

June 29, 2012

"Going into this summit we had a monetary union in Europe that clearly did not work. Coming out of this summit we have a monetary union that still does not work."

-PAUL DONOVAN, GLOBAL ECONOMIST, UBS

POINTS TO PONDER

1. Though the popular perception is that government spending in the US is out of control, there are already tangible signs of a shift toward fiscal virtue. Unquestionably, the fact that expenditures are coming down from obscene levels explains most of the improvement, but the trend is nonetheless encouraging.

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2. Underscoring just how feeble growth has been in this "recovery," inflation-adjusted (real) GDP has increased by less than 2% in five of the last six quarters. Previously in the post-WWII era, this has only occurred during recessions.

3. Affirming a warning expressed in EVAs earlier this year that US corporate profit margins were close to peaking, negative earnings pre-announcements are now out-weighting those of a positive nature by a ratio of 3.5 to 1. This is the highest since the third quarter of 2001, immediately after the 9/11 tragedy.

4. Unfortunately, accumulating evidence supports the view that US consumer spending has been at unsustainable levels. Such sentiment, conveyed in past EVAs, is based on the chronically weak growth in disposable income and the reasonable assumption that households won't continue drawing down savings.


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5. One of the more remarkable factoids about the current ultra-depressed state of the US housing market is that mortgage rates could more than double to 9% and affordability would merely return to its long-term average.

6. Although fears of inflation abound, the CPI, the CRB (the main commodity index), the PPI (the Producer Price Index), and average weekly earnings all fell in May. This has happened just 1% of the time in the last 50 years, indicating the other "-flation," as in "de-", is more of a present reality.

7. The Fed's seemingly perpetual zero interest rate policy is producing a series of negative unintended consequences. One of them is that the cost of long-term care insurance is soaring as insurance companies are unable to earn enough investment return on pre-paid premiums (i.e., underwriting float) to offset rapidly rising elder care costs.

8. Although an almost certain reversal of the recent contraction in the US household savings rate will inhibit consumer spending, lower gasoline prices are producing a swelling windfall. Additionally, debt service burdens relative to income are approaching 30-year lows.

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9. One of the more bizarre features of the current investment landscape is that the Japanese yen continues to trade at exceedingly overvalued levels. This is despite the fact that Japan has now been downgraded by Fitch to the same A-minus rating as Estonia and Malta. Just as inexplicable as the yen's safe haven status, bond investors still treat Japan as one of the world's elite credits.

10. While bank runs in the Club Med countries have attracted considerable—and understandable—attention, a recent *Financial Times* article pointed out another grave threat. Foreign bond investors are also fleeing en masse, with outflows from Spain reaching an amount equal to 10% of GDP since mid-2011. Italy's massive bond market, the world's third largest, is faring even worse with 15% of overseas participants having decamped.

11. Last week saw Moody's sweeping downgrade of 15 major US banks. Notwithstanding this action, US banks have reduced their reliance on bond market borrowings, in stark contrast to their European counterparts. This is largely a function of the American banking system benefiting from an abundance of stable and nearly zero cost deposits.

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12. Thanks to an inherently more dynamic and less government-controlled economy, the US has managed to keep its share of world GDP close to 30%, while Europe has seen its slice of the global pie steadily shrink.

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13. China's monolithic state-owned enterprises (SOEs) have traditionally received preferential lending access. This granted them unfair advantages versus their privately owned competitors in addition to other perks of having the government in their corner. Lately, however, bank financing is beginning to favor private businesses.

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14. Fears are escalating that China might be in worse economic shape than is generally assumed. One of the more interesting factoids in this regard is that some local governments are being compelled to liquidate their luxury car fleets to raise badly needed cash. Further, dealer lots are overflowing with unsold cars in much of the country.

15. With the whole world seemingly betting against the euro, it may be tough to profit much from further declines, at least until bearish sentiment recedes somewhat. However, in the event that Germany pulls out of the currency union, or the Continent decides to do a flash devaluation, the euro is almost certain to fall much further.

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Viewing the world as it is... For at least 25 years, I've been a religious reader of the *Barron's* Roundtable articles in which eight or so of the nimblest investment minds are debriefed. In the old days—when I wasn't—this was covered in just a single January edition. Over time it eventually grew to be the feature story in three successive issues. Then, in more recent years, *Barron's* began to publish a mid-year update and that's the topic of the narrative for this week's Points to Ponder EVA.

Felix Zulauf has been a member of this august assembly for as long as I can remember and I was particularly intrigued by what he had to say in the recently published mid-year Roundtable. Showing that I'm not alone in being impressed with his take on the state of the financial world, Gluskin Sheff's ace economist and strategist, David Rosenberg, recently ran an excerpt that I'm relaying below.

Certainly, Felix is a fallible human being like the rest of us, but he's been right far more often than he's been wrong. After reading his views, I think you will understand why Evergreen is maintaining a cautious investment stance despite the mild correction we've seen in US stocks.

In this regard, it's important to reiterate something I've written numerous times in the past: The world will survive this difficult phase. After all, it's withstood much worse in the not too distant past. Yet, my investment team and I worry there is a disconnect between a fairly valued US stock market (some would argue it is grossly overvalued but we disagree) and the severity of the problems the planet's major economies are facing.

It continues to be our operating thesis that the next few months will bring bouts of serious market dislocations allowing those with cash on hand to snag some exceptional long-term

bargains. Blue chip stocks yielding 3.5%, and energy infrastructure master limited partnerships (MLPs) paying 7%, will become even more attractive from a cash flow generation standpoint if they pull back another 15%. Such a swoon is certainly not preordained, but I think once you read Felix's comments it might strike you that "only" a 15% further decline would actually be getting off pretty lightly under the circumstances.

Now, let's hear what Felix has to say...

There is too much debt in the industrialized world and the financial system is virtually bust. Real disposable personal income is stagnating or declining. Employment participation keeps heading south. This produces a chain reaction: Weaker consumer demand in the West weakens manufacturing in places like Asia, which weakens natural-resource producers such as Australia or Brazil.

As for the euro, it is a misconstruction. As I said in January, I expect the disintegration to begin in the second half of this year.

That should lead the world into financial and economic chaos. My two major themes into 2013 are euro disintegration and China weakness, due to the bursting of a real-estate boom.

The global economy is weakening cyclically on top of a highly fragile credit system. It is an explosive cocktail. The tower of debt is compounded by the gigantic over-the-counter derivatives market. In the past 10 years the notional value of derivatives worldwide has grown from \$100 trillion to almost \$800 trillion. The numbers are mind-boggling. If something goes wrong in the real economy, it could shake the whole credit system dramatically. It is a dangerous situation.

The euro is not the real problem but a trigger and compounder of the structural problems. It could only work if the euro zone entered a fiscal and political union, which won't happen, as Europeans aren't prepared to give up national sovereignty. Politicians therefore will go from one compromise and quick fix to the next, with the crisis deepening until some nations at the periphery won't be able to stand the economic pain anymore. They will want their old national currency back, and devalue to adjust the external accounts.

China won't be able to save us, as it did in 2009. The Chinese will lower interest rates but their actions will be reactive and lag. If my thesis is right, we must assume things will go awfully wrong in the next 12 months and the system will be at risk of collapsing. Most U.S.-focused investors might not understand it as they see corporations doing well.

The potential exists for a broad-based nationalization of the credit system, capital controls and dramatic restrictions on financial markets. Some might even be closed for some time.

We are witnessing the biggest financial-market manipulation of all time. The authorities have intervened more and more, and thereby created this monster. They might change the rules when the game goes against their own interests.

We are in a severe credit crunch. It starts when the weakest links in the system can't finance their activities. Then you have a flight to safety into Treasuries and German bunds, compounded by a quasi-shortage of good collateral. That's why bond yields have fallen so low. This isn't an inflationary environment but a deflationary one.

As a closing thought from the Evergreen investment team, today's "blockbuster" announcement of eurozone bank recapitalizations doesn't cause us to alter our cautious view. In fact, given the stock market's ebullient reaction to what looks to us like another fig leaf on a very naked

emperor, we are inclined to hunker down even a bit more. Call us cynical, but we're believers in the old saying: "Fool us once, shame on you; fool us twice, shame on me." And the eurocrats are way beyond twice.

David_Hay_Signature

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