The Global Slowdown

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By Peter Scholtz

Each day begins to feel more like 2008 in the capital markets. The main event this time is in Europe although the US is closely tied to the outcome. Once and for all, Greece WILL default. It will probably occur in the current quarter and although there is a bail-out package, the bailout is for European banks, not Greece. The Greek bailout is simply to buy time for the banks to raise capital and prepare for the hits to their book value that a Greek default will create. Expect a "structural" default which is a nice way of saying that the Central Bank will swap new debt for old and give you fifty cents on the Euro in a nice orderly fashion. This "structural" default is when the fun begins. What will the banks and the other weak EU members look like after these massive debt write-offs? Will contagion put pressure on Spain, Italy, and Portugal?

Another grenade in our lap is the fact that Europe is sliding into a recession. Spain and Greece are already there and Germany has slowed to a crawl. Italy has one of the highest debt to GDP ratios but teeters on the brink of a budget surplus, giving participants hope that they will not go the way of Greece. This precarious position will be aggravated by a European recession. The nervousness of the markets has clearly been heightened, as evidenced by the rise in price of sovereign CDS' (debt insurance). European stock markets have all been in solid declines.

The United States provides little solace as the US economy continues to decelerate. Last month we created no jobs, no growth in retail sales, no increase in housing prices, and no growth in real consumer income. Net total bank loans have stopped growing, a key indicator of economic activity. Confidence numbers among consumers and business continue to bounce around. The only recent constructive numbers are in industrial production, but the backlogs of business have declined sharply, suggesting that it is short lived. Economists have increased the odds of a recession from twenty-five to fifty percent. If housing prices roll over and resume a steady decline, it could get very ugly. We need consumer income growth which would come about from increasing jobs. This would slowly bail out the housing market and start the economy on a re-acceleration path.

The problem is therefore, how to get the economy going. Are there any more Federal bullets available? The huge stimulus package has run its course, and the appetite for more government spending has waned dramatically. Politicians are looking at spending cuts in the out years. There is a growing belief that temporary government spending can maintain, but not increase economic growth. The Fed has already reduced short rates to zero, and printed a lot of money to buy short term government paper, as well as mortgage-backed securities. They have now embarked on a program to buy intermediate government bonds, although with no increase in their net holdings. As things mature, they will buy different securities than before. Previously their QE2 stimulus created a rising stock market as the exploding money supply spilled into income stocks from lower yielding bonds. Without creating additional money, as the Fed has described their current behavior, this wealth effect is open to question. So far, it seems that the stock market is not accommodating the Fed. Instead, the market decline has a negative wealth effect on the upper middle class and high end consumer spending is in jeopardy. We have seen the high end retail stocks swoon with the market. Gasoline prices declining, however, help a lot. This frees up more money for other purchases. Gasoline prices are particularly important, as higher energy costs send more money overseas paying for oil imports, preventing any stimulus to domestic businesses receiving these higher energy prices.

Government regulation has also impeded the recovery as the economy has been the victim of 1000 paper cuts from the authorities. Confusing new rules and expenses on health care, new restrictions on banks, delayed oil drilling, and preventing Boeing from opening a new plant to employ 5,000 workers are just a few examples. Regulation has become a mess paralyzing the economy, and at some point we will need a commission to rationalize some of these rules. In the meantime, small businesses, which do most of the hiring, are hesitant to expand.

Our industrial and technology companies are the best hope for growth as they export to the Emerging Markets. The EM's, however, are seeing slower growth as they have raised interest rates to cool off their inflation rates. which we exported to them with the lower dollar. Ultimately, we could have stronger inflation here but not before we work off our oversupply of labor. To create inflation, consumer income has to grow to cover higher prices of goods and services, otherwise, as prices of one item goes up, demand for another will suffer and ultimately have a price decline. Overall inflation is therefore relatively stable. Rising inflation must be reinforced with rising labor costs which we don't have.

We are on the cusp of what appears to be a binary event. If we do not have a recession, the market is poised to roar ahead. If we have a recession, we could slip into a persistent decline as any fall in housing prices will put more pressure on the banking system, eliminating loan growth and therefore contributing to job loss and an economic decline that is potentially catastrophic. Otherwise, any accelerating growth that leads to the virtuous cycle of increased job creation, rising housing prices, increased business confidence and profits will make this market soar. The trick is to strike a delicate balance between protecting capital and keeping exposure in high beta cyclical stocks. It sounds like the classic client who wants to make a lot of money but does not want to have any risk. Where are these golden stocks? This is the current challenge. We are attempting to own some aggressive stocks while maintaining a total portfolio that outperforms on the downside.

32 HAVILAND STREET – SUITE 3—NORWALK, CONNECTICUT 06854
TEL: (203) 714-9900 – FAX (203) 286-7985