

June 15, 2012

"When you do a stimulus, you should target supply-side measures that will also improve your long-term growth."

-SWEDISH FINANCE MINISTER, ANDERS BORG

POINTS TO PONDER

1. Over the last five years, American consumers have methodically paid down debt. In vivid contrast, the US government continues to blow through debt ceiling limits like Europe goes through bailout plans. American corporations have been deleveraging for even longer, starting their debt reduction campaign a decade ago. Interestingly, China's corporate sector has been heading in the opposite direction. (See *Figures 1 and 2*)

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2. Citigroup just released a study estimating that assets in hedge funds may triple over the next five years to \$5 trillion. This optimism is despite the notorious issues of high fees and lack of transparency as well as performance that has been less than scintillating. Once again, hedge funds are lagging the stock market in 2012 after three previous years of underperformance.

3. US stocks have experienced a controlled correction in recent weeks, but in the once hallowed commodity complex the damage has been much more severe. The main commodity index made a 20-month low in late May, having fallen 18% from its peak.

4. A recurring EVA message earlier this year was that the US employment picture looked artificially strong due to the warmest winter in more than a century. Now, with the consensus souring on the labor outlook, it's important to note there is a positive underlying dynamic—the much healthier trend in private versus public sector job creation. (See *Figure 3*)

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5. Although the dollar has been strong in the latest "risk-off" phase, as has happened in every full-blown (and half-blown) crisis of the last five years, it remains at an extremely depressed level on a trade-weighted basis. This is likely to be a long-lasting propellant for the emerging renaissance of the US manufacturing sector. (See *Figure 4*)

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6. Another consistent EVA theme during the superficially strong first quarter was that US consumers were drawing down savings. The savings rate in April hit 3.4%, half the normal level. This is also the lowest since 2007 when extracting equity from homes to finance spending was still a national pastime. Without that prop, present consumption rates look unsustainable.

7. There are several US economic measures indicating the economy is not poised to enter another recession, one of these being consumer confidence. However, despite the upward trend, these readings remain unusually subdued. (See *Figure 5*)

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8. Those who continue to believe that inflation is in the immediate vicinity, if not right around the corner, might want to reflect on the two charts to the right. Long-term, though, inflation could go viral if central banks continue to leave massive liquidity in the global financial system once money velocity begins to rise. (See *Figures 6 and 7*)

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9. Environmental groups continue to be generally hostile toward the fracturing process, "fracking," which has produced the surge in US natural gas output. Yet, according to the International Energy Agency, there has been a 450 million ton contraction in the emission of carbon dioxide over the last five years. During this time, gas-fired power generation in the US has leapt 38% while coal-based production has dropped 19%.

10. Personal disposable income, adjusted for inflation and taxes, contracted in April for the seventh month in a row. This pattern was a prime reason EVAs earlier this year were skeptical of the prevailing view at that time of a vigorous US economy. (See *Figure 8*)

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11. The former sclerotic welfare state of Sweden continues to be one of the few pockets of economic and fiscal fitness in Europe. Assistance payments are back down to where they were prior to the Great Recession thanks to an economic growth rate more than double that of the US. Moreover, Sweden's budget has already returned to surplus.

12. Investor spirits were briefly lifted this week by news of the \$125 billion bailout of Spain's banking system. Yet, European authorities are once again resorting to additional debt, rather than injecting equity capital as was done by the US TARP. Additionally, Spanish banks own 67% of their government's debt, which has fallen dangerously close to junk status, far more than is the case in other countries.

13. While fears about a quasi-recession in China are rising, the important economic indicator of freight traffic is actually encouraging. (See *Figure 9*)

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14. China and the US are essentially neck and neck when it comes to industrial output. However, America's immense productivity edge is underscored by the fact that we match Chinese production with a manufacturing workforce one-tenth the size.

15. Germany is becoming increasingly alarmed, for good reason, by the ballooning balance due it from European countries with which it runs a trade surplus. This amount (called the Target2 balance), representing the amount of money Germany's Bundesbank is owed by chronic trade deficit countries such as Italy and Spain, has grown to \$616 billion euros (about \$770 billion US). It seems unlikely this sum will be allowed to accrue much further. (See *Figure 10*)

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What happens when you mix Spain and panic? If you've ever wondered where the word smog comes from, it's actually what's known as a "portmanteau". Basically, this is an elaborate way of describing the contraction and fusing of two words into a new word.

In the case of smog, it's a conflation of the words "smoke" and "fog" and these days there are plenty of both engulfing Europe. But there's another portmanteau I came across this week that perfectly sums up the state of panic currently gripping the Spanish banking system: "Spanic."

As someone who has intently studied Europe's tai chi-paced implosion (like those old Sam Peckinpah westerns where the most violent scenes happen in slow motion), I've literally read thousands of articles and essays on the subject. To say that I've got data overload is akin to saying Seattle fans are less than thrilled to see their once beloved Sonics make the NBA finals as the Oklahoma City Thunder. (This is another reason, along with having been a recent owner of Chesapeake Energy bonds, that I regularly bring out my Aubrey McLendon voodoo doll.)

Frankly, I'm sick of reading about this historic screw-up (and that applies to both Europe and how Seattle managed to lose its NBA franchise). Yet, it has recently dawned on me that about the only statistic you need to focus on to determine if Europe has finally figured out how to arrest its dash-to-crash is Spanish unemployment. Admittedly, "Spunemployment" isn't quite as catchy as Spanic, but I'm convinced that any measure that doesn't cause Spain's jobless rate to dramatically contract is just more euro-blabber. You simply can't allow a country as important as Spain to have 24% and rising unemployment.

This week saw yet another grand scheme unveiled, this one attempting to triage the calamitous run on Spain's banking system. The relief rally lasted mere hours as Spanish bond yields broke to new crisis highs, hitting nearly 7%. Obviously, the markets are becoming numb to massive bailouts that merely pile more debt on an already creaking edifice of excessive leverage. Maybe it's just me, but this entire saga is feeling more and more as if it was written by Rod Serling for the old *Twilight Zone* series. Is there any way to describe a bailout that has Italy putting up almost \$30 billion of the Spanish rescue as anything other than surreal?

Thankfully, I did come across an article late last month in the *Financial Times* that made me sit up and take solace. It was from the Wharton Business School's illustrious Jeremy Siegel, he of *Stocks for the Long Run* fame. In essence, Dr. Siegel believes the only way to save the euro is a massive, literally overnight, devaluation down to around parity with the dollar.

In all of my studies of the European debacle, I haven't come across this simple but elegant solution, though I'm sure there have been some obscure suggestions to this effect. However, Dr. Siegel is a heavyweight and his solution strikes me as the least repulsive remedy. Unquestionably, a flash euro devaluation, like all exit strategies from Europe's morass, would create severe problems, most notably an inflation flare-up in Germany. And we all know Germans are as fond of upward price pressures as I am of Chesapeake Energy's CEO (yes, that would be the same dude who helped steal the Sonics).

Forcing the euro down to par with the dollar, or even lower, would provide a huge lift not only to Spain but to all of southern Europe by boosting exports and attracting capital into their depressed economies. If such a move were combined with a pan-European guarantee of bank deposits, to halt the sickening chain reaction of bank runs, it might still be possible to turn the tide. But the powers-that-be better hurry. Unfortunately, I just can't imagine combining "eurocrats" and "speed" into one word.

David_Hay_Signature

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