February 17, 2012

"In short, the Fed's actions, rather than helping, are having the perverse effect of destroying the confidence of businesses and individuals and the willingness of banks to loan to anyone but those whose credit is so strong they don't need loans."
- CHARLES SCHWAB

POINTS TO PONDER

1. The Fed's massive monetary expansion has been necessary due to the collapse in US money velocity from the normal 17.7 times a dollar circulates per year to a mere 5.7 times today. Should velocity recover to its typical rate, the overall price level could nearly triple unless the Fed were to rapidly shrink its bloated balance sheet, a liquidity withdrawal that might pose some serious problems in the future.

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2. In a scathing Wall Street Journal op-ed piece last week, Charles Schwab, founder of the discount brokerage firm bearing his name, lashed out at the Fed's seemingly perpetual policy of near-zero interest rates. Accordingly, he is joining the King of Bonds, Pimco's Bill Gross, in asserting that the Fed is actually retarding economic growth.

3. While miniscule interest rates and trillions of dollars of printed money are not doing much for the real economy, they are driving stocks higher, at least for now. There are growing signs the recent advance is becoming increasingly frothy, including short interest on stocks hitting a four-year low. Numerous other sentiment readings are also indicating pervasive optimism and an extremely overbought market.

4. Based on the continuation of trillion-dollar deficits, it's hard to realize that federal spending has actually been plunging at a rapid clip, albeit from outrageously elevated levels. Next year, the combination of potential tax increases and spending cuts could create the most serious "fiscal drag" seen in more than 30 years.

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5. One of the most distressing aspects of President Obama's latest budget is that three years into an economic recovery, and despite the aforementioned spending drop, the federal deficit is still projected to exceed $1 trillion.

6. The budget news is much more encouraging at the state level, with the once chronically red ink-drenched state of New Jersey now running surpluses. Even more remarkable is that the poster child for economic devastation over the last decade, the state of Michigan, posted nearly half a billion dollar surplus for 2011.

7. Although it is this author's belief, as well as Fed Chairman Bernanke's, that the labor market is not mending as fast as the official unemployment statistics indicate, there is clearly a steady improvement underway.

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8. Senior management compensation has increased at an unjustifiable rate at American

companies in general, but the banking industry stands out as particularly abusive. In 1989, the average CEO pay at the seven largest banks was $2.8 million, nearly 100 times median household income. By 2007, on the eve of the global financial crisis, it had exploded to $26 million, a staggering 500 times what the typical household earned.

9. Corroborating those who believe that the average investor lost money in 2011, Wells Fargo has stated that its retail brokerage assets fell 3%. Given that Wells' wealth division custodies $1.1 trillion in assets, this is likely a very representative sample set.

10. The perception seems to be spreading that Europe has its crisis under control and that Greece will agree to further austerity measures. This view may be overly optimistic, however, given that Greek unemployment is now nearly 21% and almost certain to head higher as its beleaguered economy continues to contract. Consequently, the odds of a sudden and disorderly exit from the European Union by that country remain appreciable.

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11. One of the most pernicious aspects of Europe's financial crisis is the contraction in lending that is occurring. On a rolling three-month basis, credit is shrinking at a faster rate relative to GDP than it did after the collapse of Lehman. This, among other factors, has caused S&P to raise its estimate of eurozone corporate defaults to 8.4%.

12. The situation in Greece has devolved to the point that a growing number of senior eurocrats are discussing its exit from the EU. When and if that happens, it will become essential to further buttress the bond markets in Italy and Spain. This will be no easy task as each country needs to raise and/or refinance a sum exceeding 20% of GDP in 2012, equivalent to the US government needing to sell or roll over $3 trillion in debt.

13. The creative efforts of Mario Draghi, the new head of the European Central Bank (ECB), deserve accolades for bringing interest rates down for the weaker eurozone countries from cataclysmically high levels. However, the issue of extremely weak, or even negative, growth continues to plague the Continent, with more of the same likely for the foreseeable future. (Please reference chart below)

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14. China’s economic advance over the last 30 years provides one of those rare instances when the word "miraculous" is not hyperbolic. Yet despite—or perhaps because of—its parabolic growth, income inequality has been extreme, essentially on a par with some of the most unequal African nations. The good news is that even though the highest income segment in China saw its earnings double from 2002 to 2007, the poorest saw a 40% gain.

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15. Japan’s deepening government debt hole has become truly shocking. It is now issuing more in bond debt annually than it collects in total revenue, although this is partially due to the cost of rebuilding after the Fukushima earthquake. Sadly, there does not seem to be a plan in place to reverse this unsustainable situation.

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