


December 7, 2012

"That men do not learn very much from the lessons of history is the most important of all lessons that history has to teach."

-ALDOUS HUXLEY

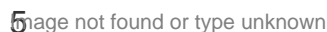
POINTS TO PONDER

1. The initial report on third-quarter GDP showed a respectable 2.7% growth rate, reinforcing views that the US economy is relatively robust. Yet, based on an array of US economic data, those experts asserting the US is in a recession may not be as alarmist as the optimists contend. Prominent forecasting firm ECRI, which called the last three recessions, is standing by its view that the US entered a new downturn this past July. (See *Figures 1-4*)

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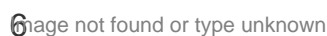
2. As experts parse the Q3 GDP data, they are less than impressed with the quality of that report. Specifically, unsustainable jumps in both inventories (indicating soft final demand) and government spending, largely on defense (where major cuts are looming), accounted for nearly half of the total 2.7% increase. It was also just reported that both US manufacturing and new orders plunged to their lowest levels since July 2009.

3. Perhaps indicating that bullish perceptions of the US recovery are overblown, market maven Dennis Gartman notes that jobless claims have broken their long-term downtrend. Of more concern is that they actually appear to now be trending up. (See *Figure 5*)

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4. Past EVAs have emphasized the negative impact high gasoline prices have on consumer purchasing power. Fortunately, that drag has reversed with pump prices tumbling from \$4 to \$3.50 since September. This gives consumers around \$65 billion of much-needed additional purchasing power (or an equally crucial ability to rebuild savings).

5. As underachieving as the US recovery from the Great Recession has been, it would be even weaker if consumers weren't drawing down savings. (See *Figure 6*)

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6. The US economy faces a number of headwinds but the auto industry isn't likely to be one of them. Production schedules of US automakers imply a 16.5% rise in fourth quarter output versus a year ago.

7. Over the last 30 years, outflows from stocks funds have been an extremely reliable buy signal. Since the global financial crisis, however, outflows have become the new normal (as was also the case during the 1970s.) Downward spikes in flows continue to provide actionable buy readings. (See *Figure 7*)

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8. US investors worried about four more years of trillion dollar budget deficits and extreme monetary incontinence might well look across their northern border for refuge. The Bank of

Canada is keeping short-term interest rates a full point above US money market rates. And while the Fed has inflated the US monetary base by 22%, six times the increase in nominal GDP, the Bank of Canada has allowed its money supply to grow by just 5%, in line with the growth of Canada's economy.

9. As the *Wall Street Journal* pointed out in a recent article, not all is idyllic in Canada. Although Canada's federal debt relative to the size of its economy is less than one-half the US ratio (35% vs over 80%), and it carries one of the world's few remaining AAA sovereign ratings, household leverage has been increasing. By contrast, US consumers have been persistently paying down debt over the last five years. (See *Figure 8*)

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10. There is mounting evidence that Spain is regaining competitiveness with its eurozone peers. This resurgence has been a function of a long and exceedingly painful process known as "internal devaluation," essentially where wages are reduced, usually substantially. The dark side of this improvement is an unemployment rate of 26%, akin to the US during the Great Depression.

11. Northern European countries, as is the case with China, are being urged to spur domestic demand in order to import more from, and export less to, their southern neighbors. Over the last five years, this "rebalancing" has been gathering momentum. (See *Figure 9*)

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12. Similarly, Germany is also being pressed to allow its inflation rate to rise in order to stimulate demand for goods from Europe's struggling periphery. Signs are increasing that they are caving

to such pressure. Two million German public-sector workers will get a 6.3% pay hike over the next two years. Another goal of this plan is to narrow Germany's significant labor cost advantage over the "Club Med" countries.

13. Although Germany's economy is the envy of Western Europe, it is nonetheless looking increasingly anemic based on both industrial production and the closely followed Purchasing Managers Index (PMI). (See *Figure 10*)

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14. Despite the ascendance of economies such as Japan, China, South Korea, Taiwan, and Singapore over the last 40 years, Asia represents just 35% of global GDP. Two hundred years ago, Asia had a 40% share of worldwide economic activity.

15. Global stock markets have shrugged off consistently deteriorating economic data this year. There has been one notable exception, however. China's Shanghai Composite Index recently closed below the low last seen in January 2009, during the most ferocious stage of the global financial crisis. Mainland Chinese stocks are now trading at just 8.4 times forward earnings estimates. (See *Figure 11*)

Be careful what you wish for, Ben! One of my constant goals for this newsletter is to focus on uncommon—and often controversial—ideas that ring true to me. Fortunately, this pursuit is consistent with my inherent contrarian nature. Over the years, it has allowed Evergreen to identify a number of long-running up-trends, as they morphed into manias, but before they cataclysmically blew apart.

Two graphic cases in point were the tech and real estate bubbles, which ensnared millions of investors and destroyed literally trillions of dollars. But there were also less dramatic examples such as the speculative frenzy in both Chinese stocks and commodities during 2007 and 2008.

Invariably, the irrational attitudes and other conditions that support major asset inflations often last much longer than I, and others who see the swelling risks, anticipate. This is a situation that exists today due to the fact that the world's two most important central banks, the Fed and the European Central Bank (ECB), are clearly artificially inflating the value of both stocks and bonds. We have begun referring to this, justifiably we believe, as "The Great Levitation". The overarching question is: how much longer can this multi-trillion dollar monetary illusion last?

Relevant to this query, and definitely qualifying as a unique view, is a recent observation from one of my most hallowed resources, Charles Gave. Charles is now three score years plus ten, meaning he's seen more market and economic cycles than nearly all those running money (usually other peoples') these days. He is a prolific generator of some of the most unusual—and

unusually perceptive—insights of all things financial. This includes one of the themes he's brought up over the years and is highlighting with more emphasis lately. Frankly, I've never seen anyone else zero-in on this concept.

It seems to me that most Americans view an improvement of the US trade deficit as a good thing. Certainly, our esteemed Fed chairman, Ben Bernanke, feels this way based on his relentless campaign to cheapen (aka debase) the dollar with the aim of boosting US exports. On that basis, he has been reasonably successful (it's nice that he has something to show for his hyperkinetic money manufacturing!)

As the chart below illustrates, from a recent e-mail Charles sent out, the US trade deficit has improved materially since the global financial crisis first erupted. You can also see that the valuation of the greenback has closely tracked the variations in the current account deficit. (Please note that the red line showing the dollar's fluctuations is inverted; therefore, up is really down as indicated by the right-hand axis.) (See *Figure 12*)

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Past EVAs have noted that a most remarkable event has occurred for the first time in twenty years. If you back out America's trade shortfall with China and the oil-exporting countries, we are actually running a surplus with the rest of the world.

Consequently, the dollar, still the world's reserve currency despite Mr. Bernanke's best (worst?) efforts, is becoming increasingly scarce. This is especially true for the majority of our trading partners who are actually running a cumulative trade deficit with the US. Now for the really important part...

Charles is the only strategist/macro economist I know who has highlighted a very tight linkage between an improving US current account and major train wrecks in the global economy and financial markets. To quote Charles: "This (a narrowing US current account deficiency) implies that the probability of a financial accident (black swan) is fairly high since they **always** occur when we have an 'improving' US trade deficit and a fall in foreign exchange reserves." (Note in this case the left axis is inverted; thus, an improving US trade deficit is reflected by values below the dotted horizontal line.)

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It's worth paying attention to the word he underscored: *always*. That's about as unequivocal as an economist can get. Furthermore, please observe that the abrupt improvement in the US current account deficit starting in 2006 gave an excellent early warning signal for the coming global financial tsunami. One could reasonably deduce now, however, that the US trade shortfall is no longer narrowing. But there are a couple of counterpoints to this comforting conclusion.

One is that much of the stabilization of the total deficit is due to the surge in oil prices since their trough during the Great Recession. If you look closely at the dotted line in figure 12, which backs out oil and China, you'll see that what was once a deficit with the rest of the world has jaggedly moved up into a surplus in recent years.

Additionally, one of Charles' uber-fears is that four more years of a Fed whose monetary promiscuity knows no bounds is highly likely to further cheapen the dollar. This, in turn, should push the US deeper into surplus with most of the planet, again excluding oil exporters and China. In fact, I would further add that with the US now moving beyond being "just" the Saudi Arabia of food and also becoming the Saudi Arabia of oil, the overall deficit is likely to move closer to parity as well.

Finally, given the rapidly diminishing cost advantage of China versus the US, our perpetual outflow of dollars to their coffers is set to decrease, perhaps substantially.

OK, what does it all mean? Basically, it's very probable that some country is vectoring for serious trouble. You can look right across the Bosphorus Straits from Greece (which has now effectively defaulted twice) to find the next potential crisis in the making: Turkey.

Countries like Turkey, with large current account deficits and considerable foreign currency debts, are seriously at risk in an increasingly dollar-short world (outside of the US banking system which is awash in excess reserves but unwilling to part with them). It also has the most overvalued currency in the world, according to the Peterson Institute.

Then just to the south of Turkey lies the tiny isle of Cyprus. It is already bust and unless Russia again writes the country a fat check, or the ECB issues yet another bailout, Cyprus might be the second European Union country to go bust.

As the Asian crisis proved nearly 15 years ago, small countries can create big problems. Sadly, our current Fed chairman seems blissfully ignorant of that fact. He also appears oblivious to the effects of his dollar-trashing campaign on the world's struggling economies. He may well soon learn—once again—the law of unintended consequences.

Correction: *Due to the feedback of a perceptive EVA reader, who pointed out the questionable accuracy of the "STASI" anecdote we ran last Friday from The Gartman Letter, we did some further digging. We found that the quotation attributed to a California legislator suggesting the establishment of an organization called State Team Action to Stem Income was untrue. We apologize for the misinformation.*

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