November 23, 2012

"The tax on capital gains directly affects investment decisions, the mobility and flow of risk capital" (as well as) "the ease of difficulty experienced by new ventures in obtaining capital, and thereby the strength and potential for growth in the economy."
-JOHN F. KENNEDY

POINTS TO PONDER

1. Over the last four years, when the economy has been largely expanding, the US has added just 194,000 new jobs. At the same time, the number of food stamp recipients has risen by nearly 15 million. (*See Figure 1*)

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2. Entitlement spending, much of which flows to the affluent, continues to march relentlessly higher. This is starving our nation's ability to invest in vitally needed infrastructure upgrades. Such investments have been shown to have a "multiplier" of 2.5 to 1. This means that for every $1 of certifiably productive investments (as opposed to the politically driven variety), $2.50 of economic growth is generated. (*See Figure 2*)

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3. It may come as a surprise to many that US tax revenues are essentially back to where they were in 2007, before the Great Recession and when the Federal deficit was just 1.2% of GDP. Spending, however, is up by over $800 billion.

4. Based on the history of the last 45 years, when the US government has been in rapid expansion mode, P/E ratios have experienced long-term shrinkage. Alternatively, when government encroachment into the private sector has been restrained, or actually contracted, P/Es have tended to rise. (*See Figure 3*)

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5. Demonstrating the confidence-sapping impact of the fiscal cliff, half of the 40 largest US companies are scaling back capital investment plans. (*See Figure 4*)

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6. Americans seem to be increasingly numb to the degree to which our nation's finances have devolved. Yet, when the Fed-administered novacaine of buying trillions of dollars of government debt wears off , the pain is almost certain to be intense given that the government is spending an unparalleled (in peacetime) 50% more than it is taking in. (*See Figure 5*)

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7. The US dollar has been rising against most currencies this year, but thus far it looks like a minor bounce in a very long-term bear market. Given current policy trends, this chronic weakness is unlikely to reverse. (*See Figure 6*)

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8. One of the more encouraging elements of the US economy is the continuing rise in demand for bank loans. It should be noted, however, that overall bank lending remains far below its pre-crisis level. It is also substantially lower than in the eurozone or Japan. (*See Figures 7 and 8*)

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9. Regular EVA readers should not be surprised by Moody's decision to strip France of its AAA rating, mirroring S&P's earlier move to cut Europe's second largest economy to AA. Based on its weakening economic prospects and runaway government spending, more credit rating cuts are likely.

10. The most recent data out of Europe appear to be confirming the EVA view of an intensifying recession. Comparing the eurozone's crucial PMI (purchasing manager's index) to the US highlights how weak European activity is currently, even compared to a less than dynamic American economy. (*See Figure 9*)

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11. In contrast to Europe's deepening recession, Poland's healthy growth rate stands out like a swan in a gaggle of mud hens. (*See Figure 10*)

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12. Southern Europe's early retirement age structure is well known (and broadly criticized). Much less perceived is that China's male retirement age is 60, while for women it is just 50.

13. Putting into perspective China's credit-fueled expansion to offset the impact of the Great Recession, Chinese banks have increased their balance sheets over the last five years by an amount equal to the total assets of the US banking system. This is despite the fact that China's economy is half the size of America's.

14. McDonald's recently reported disappointing results from its Chinese operations. KFC and Pizza Hut are also experiencing a dramatic slowdown in China, implying that its growth rate is likely worse than official government statistics indicate. The good news is that there does appear to be an improving tone in the Chinese economy of late. (*See Figure 11*)

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15. With the once controversial view that Europe is entering a deep downturn having become broadly accepted, the realization is now growing that Japan is also likely in recession yet again. The island nation recently reported a third-quarter GDP contraction of 0.9%, equal to an annualized shrinkage of 3.5%. (*See Figure 12*)

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Hitting a nerve. Last week's EVA, discussing the potential end of the 30-year bond bull market that was born under Paul Volcker, elicited an unusual number of responses. It's my suspicion this was a function of the fact that many EVA readers have been worried about exactly the same scenario. Actually, based on numerous conversations I've had over the last few years, when Evergreen has maintained a steadfastly bullish view on US yield investments, it's clear many clients have felt the bond market was primed to be taken to the woodshed long ago.

One of the reasons Evergreen resisted turning bearish on bonds even once the Fed went into monetary hyperdrive was our oft-discussed belief that the velocity of money was the missing link in the inflationary chain-reaction. In last week's issue, I didn't give this much press, but in our view, this remains a necessary pre-condition for arousing inflation. And, as you can see below, velocity remains in a powerful long-term downtrend.

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Yet, inflation isn't the only reason bond markets can fall apart at the seams. Consider the current example of southern Europe. Bond yields from the "Club Med" countries (plus Ireland) are three to four times the level of US Treasuries. In the case of Greece, the multiple is about 10. This is despite the fact that these same countries are actually caught in a deflationary trap of rising unemployment, self-defeating austerity, and an overpriced (for them) currency they can't devalue.

Accordingly, it's clear that interest rates can move up even if inflation is nonexistent once markets become concerned about the ability of an issuer to make good on its liabilities. And this brings me back to last week's closing section on California. Actually, the story goes well beyond the fading star of the "Left Coast."

In addition to the wall-hitting experience much of Europe is going through right now--due to diligently pursuing an economic model of high taxes, onerous regulations, and a generous welfare state--other large US states are also proving the toxicity of this policy formulation. While Illinois isn't endowed with the same degree of extraordinary natural advantages as California, it was at one time the economic dynamo of the American heartland. It's only rival for that title would have been, of course, Michigan. These days, Illinois and Michigan are vying to win the credit downgrade race.

Let's consider what the market is telling us about the creditworthiness of California, Illinois, and Michigan. All three are now required to pay interest rates that are substantially above what the debt-drenched US Treasury pays to borrow for 30 years. Remember, these are tax-free interest rates; therefore, the excess yield they must offer is effectively much higher than the current 1% to 2% spread over long-term Treasuries (with Michigan having to pay an Italy-like 4.8% rate).

Could it be just a coincidence that all three of these populous and once prosperous states, which have consistently pursued the big government model, are now in serious financial peril?

The French Connection--and American Division. It's possible that these three examples of fiscal ineptitude are unconnected, but it does again raise the specter of what is happening in Europe today. To the list of Continental countries listed above, I would also add the unfolding fiasco that is France.

While France is considered part of Europe's healthy core, its finances and economy are increasingly looking much more connected to the imploding periphery. Thus, it's reasonable to

wonder if France's dedicated practice of socialism, which is becoming more devout under its current president, is responsible for imperiling one of the world's wealthiest nations.

Since the presidential election, my team and I have been privileged to read the fierce internal debate that has been raging among the globally dispersed partners of GaveKal Research. It may surprise many EVA readers, who have often read GaveKal's analysis in these pages, that its principals are as divided politically as is the US (and most of the developed world, for that matter).

Predictably, those with Friedmanesque leanings, such as Charles and Louis Gave, are deeply distressed by what they see as the decision by the majority of American voters to more closely emulate California and its "soul-mate" states. Others, such as co-founder Anatole Kalestky, feel a more activist and free-spending government is exactly what is needed to cope with the deflationary forces of a post-credit bubble world.

Interestingly, though, even Anatole has been highly critical of the current Fed policy of continuing to fabricate reserves (i.e., electronic money). Notwithstanding Anatole's Keynesian leanings, he realizes that the double whammy of trillion dollar deficits and wild money creation is dangerous in the extreme.

Frankly, in my humble opinion (which, compared to the coruscating minds mentioned above, is no false humility), it's difficult to find much fault with Charles' and Louis' argument. But before those of a more "progressive" persuasion convulse over that comment, let me reiterate a central point from last week's issue: This isn't a left vs. right argument; it's rational vs. irrational.

It's always been my goal to be an equal opportunity offender and, to prove that, it's also my opinion that one of the worst presidents, from an economic standpoint, was that paragon of Republican rectitude (at least before he was defrocked), Richard Nixon. His economic "strategy" of leaving the gold standard, instituting wage and price controls, pressuring a pliant Fed for easier money, and a general inclination to do whatever was needed to be re-elected, established the pre-conditions for the mess we find ourselves in today. Moreover, Bush the younger was not exactly the poster boy for enlightened economic stewardship.

Conversely, Jack Kennedy and Bill Clinton both created an environment for capitalism to flourish. In fact, the more I read of Jack Kennedy's economic views, the more he reminds me of another politically renowned Jack—as in, Kemp. I don't think it's a stretch to say that If JFK were around now, he'd be likely be considered a supply-sider!

Unfortunately, however, these days the debate between more and less government has become so poisoned that logic and previously effective remedial measures have become the victims of collateral damage. In the place of rationality and respect for proven policy remedies, we now have a situation where whichever party garners a slight majority of the popular vote feels entitled to ram its policies through, regardless of the economic havoc this causes.

Last week, two Evergreen team members, Jeff Eulberg and Tyler Hay, attended the Schwab Impact conference in Chicago where they heard a speech by one of the most acclaimed political observers of our time, Greg Valliere. Greg (who, among other hits, correctly called the global financial crisis and the recent presidential election), feels that US politicians won't do anything meaningful, like passing Simpson-Bowles, until we have another full-blown disaster.

Coincidentally, literally as I was typing these words, my cell phone rang and it was the iconic

Woody Brock on the other end. Even though Evergreen is a client of his firm, seeing Woody's number on my caller ID is sort of like receiving a call from God himself, at least when it comes to economics.

We discussed the present Mexican standoff between the left and the right and he correctly observed that it doesn't need to be this way. There is a solution begging for implementation that can satisfy both sides. More importantly, it has the added benefits of being both rational and feasible—if our elected representatives can summon up some courage and creativity (admittedly, two qualities rarely associated with politicians). Since I have previously discussed at length his proposed domestic Marshall Plan (click here for a detailed description) I won't do so again. However, I continue to believe it is our best shot, if combined with Simpson-Bowles, at unifying our fractured country and lifting us out of our national malaise.

Sadly, I don't see anything on the horizon that offers this kind of comprehensive remedial plan for what ails our country. As long as this is the order, or disorder, of the day, we will continue to move our clients' assets into truly safe harbors. Given present conditions, that definitely excludes Treasuries. Unless our country does an extreme mid-course correction very soon, US IOUs are almost certain to end up with yields that look a lot like those of Southern Europe, California, Michigan, and Illinois—or even worse.

David_Hay_Signature

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