

July 13, 2012

"I'm terrified of missing a big rally but equally terrified of a possible apocalypse."
-BARTON BIGGS, ACCLAIMED MONEY MANAGER

POINTS TO PONDER

1. Unfortunately, the US Purchasing Managers Index (PMI) for both services and manufacturing has fallen to levels below those hit during the 2010 and 2011 "soft patches." These key measures are considered to be among the most accurate leading indicators of the economy's direction.

2. Market participants tend to be fixated on the data in the immediate releases of jobless claims. Yet these are almost always revised, attracting scant attention even though the revision trend is often illuminating. Unfortunately, initial jobless claims have been revised up every week since July 7th of last year.

3. Although \$350 billion has been pulled out of US stock mutual funds since 2007, while \$1 trillion has flowed into bond funds during this period, 45% of total retail assets are in stock funds versus 25% in bonds.

4. US housing prices are more affordable relative to disposable income than they have been in nearly 40 years. Compared to rents, homes are also undervalued though not as dramatically. (See *Figure 1, below*)

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5. It appears increasingly likely that US home prices have bottomed this year after a staggering 43% plunge since 2006. Yet there are roughly 4 million vacant housing units being held off the market. This is more than 40% above the pre-crash level.

6. The peak oil theory may be past its peak. The Kennedy School's Belfer Center for Science is projecting worldwide oil production of 110 million barrels per day by 2020, versus 93 million today.

7. The projected surge in US oil production, driven by a massive increase in active drilling rigs, will radically shrink America's chronic trade deficits in the years ahead. Crude imports are estimated to fall by 7 million barrels per day by 2020, amounting to roughly a \$250 billion annual improvement in the US trade deficit. (See *Figure 2, below*)

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8. In Europe, the much ballyhooed rescue plan announced late last month continues to lose credibility. Bond yields in Spain and Italy are once again rising, while unemployment continues to march inexorably higher. The International Labor Organization, a UN agency, is now warning that Europe is at risk of losing another 4.5 million jobs in the next few years barring desperately needed and radical reforms.

9. China's economy appears to be vectoring for a soft landing, according to official statistics. However, based on the analysis of less biased sources, the deceleration is more pronounced. (See Figure 3)

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11. One main mission of Chinese policymakers in 2011 was attempting to rein in accelerating inflation. They may have succeeded too well. In addition to increasing evidence of economic sluggishness, deflation has actually begun to surface. Both consumer and producer prices fell in June, with the latter down 2.1% from a year earlier.

12. One reason China's housing bubble has deflated gradually, at least thus far, is that even during its frothiest phase the loan-to-value ratio never exceeded 70%. Today, it has fallen to barely above 20%. (See Figure 4)

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13. Discouraging PMI data are not merely a US reality. Currently, most countries are seeing readings below 50, the demarcation between expansion and contraction. (See Figure 5)

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There are two sides to every coin! and financial market. For many investors, the past few months of market volatility have brought back painful memories of 2008. Currently, markets seem to be focused on three large economies: Europe, the US, and China. Highlighting their importance, overall trading has largely reflected the news headlines emanating from these regions. While Europe's struggles have kept it in the driver's seat for markets around the world, next to it in the passenger's seat sits a resilient US economy and market. Stirring around in the backseat on this summer road trip is the Chinese economy, bringing its myriad potential troubles along for the ride. Within these markets, the news flow seems to be divided into two categories: hope and fact. Over the past few months, this tug-of-war between hope and facts has led to volatile market swings. However, we may be getting close to a winner, which could send the market markedly higher or lower depending on the outcome.

In Europe, we've seen financial markets sell off when the facts take control of the daily headlines. Recently, as you can see above in the *Points to Ponder*, the facts haven't been all that great. First, the unemployment situation throughout Europe is abysmal. Current unemployment numbers for the entire eurozone have been on the rise and now stand at an all-time high of over 11.1%. The youth unemployment numbers are appallingly high as well, reaching 22.7% in May. As you can see above in *Points to Ponder* 13, recent Purchasing

Manager's Index (PMI) manufacturing data released for the month of June show signs of contraction throughout Europe. Further, this slowdown hasn't been limited to the maligned PIIGS (Portugal, Ireland, Italy, Greece, and Spain). Even Europe's financial stalwart, Germany, posted disappointing PMI numbers in June, with an index reading of 45. Recent earnings disappointments from multinational corporations have also pointed the blame at Europe. Ford, Nike, Proctor and Gamble, and Cummins all cited poor European sales as the culprit for recent, disappointing earnings results. This list is likely only just starting to grow, as earnings season started on Monday.

However, there have been headlines of hope that have kept these markets afloat. Constant rumors of European banking Unions, political Unions, and euro bonds have offered hope that there might be a little light at the end of the tunnel. Originally deemed a success, the afterglow has all but faded from late June's European summit to address the region's financial perils. Spanish and Italian yields earlier in the week rose close to their pre-summit level of over 7% for Spain and close to 6.5% for Italy. Thus, the market is starting to look at the facts again and realizing that hope may be fading.

Over the first few weeks of July, the US market has faltered due to some recent economic facts that weren't so rosy. At the month's outset, the Institution for Supply Management (ISM) number came in at 49.8, signaling a contraction in the manufacturing sector for the first time since 2009. Furthermore, new orders fell to 47.8 from over 60.1 a month earlier. This is the largest month-over-month decline of this reading since the 12.4% drop in October 2001 following 9/11. Last week, the closely watched payroll number revealed that a measly 80,000 new jobs were created in June. Even worse, that meant 2012's second quarter averaged monthly new job creation of only 75,000, down from 226,000 in Q1. At this pace of job creation, the economy will match the peak employment levels of 2008 by 2015, just six years after the recession officially ended. Finally, second quarter GDP estimates continue to be moved lower by economists, with many now expecting growth to be less than 1.5% (annualized) in the second quarter.

Despite the negative facts that have been rapidly flowing out of the U.S. economy, the S&P 500 is still only about 5% below its 52-week high of 1420. Hope is not lost for this market either. Market participants are now optimistic that some of the bad facts mentioned above will lead Mr. Bernanke and company to fire up the printing presses and start another round of quantitative easing (or QE3). Such sentiment has led to a case of any news is good news, which in turn leads to an incredibly frustrating market environment for investors who prefer to invest on facts, not hope.

The final economy that has garnered the attention of investors is, of course, China. Recent facts have left many participants in this market feeling rather uneasy. China's manufacturing PMI data also showed a contraction reading of 48.2 for the month of June. Furthermore, as of July 12th, China's second quarter GDP growth is slowing with a reading of 7.6% annualized growth. This rate indicates a 3-year low for Chinese economic growth and is down from the 10-year average of over 10% growth per year. On July 9th, China's trade data was released and exposed a gaudy trade surplus of \$31.7 billion. This was almost double May's total of \$18.7 billion. However, most alarming was the slowdown in Chinese imports, which increased only 6.3%, significantly missing expectations. This seems to be a clear sign that the Chinese consumer is taking a breather.

Of late, one particular piece of factual data has been fueling excitement and hope for the

Chinese market: Inflation rose 2.2% in June from a year ago. This manageable inflation rate has led many to believe that China's government is again in a position to ease monetary policy, effectively becoming the nation's proverbial "knight in shining armor". However, recent European Central Bank, Bank of England, and People's Bank of China monetary easing did little to spark enthusiasm from the market. Many investors seem hopeful that the Chinese market will be able to coordinate a soft landing from the massive amount of easing that the Chinese government has initiated over the last several years. This proposition has proven rather difficult in the past, however. In 2008 and 2009, China helped the world economy by spending when no one else could. But what would happen now if we go through another global slowdown and China's wallet is empty?

As our loyal readers are aware, we prefer to invest based on facts. Hope should not be ignored, but when the facts show a strong disconnect from hope, we will adjust accordingly. Europe has shown little sign of being able to implement an effective solution. As some of our partners at GavKal believe, this may be because the only resolution for the EU is dissolution. Additionally, paltry US economic data have shaken our confidence in risk assets going into this summer. Finally, the news emerging from China has us questioning a soft landing or any savior emerging from the Far East. Thus, as we review all the data and rumors out there, we're comfortable being in a defensive position focused on companies with strong balance sheets that will pay us reliable cash flow. Hope isn't lost; it just may not be as prevalent in the coming months.

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