

May 18, 2012

"Why save the bubonic plague?"

-GAVEKAL RESEARCH'S CHARLES GAVE, IN AN INTERVIEW ON FRENCH TV THIS WEEK WHEN ASKED WHAT SHOULD BE DONE TO SAVE THE EURO

POINTS TO PONDER

1. A recurring warning in numerous EVAs this year centered on the carefree attitude of the US stock market as the European crisis intensified. Another concern has been the degree to which very short term market participants, such as hedge funds, have driven US stocks higher. With these notoriously skittish "investors" basically all-in, there is the potential for what remains a mild correction to become disorderly.

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2. Past EVAs have noted that since the Great Recession economic optimism tends to peak early in the year and, thus far, 2012 seems to be following that pattern. Similarly, Hoisington Investment Management, one of the most successful US fixed-income managers, observes the same is true in the bond market where long-term Treasury yields have peaked in the first half of 14 out of the last 20 years.

3. Typically, at this stage of a recovery, total jobs are 3.5 million above their prior cyclical apex. Yet, three years after the recession's end, they remain 5 million below. We have also not gone this long—more than three years—with the unemployment rate above 8% since the 1930s.

4. For almost two years, despite negligible growth in real disposable income, US consumers have supported the economy by drawing down savings. This is unlikely to be sustained without the crutch of home equity extraction (aka the house as ATM) as was the case six years ago.

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5. Natural gas prices have fallen so severely that it now costs twice as much to generate electricity from coal than it does gas (12 cents per kilowatt hour vs. 6 cents). Nonetheless, coal still represents 45% of power production versus 24% for gas. However, utilities are in the process of a broad conversion from coal to gas, offering hope to gas producers battered by low prices.

6. Although natural gas continues to be America's most affordable—and relatively clean—fuel choice, renewables are no longer the rounding error skeptics maintain. US "green" energy, excluding hydroelectric, now amounts to 195 gigawatts, enough to power 17 million homes.

7. Citigroup chief equity analyst Tobias Levkovich has frequently questioned the commonly held belief that consumer spending makes up 70% of US economic activity. He notes that backing out the government reimbursed portion of medical costs, this falls to 64% and excluding out-of-pocket healthcare spending it declines further to 55%. This chart also drives home the vast amount of GDP consumed by medical outlays. (See Figure 3)

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8. Notwithstanding a recent mild correction over the last month, the US stock market is up 4%

this year, once again besting most world markets. However, excessive risk acceptance by institutional investors was revealed in a recent "Big Money Poll" with 55% of portfolio managers bullish or very bullish versus just 14% who were bearish. Additionally, low-risk utilities were seen as laggards, as were bonds.

9. The "new normal" has been very challenging for investors as interest rates have collapsed to Lilliputian levels, depriving savers of \$350 billion of cash flow. Fortunately, dividend income has swelled by roughly \$70 billion over the past five years. This is despite the fact that dividend payout ratios are only 35% compared to their historic average of 52%.

10. While investor trepidation of late has primarily been riveted on Europe's worsening economic conditions, as well as its escalating social unrest, China's once head-snapping growth rate has dramatically downshifted. (See *Figure 4*)

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11. Reliable economic data out of China is hard to come by; therefore, one of the most closely watched statistics is electricity output. This was up just 0.7% year-over-year in March, validating beliefs that the Chinese economy has chilled considerably. Other similar "shadow" GDP trackers, such as rail cargo traffic and bank loans, are telling the same story.

12. A recurring EVA forecast has been that the Euro-crisis would eventually engulf Spain and Italy, a view that is now being affirmed. A further prediction is that France will not be far behind. It runs twin trade and budget deficits exceeding 8% of GDP and, very ominously, two-thirds of its debt is held by foreigners. Moreover, unlike the US, it does not issue debt in its own (i.e., printable) currency. (See *Figure 5*)

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13. It is looking increasingly likely that Greece will seek to abandon the euro and return to its own currency, the drachma. One reason is that, excluding interest costs, Greece is close to running a balanced budget, making it easier to default on its overseas debts and finance internally. Also, should the drachma plunge, foreign capital would likely flood in, attracted by bargain prices on stocks, real estate, and other fixed assets.

14. A rare glimmer of good news among Europe's periphery is that Ireland plans to return to the global bond market later this year. Voters could upset those plans, however, should the May 31st referendum come out against the EU's fiscal treaty, a distinct possibility.

15. One of the most disturbing aspects of Europe's financial fiasco is that the odds of a run on the banking systems in the weaker countries are rapidly rising. For now, this threat is being mitigated through unprecedented borrowings from the ECB. "Club Med" banks, however, are running short of eligible collateral. Spanish bond yields have also broken above the critical 6% threshold.

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Won't it just all go away? Well, I guess the answer depends on that question's context. If it refers to Europe's problems, the answer, unhappily, is no. While most of us are sick of the subject, the reality is that conditions have devolved to the point the long postponed "end game" appears close at hand. And it's such an important part of the world that it's foolish to minimize the consequence of a convulsive conclusion.

If, on the other hand, the question relates to the euro experiment, with all of its attendant bureaucracy and stultifying regulations, the answer might just be yes. And we're in the camp that such a denouement (to use one of the few French words I know) is actually bullish in the long run. But, as I've admitted before, it's the thought of what the transition phase would look like that has caused considerable queasiness on the part of the Evergreen investment team.

It's certainly possible that the Eurocratic community can pull another coniglio (one of the few Italian words I know) out of the hat but they're running low on magic tricks in Brussels these days. The mass exodus of bank deposits from Europe's periphery is particularly menacing, as is overall eurozone unemployment at nearly 11%. Youth unemployment of 50% in several countries virtually guarantees mass demonstrations, if not paralyzing riots, this summer.

To repeat a refrain from a recent EVA, the world doesn't come to an end all that often. Europe will get through this and so will the rest of us. At Evergreen, we've been preparing for the dislocations--and buying opportunities--that occur when an unworkable economic system comes to its inevitable and inglorious finale. We don't think we'll have to wait much longer.

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