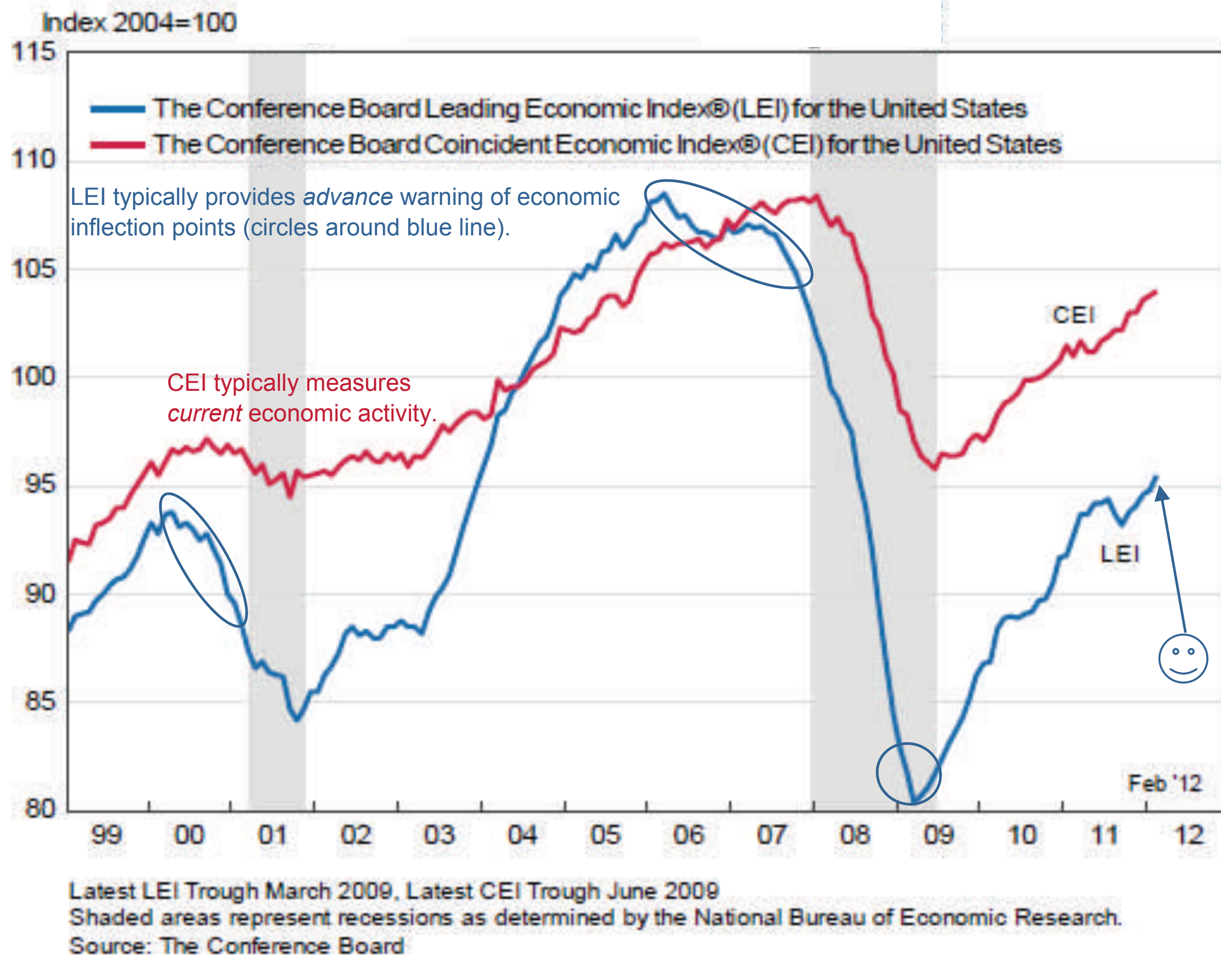
- End of America
- Kiss America Goodbye?
- European Crisis Can Still Cripple U.S.
- Is Europe Throwing Us into a 1930s Moment?
- How the U.S. Debt Downgrade Will Change Your Life
- Confusing Gradual Bankruptcy with Economic Recovery
- Up to 308,127,404 Americans Could Be in Serious Trouble

While it's easy to discount outlandish headlines like these, the folks who produce them also know that many readers may wonder, "What if it's true?" Over the years, folks have passed a variety of articles along to me, many of which were laced with large doses of bias. In some cases, I've taken the time to research the firms and the writers offering such opinions — often to find a history of run-ins with regulators that, unsurprisingly, involved deception. With this in mind, please know that legitimate research efforts are typically subjected to peer review and tend to make for significantly drier reading (drier than even this!) than the marketing efforts that are designed to emulate them. If I were to liken the typical investment opinion to one's diet, I would say that most of what comes out of the popular press would be analogous to fast food and empty carbs.

With that in mind, let's have a look at the much more measured approach taken by The Conference Board which is, interestingly, both a nonpartisan and nonprofit research group.

CONFERENCE BOARD: U.S. ECONOMY "POISED TO ACCELERATE"

In its March 13th press release, The Conference Board suggested that the U.S. economy was becoming fundamentally stronger based on improvements in consumer confidence, employment trends, and Board's own index of leading indicators which has continued its strong upward ascent. Refer to the chart on the next page.



In a recent press release, Conference Board economist Ataman Ozyildirim wrote, “Continued broad-based gains in the [index of] Leading Economic Indicators for the United States confirm a more positive outlook for general economic activity in the first half of 2012, although still subdued consumer expectations and the purchasing managers’ index for new orders held the LEI back in February. The [index of] Coincident Economic Indicators (CEI) for the United States, a measure of current economic conditions, has also been rising as employment, income, and sales data all continue to improve. Industrial production, however, has not yet picked up strongly.”

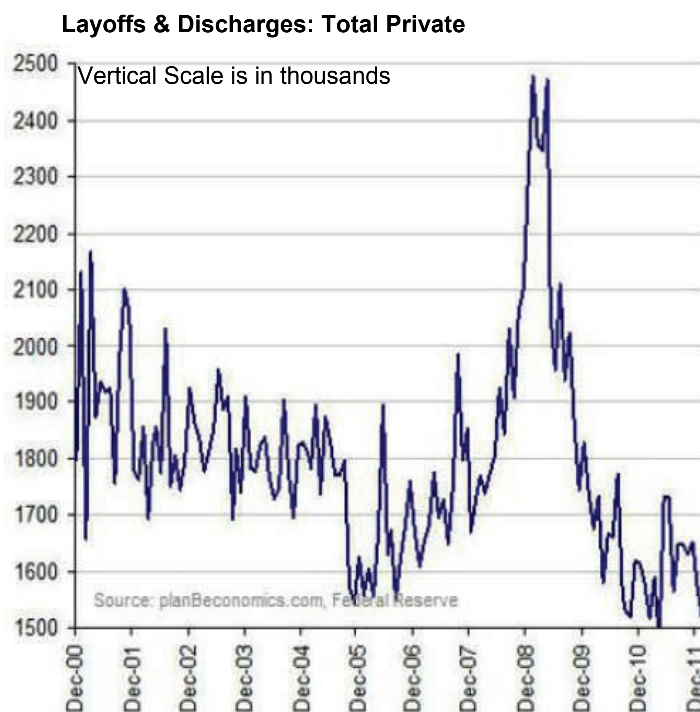
Ken Goldstein, also an economist at The Conference Board, noted, “Recent data reflect an economy that improved this winter. To be sure, an unseasonably mild winter has contributed to many of the recent positive economic reports. But the consistent signal for the leading series suggests that progress on jobs, output, and incomes may continue through the summer months, if not beyond. Consequently, we have revised up our second half of the year growth expectations, though growth should remain moderate by historic standards at less than 3%. Improvement in

employment gains are key since they buoy stronger wage and salary increases, which in turn powers consumer spending. The pick-up in hiring by corporations also suggests that corporations might soon loosen up a bit on their tight reins on capital expenditure spending and deploy some of the large cash reserves they have built up over the years. The drag from the state and local government sectors is easing up as the most intense austerity measures look to be behind us. However, the U.S. economy still faces headwinds from higher gasoline and oil prices, ongoing consumer caution, the winding down of U.S. fiscal stimulus, slower emerging market growth, and still risk from Europe, albeit somewhat diminished." All in all, that's a fairly upbeat outlook.

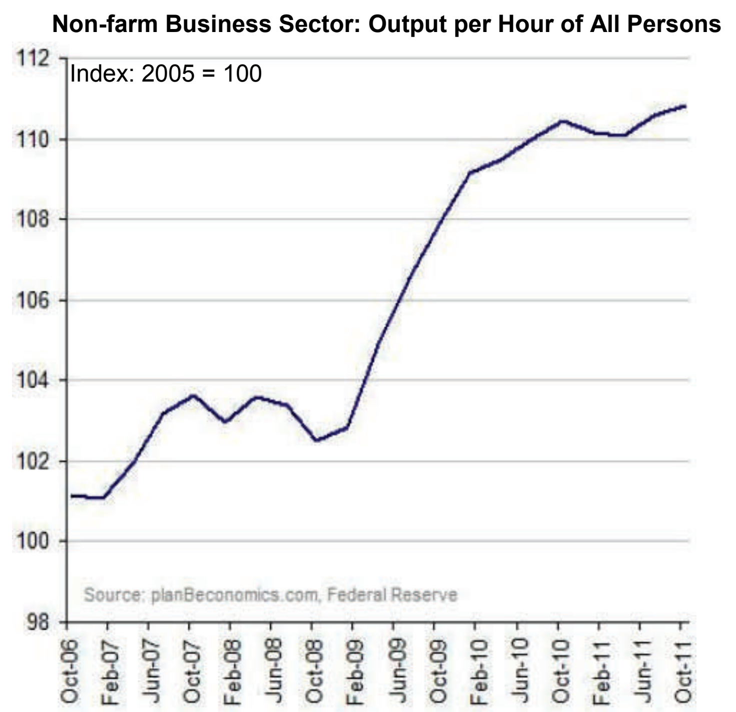
FAVORABLE EMPLOYMENT DATA

Despite the fact that unemployment statistics generally serve as *lagging* economic indicators (i.e., definitionally devoid of predictive value), other types of employment data may offer some predictive value. With respect to the Layoffs and Discharges chart below, the rate of layoffs has now fallen below prerecession levels. Of course, the number of unemployed people is still high, but the rate at which people are being added to that roster has fallen sharply. This is unambiguously good news — especially since the U.S. now has a larger population. It is also heartening to find that productivity (as measured by output per hour) has continued to rise because increases in productivity pave the way for a rising standard of living.

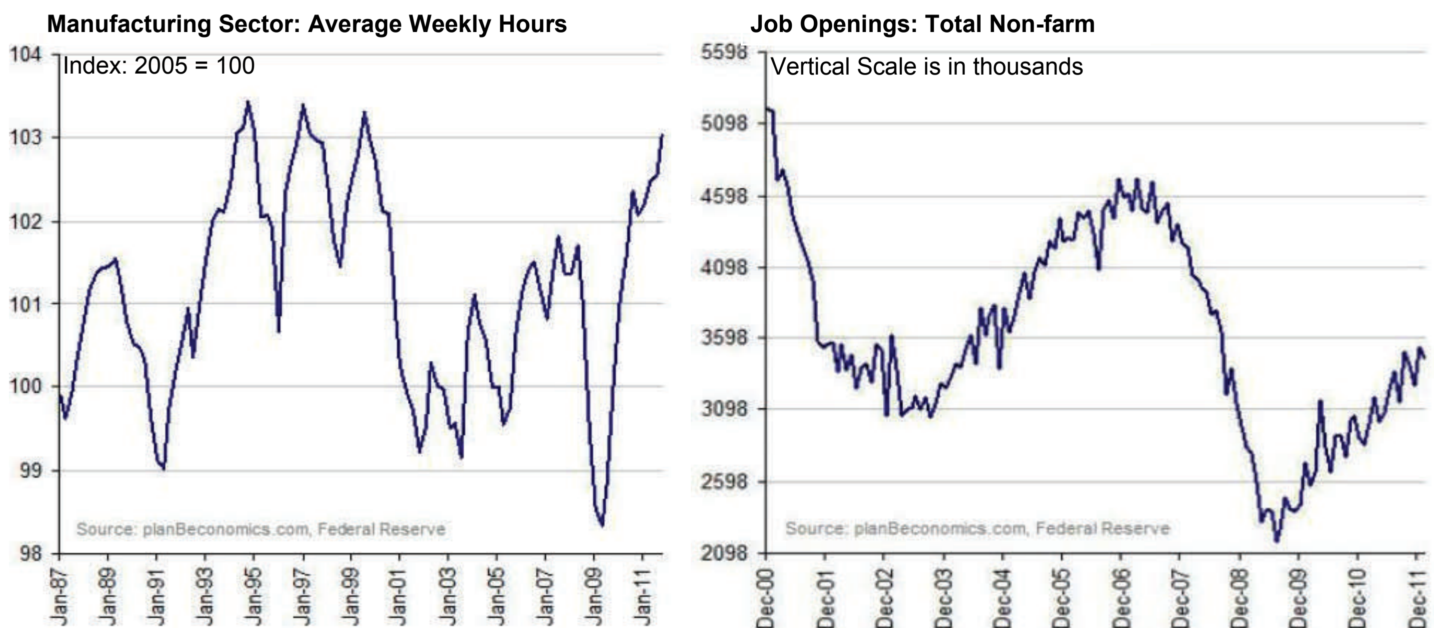
Layoffs & Discharges: Total Private



Non-farm Business Sector: Output per Hour of All Persons



Other employment-related data that may offer some predictive value appears below. The number of hours worked by the average employee (left-hand chart) can only rise to a certain extent before employers are induced to boost staffing levels. In order to do that, employers generally post additional job openings (right-hand chart). The trendlines in both of these charts are solidly positive.



INTERNATIONAL MONETARY FUND ESTIMATES GLOBAL ECONOMIC GROWTH

Many of the world's advanced economies continue to struggle with legacy debt burdens, high unemployment, and weak housing markets. As shown in the chart on the next page, advanced economies face slower growth prospects than do countries that are considered to be developing or emerging — particularly Asian countries. Of note is that while the International Monetary Fund (IMF) expects the world's advanced economies to grow faster during 2012 (box "a"), it now expects that faster growth to be somewhat less fast than it did last summer (box "b"). The IMF has also somewhat reduced its growth expectations for emerging and developing economies, but even so, the IMF still projects their collective growth rate to be more than three times as high as for advanced economies (boxes "c" and "d").

The IMF thinks the European Union will also see some growth during 2012 (box "e"). This is interesting because many other economists expect Europe to experience a recession.

Table 1.1. Overview of the *World Economic Outlook* Projections

(Percent change unless noted otherwise)

Source: International Monetary

	Year over Year					
			Projections		Difference from June 2011 WEO Projections	
	2009	2010	2011	2012	2011	2012
World Output[1]	**–0.7**	**5.1**	**4.0**	**4.0** a	**–0.3**	**–0.5** b
Advanced Economies	**–3.7**	**3.1**	**1.6**	**1.9**	**–0.6**	**–0.7**
United States	–3.5	3.0	1.5	1.8	–1.0	–0.9
Euro Area	–4.3	1.8	1.6	1.1	–0.4	–0.6
Germany	–5.1	3.6	2.7	1.3	–0.5	–0.7
France	–2.6	1.4	1.7	1.4	–0.4	–0.5
Italy	–5.2	1.3	0.6	0.3	–0.4	–1.0
Spain	–3.7	–0.1	0.8	1.1	0.0	–0.5
Japan	–6.3	4.0	–0.5	2.3	0.2	–0.6
United Kingdom	–4.9	1.4	1.1	1.6	–0.4	–0.7
Canada	–2.8	3.2	2.1	1.9	–0.8	–0.7
Other Advanced Economies[2]	–1.1	5.8	3.6	3.7	–0.4	–0.1
Newly Industrialized Asian Economies	–0.7	8.4	4.7	4.5 c	–0.4	0.0 d
Emerging and Developing Economies[3]	**2.8**	**7.3**	**6.4**	**6.1**	**–0.2**	**–0.3**
Central and Eastern Europe	–3.6	4.5	4.3	2.7	–1.0	–0.5
Commonwealth of Independent States	–6.4	4.6	4.6	4.4	–0.5	–0.3
Russia	–7.8	4.0	4.3	4.1	–0.5	–0.4
Excluding Russia	–3.0	6.0	5.3	5.1	–0.3	0.0
Developing Asia	7.2	9.5	8.2	8.0	–0.2	–0.4
China	9.2	10.3	9.5	9.0	–0.1	–0.5
India	6.8	10.1	7.8	7.5	–0.4	–0.3
ASEAN-5[4]	1.7	6.9	5.3	5.6	–0.1	–0.1
Latin America and the Caribbean	–1.7	6.1	4.5	4.0	–0.1	–0.1
Brazil	–0.6	7.5	3.8	3.6	–0.3	0.0
Mexico	–6.2	5.4	3.8	3.6	–0.9	–0.4
Middle East and North Africa	2.6	4.4	4.0	3.6	–0.2	–0.8
Sub-Saharan Africa	2.8	5.4	5.2	5.8	–0.3	–0.1
Memorandum						
European Union	–4.2	1.8	1.7	1.4 e	–0.3	–0.7
World Growth Based on Market Exchange Rates	–2.3	4.0	3.0	3.2	–0.4	–0.5

Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during July 18–August 15, 2011. When economies are not listed alphabetically, they are orderec the basis of economic size. The aggregated quarterly data are seasonally adjusted.

[1]The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights.

[2]Excludes the G7 (Canada, France, Germany, Italy, Japan, United Kingdom, United States) and Euro Area countries.

[3]The quarterly estimates and projections account for approximately 80 percent of the emerging and developing economies.

[4]Indonesia, Malaysia, Philippines, Thailand, and Vietnam.

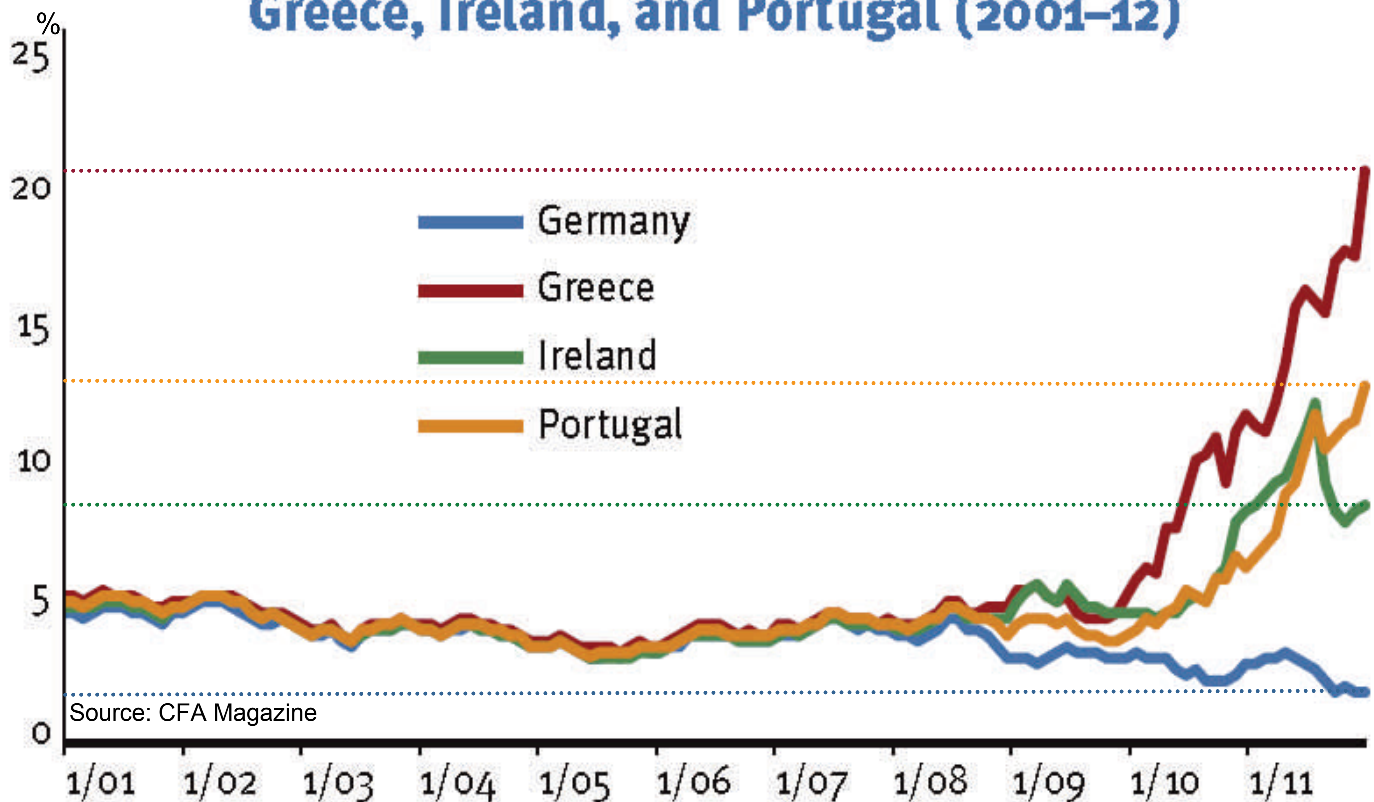
[5]Simple average of prices of U.K. Brent, Dubai, and West Texas Intermediate crude oil. The average price of oil in U.S. dollars a barrel was $79.03 in 2010; the assumed price based on futures markets is $103.20 in 2011 and $100.00 in 2012.

[6]Six-month rate for the United States and Japan. Three-month rate for the Euro Area.

GREECE

You may recall that two of the “fear” headlines featured on page one referred to the possibility of Europe’s problems wrecking the U.S. Because I made light of those headlines and because the IMF expects the European Union to achieve modest economic growth during 2012, one might conclude that Europe has been repaired. Now that Greece’s creditors have agreed to reduce the amounts owed to them by some 70%, the risk of contagion spreading to the rest of Europe has been reduced, but that’s only because some very important rules that were agreed upon in

advance have been conveniently set aside. You see, much of the money that creditors lent to Greece was insured by instruments called credit default swaps. To the extent Greece defaults on its payments to creditors, those same creditors would then have a contractual right to be reimbursed by the issuers of those credit default swaps. Now that Greece has struck a deal to repay only a small portion of the amount it originally owed to its creditors, common sense would dictate that Greece has, in fact, defaulted and that those creditors who were prescient enough to have purchased credit insurance on amounts lent to Greece would now be entitled to compensation for their losses. Unfortunately, the rulemakers have declared that because Greece's creditors *voluntarily* (wink, wink) agreed to accept less than full repayment, they are not entitled to receive compensation under the insurance contracts (the credit default swaps) they purchased. The unstated reality of the situation is that the rulemakers have changed some very important rules in the middle of the game in an effort to side-step a financial shock to the European banking system and the contagion that would likely have ensued. So, there is now less risk that Greece will rattle the rest of Europe, but only because the rules have been tortured to suit immediate needs.



Have a look at the chart on the previous page to see the interest rates that creditors are demanding from the governments of Portugal and Ireland. While those rates are nowhere near as high as the rates Greece faces, they're still very high by sovereign debt standards. In the opinion of some, they're unsustainably high. However, through a series of structural reforms and ample outside help, Italy has been removed from charts like the one on the left — at least temporarily.

EUROPE

While high borrowing rates certainly are evidence of a larger problem, the real issue, according to John Rubino in a recently published paper entitled *After the Euro*, is that the eurozone has some structural design flaws, "beginning with the assumption that simply imposing the same currency on a group of widely disparate nations would lead to a cultural convergence around Germanic thrift and efficiency. This convergence would, it was hoped, justify low interest rates and ready loan availability for all. And for a while, the easy money did come, with euro-denominated sovereign debt initially being viewed as a single market."

He further states, "By the middle of the previous decade, "peripheral" countries — Portugal, Italy, Ireland, Greece, and Spain (the PIIGS, as they've come unflatteringly to be known) — were able to borrow at interest rates comparable to and in some cases lower than "core" countries Germany and France. And borrow they did—but without adopting sound budgetary practices. The result was a variety of debt-driven ills, from housing bubbles to soaring deficits to insolvent banks. How could something so obvious in retrospect have been allowed to happen? One explanation is that much of the debt was essentially vendor financing, with Germany and France subsidizing the peripheral countries' purchase of core-country exports. This was pleasant for all concerned, pumping up core countries' trade surpluses and tax revenues while allowing peripheral countries to "boom" without apparent consequence. Meanwhile, European banks were encouraged by their governments to leverage their sovereign bond portfolios to extraordinary levels on the assumption (now seen to be catastrophically naïve) that such debt was risk free. As a result, today's European financial sector is an emergency room full of over-indebted countries and mega-banks that would evaporate if their sovereign debt holdings were marked to market." He adds, "No one, however, sees the agreement with Greece as the end of the broader euro crisis. Greece is just the opening act in a drama with a long, long list of troubled, conflicting players."

A PARALLEL TO THE U.S & CHINA

Recall the point on the previous page about the peripheral European countries (the profligate ones that are now in fiscal straights) being able to borrow at low rates despite a lack of budgetary discipline. This new debt was then used to purchase (import) more goods and services from the core (exporting) European countries. This arrangement worked nicely for quite a while. After all, the peripheral (profligate) countries issued ever more debt in exchange for goods and services that allowed them to increase their standard of living. Similarly, the core (exporting) countries happily accepted that debt as payment for services rendered — until it started to become apparent that the debt they had accepted might not be repaid. Since much of this debt is held by banks in the core European countries and because the financial system is designed (for good reason) to operate on relatively small amounts of capital, forgiving huge amounts of debt is tantamount to breaking the banking system by wiping away its capital cushion.

Now, compare that recap of Europe's debt woes to the relationship the U.S. (a profligate, importing country) now has with China (a super-exporter that already holds massive amounts of U.S. debt). I am not suggesting that economic doom is imminent, but I do believe that many of the same stressors that now exist within Europe are also present in other, much larger economies around the world. I could write more about structural imbalances like these, so let me just say that as a portfolio manager, they give me pause.

OTHER LINGERING ISSUES

In addition to high levels of debt and persistent budget problems, a number of other issues linger such as the uncertainty surrounding further increases to the U.S. debt ceiling, continued financial deleveraging, expiration of the "Bush era" tax cuts, the general election in the U.S., concerns over Iran's nuclear ambitions and Israel's response, North Korean hostility, instability in Syria, the ever present threat from terrorists, etc.

Despite the fact that the near-term economic outlook seems fairly positive, I view these structural imbalances and threats in the context that the great majority of the assets we oversee are retirement assets that are *not* easily replaced.

— Glenn Wessel