October 5, 2012

"Every monetary policy action has costs and benefits, and my assessment is that the potential costs and risks associated with these actions (QE3) outweigh the potential meager benefits."
-CHARLES PLOSSER, PRESIDENT OF THE FEDERAL RESERVE BANK OF PHILADELPHIA

POINTS TO PONDER

1. Looking at a collection of US economic data makes the stock market's ebullience since early June even more perplexing. The bullish counterpoint, however, is that the Fed's monetary alchemy has overridden the trends in the real economy, at least for now. (*See Figures 1 through 4*)

2. At its current pace of $40 billion per month of mortgage purchases (with fabricated funds), after a year the Fed will have printed enough money to provide nearly 10,000,000 households with a median income of $50,000. This amounts to creating purchasing power for nearly 25 million Americans, assuming roughly 2.5 people per household.

3. Current growth rates in both US corporate sales and profits are also dangerously flirting with recession territory. (*See Figure 5*)

4. Another conflict with the effervescent stock market is that there are now a staggering 45 million Americans on food stamps, approximately 15% of the population. Additionally, the actual unemployment rate is 11.2%, if the 7 million no longer seeking jobs are included. There are also 11 million US citizens collecting federal disability (the new long-term unemployment benefits program!).

5. Lending credence to those who believe that the central bank's money spinning provides fleeting support to stocks, during the last episode of "financial repression" the market's P/E ratio remained subdued until interest rates started normalizing. (*See Figure 6*)

6. Small businesses, the engine of job growth, are already reeling under the burden of stultifying regulations. They should brace for more oppression as there are over 4,000 new federal rules on the horizon. The National Federation of Independent Business estimates that the 13 biggest impending regulations will cost entrepreneurs $515 billion over the next five years.

7. Based on a recent Barclay's poll of institutional investors, only a minority see a sharp decline by year-end. This should be a shrill warning to all those with a contrarian disposition. (*See Figure 7*)

8. Recently, a number of ominous divergences have arisen with regard to US stocks. One major example is that the Dow transportation average, which tends to lead economic activity, is trailing the S&P 500 by 17%. Also, volume this year is 20% below 2011 when the market was

roughly flat. Moreover, the excess of bulls over bears in a leading investor survey is basically at the level that has coincided with prior market tops. (*See Figures 8 and 9*)

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9. Another warning sign for the American market is that insider selling is running at eight times the rate of buying. This is the most intense insider liquidation seen this year.

10. GaveKal Research's proprietary velocity indicator recently touched a level showing a high degree of risk acceptance. Similarly, a Barclay's measure of risk appetites is also quite elevated. (*See Figure 10 Figure 11 below*)

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11. Those that are counting on the Fed's QE3 to create a sustainable bull market might want to reflect on Japan's experience since it launched its first quantitative easing program in 2000. Even though Japan is now on QE8, its market has fallen from 13,500 to 9,000.

12. On a global basis, business confidence has eroded substantially. It is now at a point that is flashing a clear recession warning. (*See Figure 12*)

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13. The magnitude of the European welfare state, and its impossible economics, is driven home by the fact that 9% of Spanish GDP is devoted to paying pensions. As bad as this is, it is actually lower than the 13% in Italy and 15% in France. If the US paid out as much in pensions as does France, this would amount to $2.5 trillion annually.

14. The contrast in northern European employment trends versus the "Club Med" countries continues to be glaring. However, France, crippled by increasingly socialistic policies and an uncompetitive labor force, appears to be diverging from Europe's "core" and converging with its "periphery." (*See Figure 13*)

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15. The IMF recently conducted a study of what debt levels in various countries would look like under three different policy response scenarios, as delineated in the chart below. The top lines show debt trajectories with no reforms. The middle lines illustrate modest adjustments. The bottom lines project radical restructuring, and even on that basis France looks worse than Greece. (*See Figure 14*)

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This trend isn't your friend. More than a few EVA readers are probably wondering, after reading the above Points to Ponder, if I woke up on the wrong side of the bed (or perhaps foolishly decided to bet on the Seahawks to beat the NFL's favorite piñata, the St. Louis Rams). Actually, I'm happy to report that neither of those events occurred this week.

To prove that, I'm now going to relay some good news. First, US manufacturing data actually rebounded above the critical 50 level in September. This means that factory output expanded at least for that month. Second, ECRI, the forecasting firm that has called the last three recessions, is reporting that its leading US index rose for the 6th week in a row. Third, our associates at GaveKal Research also compile an index of leading economic indicators, in this case for all the developed countries, and it reflects an improving trend as well.

There's even a fourth positive as outlined by Barron's in this week's issue and that pertains to the venerable Dow Theory discussed in PTP #8 above. The fact that the allegedly forward-looking transportation average is down while the market is up is gaining some press as a disconcerting divergence. Yet, the article points out that since the 1970s, the stock market has risen more in the six months after such an occurrence than its average half-yearly increase (6.5% vs. 4%).

It's one of my perpetual goals to provide EVA readers with a balanced view of the economic and investment landscape. However, as I've observed before, this runs the risk of bewildering those who rely on this missive for some clarity in a muddled world. Certainly, there are times when I can't really discern the primary trends and am just as confused as everybody else. This isn't one of those moments.

Except during the most intense phases of a boom or bust cycle, crosscurrents are the usual state of affairs. And at times like this, after years of expansion, albeit feeble, it's normal that there are lingering pockets of strength. The key is to scan the body of data, and on that basis, the ultra-sound image that emerges for the US economy isn't a healthy one.

For example, despite the bounce in the September ISM (Institute of Supply Management) manufacturing report, durable goods orders in August fell a shocking 13%, and the July number

was revised down further to minus 4%. The combined 17% slide was the worst two-month reading in the history of this data series (only July of 2000 and January of 2009, both around or in recession phases, were comparable).

Next, despite the six-week string of improvement, ECRI believes the US is already in recession. Even our usually sunny colleagues at GaveKal are not putting much stock in the small upward reversal in their leading indicator measure. While this is just conjecture on my part, I suspect the reason is that both of these are heavily influenced by the Fed's latest hyper-intervention. Leading indicator studies are typically skewed toward stock prices and credit spreads, which have been distorted by anticipation of the Fed's latest "Big Print." In other words, the risk takers have front-run the Fed.

The proof is that for the first time since the Fed launched the latest act of its Great Levitation performance, stocks have basically yawned. Perhaps even more telling, cyclical market sectors have reacted with even less enthusiasm.

As far as the Dow Theory goes, it's my belief it is giving a prudent warning this time around. My logic here is that for most of the last 35 years whenever the economy faltered, as reflected by weakness in the transportation average, the Fed would start cutting rates, thereby boosting stocks. Now, with rates at zero, and our central bank's balance sheet bloated to Sumo wrestler proportions, the Fed's ammo supply is running dangerously low.

If this were just a single dashboard light coming on, that would be one thing. But I see many others, including the chart below, showing the tight correlation between durable goods orders and the stock market. As mentioned above, that economic reading has taken a decided turn for the worse. (*See Figure 15*)

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No easy way out. Last year at this time, we quibbled with ECRI's downturn prediction but now we think the odds, unfortunately, are considerably higher that they are right. Much hinges on the outcome of the November election.

Judging by the reaction to Wednesday night's presidential debate, the market clearly favors a Romney win. But it may be a case of being careful what you wish for due to the fact that Gov.

Romney has promised to fire Ben Bernanke and unwind his increasingly Banana Republic monetary policy. While this is a laudable goal, it might also prove to be highly unsettling for a market addicted to the Fed's endless liquidity fixes.

Whether it's a blessing or a curse, I remember what it was like to be in the investment business during the first two years of the Reagan-Volcker era when they were cleaning up the inflationary mess of the 1970s. The remedies they put in place were precisely what the country needed at the time but it wasn't exactly a joyous experience as interest rates soared and the economy tanked.

If the betting lines are to be believed, Mr. Obama will emerge the victor, leaving fiscal and monetary policies to continue on their present path which means the day of reckoning will be further down the road. However, it is likely to be far worse when it arrives.

Either way, it's hard to be rationally upbeat on the market with almost every investor survey showing maximum bullishness, and market internals notably deteriorating. This is the time of the year when the market usually begins to rally. But these days, not much is usual. Heck, even the usually hapless St. Louis Rams have shown they can win two games in a row.

David_Hay_Signature

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