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2011 – Back To The Brink

A year ago, the central financial theme was markets reverting to 'near normal', including healthy stock and bond markets , narrowing credit spreads, and declines in most measures of risk. The glaring exception was the US economy, which was still struggling to regain its stride.

For the most part, both in the US and overseas, this 'near normal' status continued through the first third of 2011. Yet markets are not static; they are by nature ephemeral, seeking a new if temporary equilibrium. By early May the world's markets, and economies, began to stumble. So 'near normal' lasted maybe 16 months -- not a bad run. Then again, it was far less than anyone was hoping for.

In the US, two conditions turned critical by mid-year. First, the economy disappointed, nearly slowing to stall speed. Entering the year at a growth rate over two percent, economic expansion slipped to under one percent in the first half. But just when it appeared we might slide into another recession, third quarter growth rebounded to nearly two percent, and fourth quarter figures are likely to show further improvement. At the same time, the job market is strengthening, albeit far too slowly, and most leading indicators continue to point to an expanding economy. Crisis one averted.

The second significant mid-year change was the stock market. After reaching an intermediate high in late April, stocks reversed course abruptly over the summer months. Minor rallies only led to further declines, culminating in a bottoming climax in early October. With the S&P 500 falling just under 20% in this five month swoon, market historians will note this as a severe correction, not a bear market. Call it what you will, the downturn was sharp and painful. Since bottoming, stocks have recovered over half their loss, with major indices now sitting well above bear market territory. For the time being, as with the economy, this threat has resolved itself favorably.

So much for the US. A third critical condition is centered in Europe, and is not nearly so simple.

It all starts with Europe's common currency, 'the Euro', a half-baked concoction if ever there was one. In their ongoing desire for greater unity, EuroZone members accepted weak nations whose economies and fiscal policies argued against their inclusion. Certainly Germany had little in common with Greece, and in time the differences would prove more critical than the similarities. Nonetheless the club was formed, broad membership and all, with hopes that the weak would be uplifted by the strong. It almost worked.

Over time, a weak foundation will reveal its flaws -- first a few cracks, then some chips, until finally a fault is exposed, and stability is in doubt. So too European unification. Once club

members, Europe's leaders proved neither willing nor able to contain bloated budgets. Guidelines existed to encourage fiscal discipline, yet went unenforced. Compliance became voluntary, punitive threats were toothless -- there is no specific penalty for bad behavior, and no mechanism for nations to exit the Euro. Did they really think the Euro, and all its members, would last forever?

So now the PIIGS -- a most fitting acronym -- threaten to make a mess of the entire European experiment. Portugal, Ireland, Italy, Greece, and Spain have all seen budget deficits balloon while their economies burst. How bad is it? Spain suffers 22% unemployment; Italy carries debt at 120% of GDP; Greece's economy is shrinking by six percent per annum. These are catastrophic figures.

For the 'periphery' nations -- Ireland, Portugal, Greece -- either the problems are manageable or the nation itself is too small to induce contagion. Italy and Spain are a different matter: they are Europe's version of 'too big to fail.'

Enter the bond market, and the battle lines are drawn. If investors lose all confidence that Europe's governments can sustain fiscal solvency, then bond auctions will fail, interests rates will soar, and it is 'game over'. Banks will be forced to write-down large bond positions, calling the banks' own solvency into question. If governments collapse, followed by the banking system, where is the safety valve? The world's standard remedy -- currency devaluation combined with managed bond defaults -- does not exist. With neither Greece nor Italy nor Spain printing their own currency, they have nothing to devalue.

This is the issue that has brought Europe to the brink.

How will it play out? Nobody knows, and the permutations are innumerable. Let's simplify it to three general possibilities, excluding the extreme of permanent political fissures and Euro-zone collapse. Appropriately, we apply a US-centric focus :

1.Europe suffers a mild recession, but not a severe one.
In this case, the crisis was overblown. Stocks and bonds and everything but Treasurys are undervalued. What were we worried about? US exports to Europe account for only two percent of our GDP -- hardly enough for concern in a mild Euro-recession. US multi-nationals will feel some pain, but when was the last time anyone relied on Europe as a growth engine?

2. Europe endures a deep recession, but not a systemic banking crisis.
This is the middle ground scenario, not rosy by any means, yet still not a catastrophe. It may be the most likely outcome, with the least certain consequences. Will Europe drag us down with it? What about emerging market economies, will they suffer as well? Or will the US and emerging markets continue to grow at a pace far above Europe's, as they have for years?

3. Europe suffers a banking crisis and severe recession, ala the US in 2008.
Okay, all bets are off. It will end eventually, but it will not be pretty.

On that cheery note..

Happy New Year!!

Tidbits..

Warren Buffett's Berkshire ramps up investment spending to highest level in 15 years.
Perhaps stocks really are cheap.

US job openings reach three year high.
Improvement.. at a snail's pace.

Jefferson County, Alabama files largest municipal bankruptcy in US history.
Another failure of risk management.

Oil pipeline project running from Canada to Texas is put on hold by Administration.
Let's see.. jobs and infrastructure and energy all in one deal? No thanks.

Share repurchases reach third highest level on record
Cash rich companies spending on themselves.

US Postal Service projects $14 billion loss in 2012, approaches cash shortfall.
Only the government could mess up a monopoly this big.

Congressional Super Committee fails to reach deficit reduction agreement.
Even with miniscule targets, it is more of the same in Washington.

American Airlines parent, AMR Corp., files bankruptcy.
For airlines, the road to competitive advantage.

AT&T bows to regulatory opposition, drops $39 billion acquisition of T-Mobile.
If ever anti-trust rules applied, this must be it.

Revised data shows housing crunch was worse than reported.
It sure felt that way.. and still does.

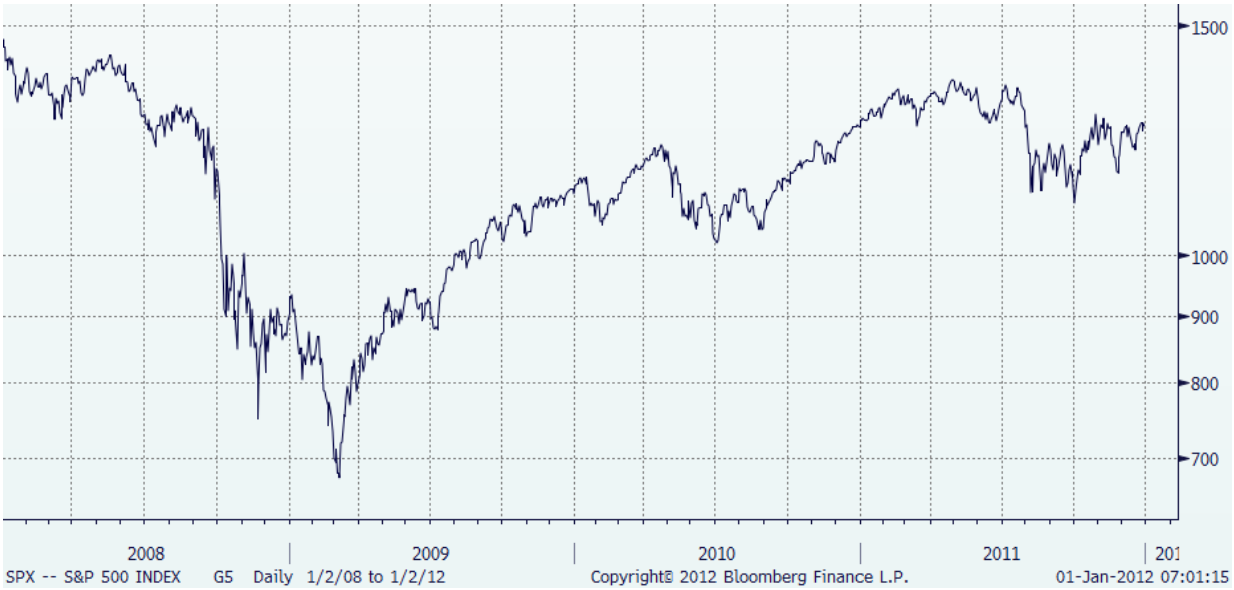
S&P lowers ratings on 37 financial institutions worldwide, targets 15 sovereigns for credit cuts.
Now they tell us.

SEC sues former executives of Fannie Mae, Freddie Mac over fraudulent mortgage disclosures.
Keystones cops chasing three stooges.

Equities

US equity markets continued their uptrend through April, then reversed course and suffered a severe correction. With a rally off the October bottom, the S&P 500 ended the year unchanged, while the broader US market declined.

SP 500 Index 2008-2011



International equity markets followed a similar pattern to the US, but with sharper declines and weaker recoveries. Most of Europe is in a bear market, along with emerging markets.

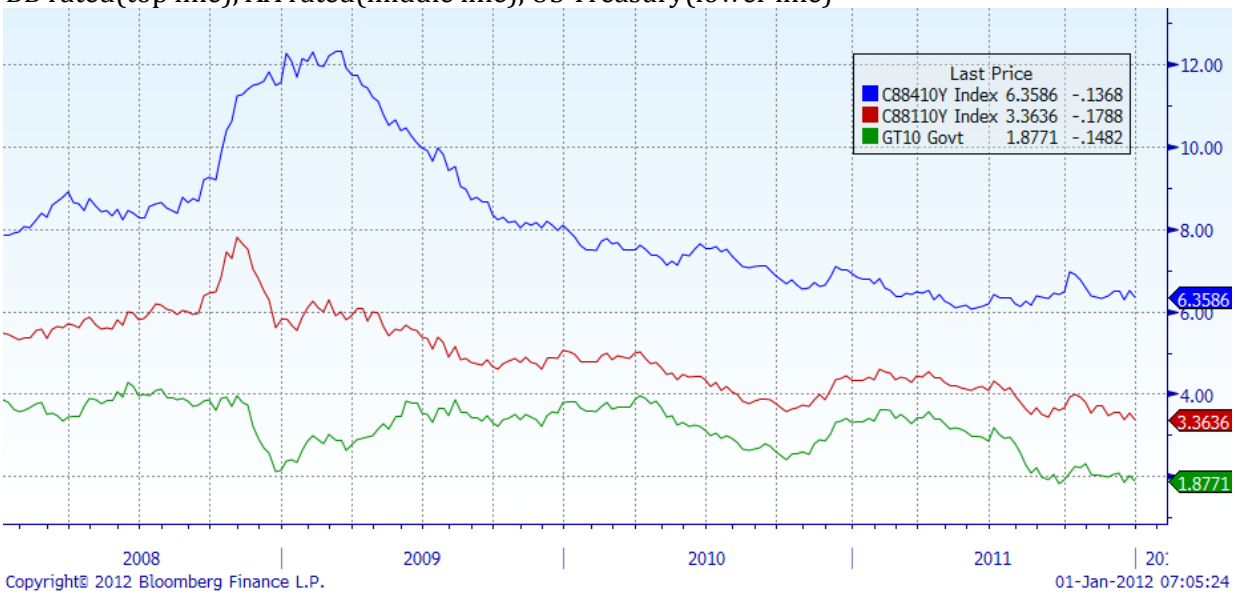
The most overblown consensus entering the year was to own emerging market equities, especially the BRICs. Full-year results? Brazil -18%, Russia -17%, India -25%, China -25%.

MSCI EAFE(Europe, Australasia, Far East) Index 2008-2011

Bonds

Bonds performed surprisingly well in 2011, led by a big drop in Treasury yields. Investment grade corporates and "quality" high yield bonds performed reasonably well.

10 Year Bond Yields 2008-2011
BB rated(top line), AA rated(middle line), US Treasury(lower line)



Treasury yields dropped to historic lows, reflecting a flight to safety and continued Fed support. There is no investment value in Treasurys yielding less than inflation; yet apparently there are still buyers.

US Treasury 10 Year Yield 2008-2011

Commodities

Commodities followed a similar pattern as equity markets and Treasury yields -- higher early in the year, then lower -- but failed to recover in the fourth quarter.

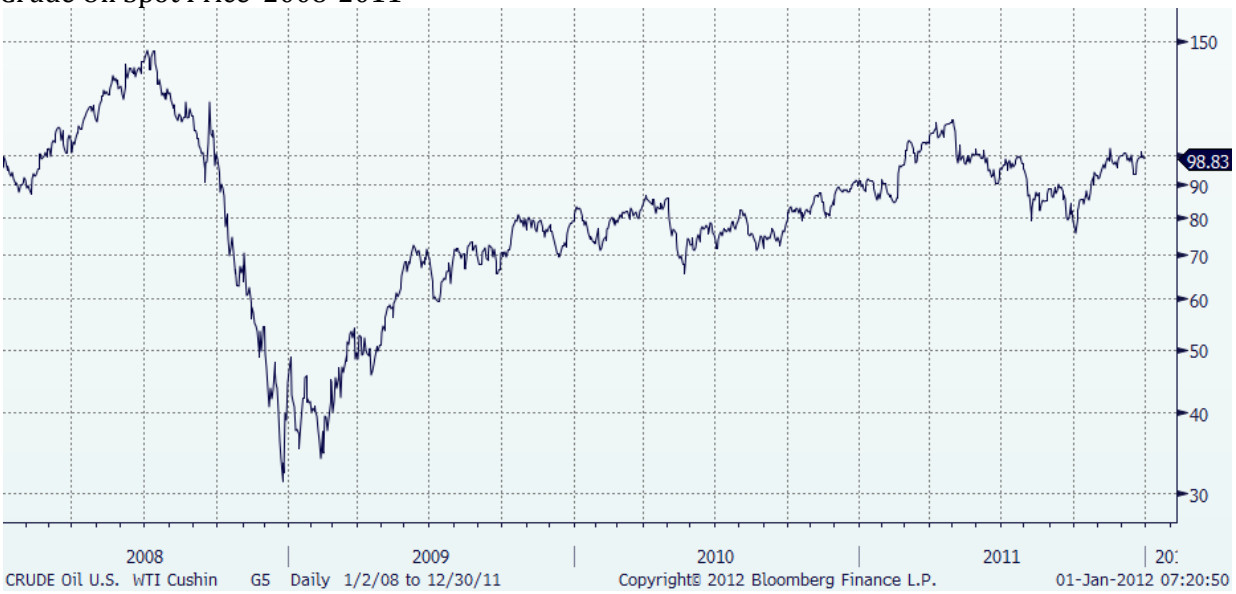
CRB Commodity Price Index 2008-2011

Gold has reached its crossroads, after a decade run of positive returns. Is it an alternative currency when all others are being devalued, or is it a metal with few industrial uses and no yield?

Gold Spot Price 2008-2011

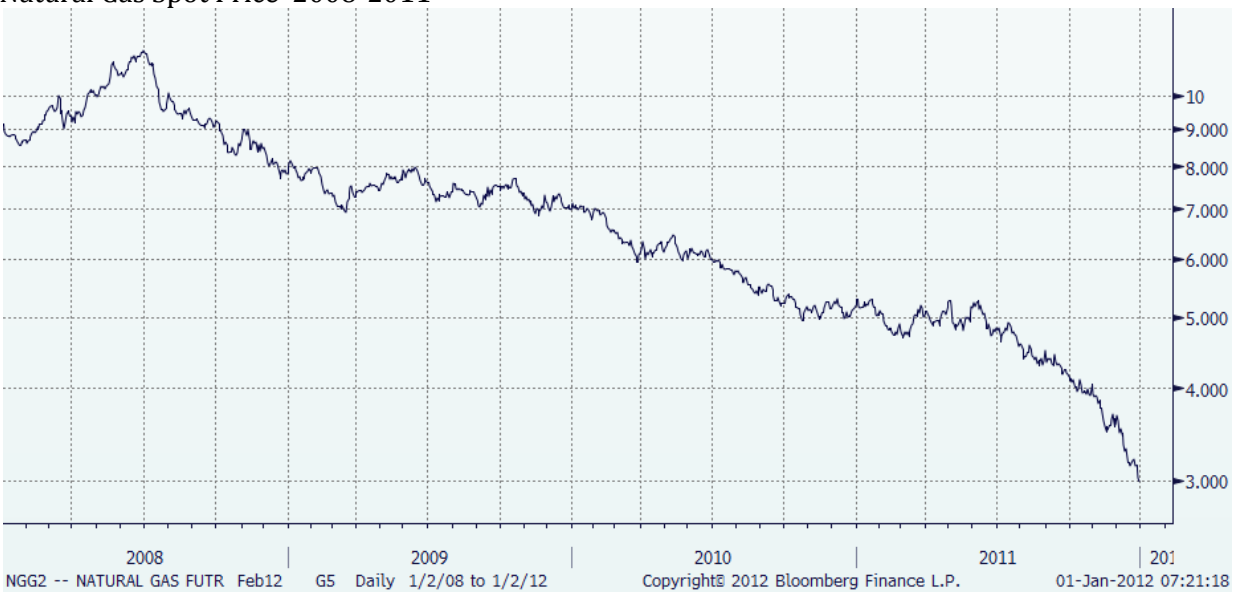
The world will not run out of oil, but the price we pay may remain high.

Crude Oil Spot Price 2008-2011

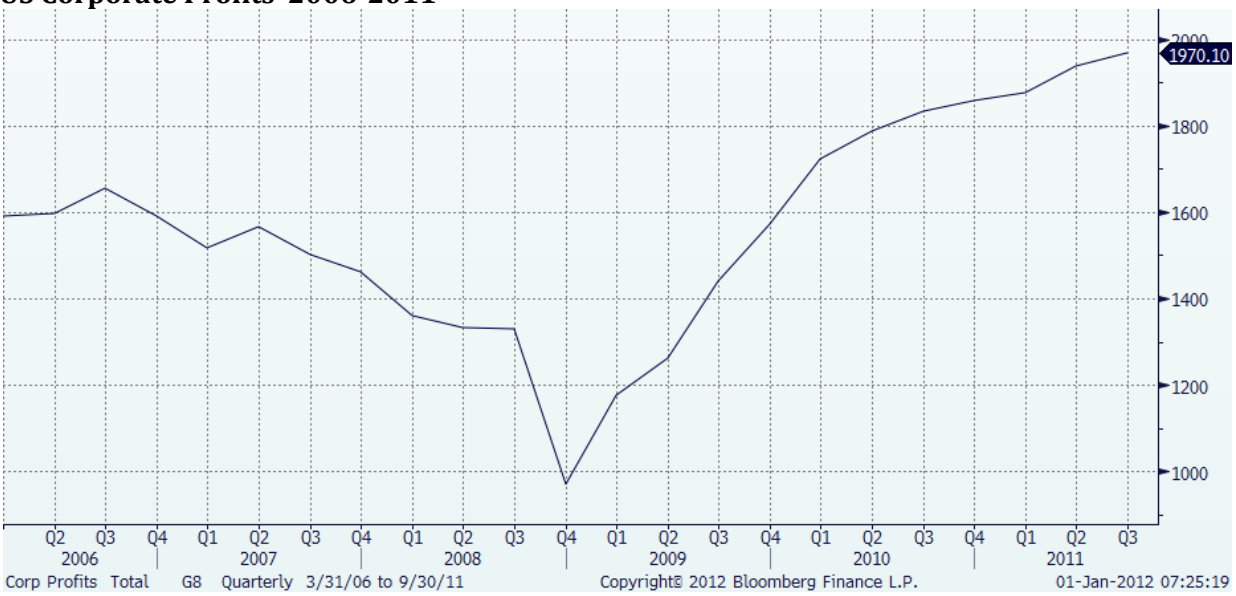


Natural gas is clean, domestic, plentiful.. and now inexpensive.

Natural Gas Spot Price 2008-2011



US Corporate Profits 2006-2011



US corporate profits continue to reach record levels, approaching $2 trillion. Profits have doubled since their recession bottom.
Profit growth will certainly slow, and runs a small risk of contracting.

S&P Case-Shiller Composite Home Price Index 2006-2011

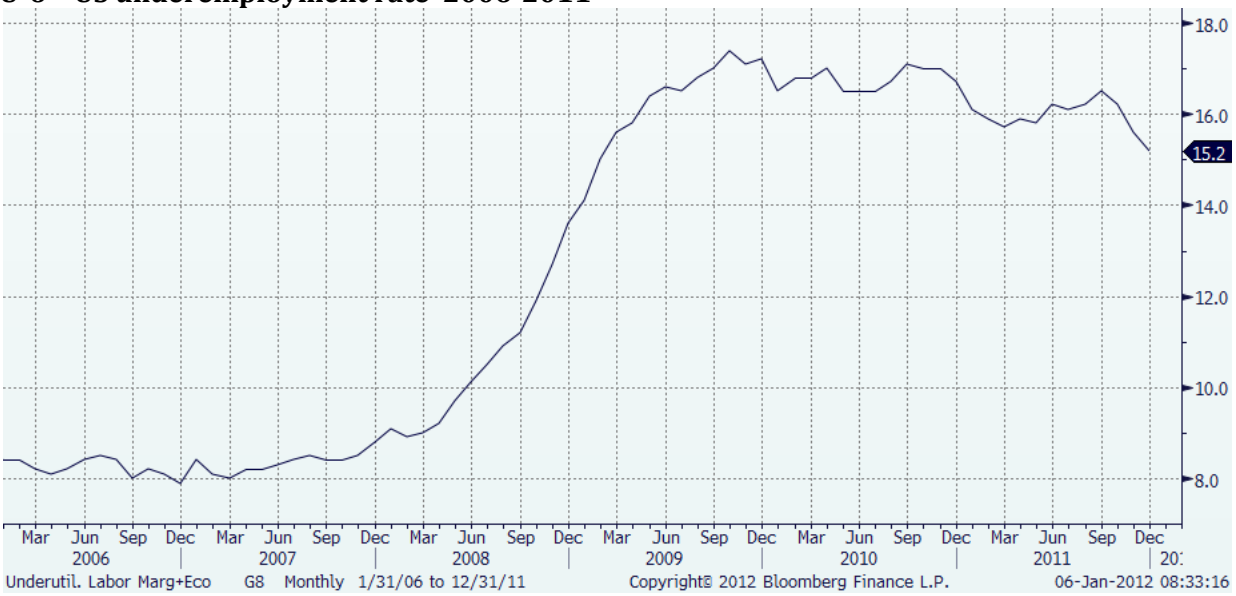
Housing activity may be forming a bottom, but prices -- down one-third since the peak -- show no signs of a meaningful bounce.

US unemployment rate 2006-2011

The labor market is improving, but at a frustrating pace.
The falling unemployment rate partly reflects people leaving the workforce. Payroll growth is still well below normal job gains in an expanding economy.

The 'underemployment rate' over 15% -- those without jobs, or working part-time, or marginally attached to the labor force -- paints a more accurate, and grimmer, picture of the job market.

U-6 – US underemployment rate 2006-2011



US Leading Indicators 2006-2011

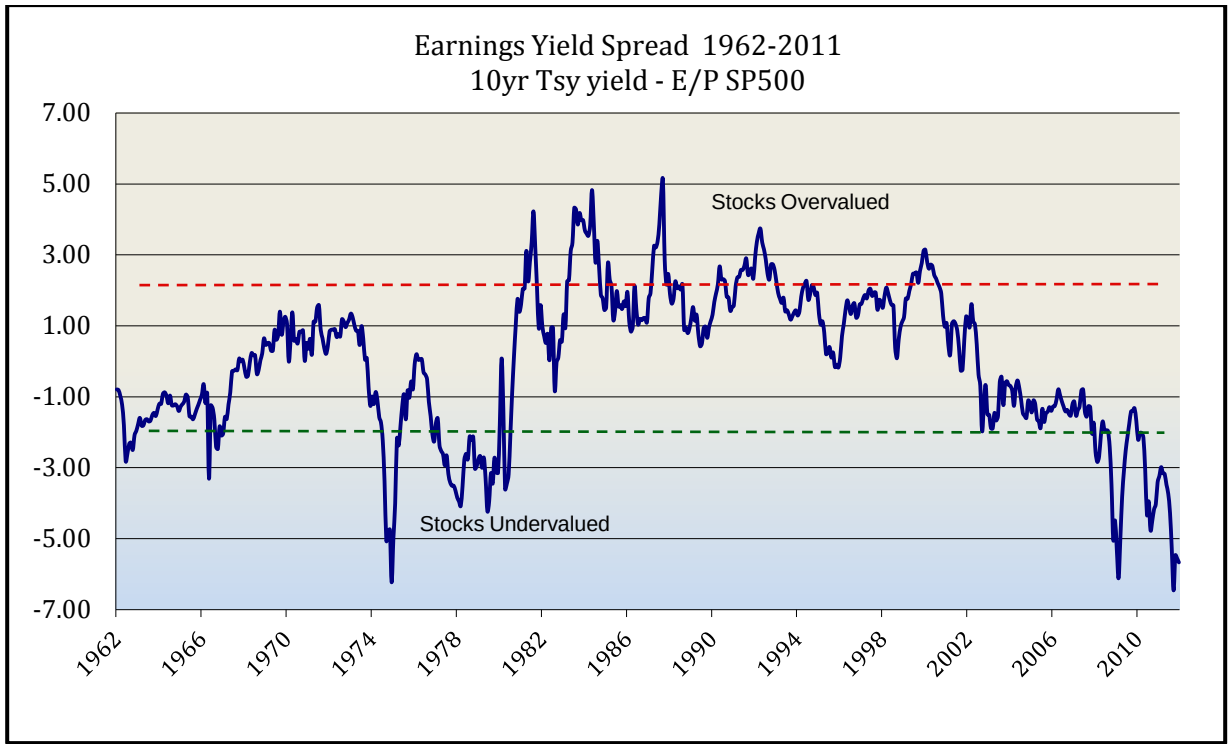
Economic growth may be feeble, but the leading indicators continue to forecast improvement.

US Dollar Index -- trade weighted basket 2008-2011

Recent Dollar strength mostly reflects weakness in the Euro. Europe is winning a race to the bottom.

One Last Thought

If we had to choose just one favorite chart, at the moment, this is it. And it has been for quite some time. It depicts the valuation spread between stocks and bonds for the past 50 years. In this case, the valuation of stocks is measured by the earnings yield (inverse of PE) on the S&P 500, based on trailing 12 months earnings. For bonds, we use the 10-year Treasury yield.



We compare the two asset classes by subtracting the earnings yield on stocks from the Treasury yield. The result since 1962 is depicted in the chart. A high positive number indicates bonds are more attractive, stocks are expensive. A number near zero indicates something close to equilibrium. And a deeply negative number indicates stocks are attractively priced versus Treasurys, based on history.

Why is it our favorite chart? For starters it is intuitive. It makes sense within financial theory that stock values are partly driven by returns offered on an alternative, and relatively safe, Treasury investment. It is also easy to measure, easy to depict, and difficult to fudge. The numbers are what they are, more so given our use of trailing earnings, not projections subject to revisions.

Moreover, at market extremes it has proven extremely useful. This measure signaled historic market bottoms in late-1974 and early-2009. It also flagged dangerous stock valuations in mid-1981, mid-1983, mid-1987 and early-2000. If those dates do not ring a bell, go back and study your stock market history.

What is it telling us now? After reaching extreme lows in early-2009, stock valuations recovered meaningfully into early 2010, only to slip back into outlier territory. On this basis, stocks are cheap, very cheap.

But it may not be so simple. Stocks are cheap based on exceptionally low Treasury yields, and these yields certainly could rise 100 basis points or more in the coming year. Moreover, stocks are cheap based on currently strong earnings. If the economy slips into recession, or corporate profits unexpectedly decline, then stocks are priced richer than they appear. And then there is Europe, and the risk of contagion. There is no rule that says cheap stocks cannot become cheaper.

So stocks are cheap, but there is a catch. Isn't there always?

We will take our chances, with care. It's the best we can ever do.

Source:
Bloomberg
Wall Street Journal