HEAD INVEST

Market Comment

JULY 5, 2011 | VOLUME 23 NUMBER 2

ESCAPE VELOCITY?

In spaceflight, the term escape velocity means the rate of speed necessary to allow a vehicle to overcome Earth's gravity and break free into outer space. The term has been adopted in economics to mean the pace of economic activity necessary to sustain growth without government support. Can the U.S. - and other nations for that matter - achieve this state?

A review. As we know all too well, the seeds of the financial crisis and subsequent recession were planted in the early years of this century when lenders forgot about risk, making loans, particularly mortgages, to borrowers less likely to be able to service their debts. While U.S. commercial and investment banks led the way, the same irrational thinking is at the root of the problems in Greece, Ireland, Portugal and other nations that financed current social expenditures with ever-growing government debt.

The recession that followed was importantly a crisis in confidence. When the global banking system threatened to seize up, the uncertainty led to curtailment of spending among both consumers and businesses. U.S. employment began falling (unemployment rising) *before* the decline in GDP began.

Historically, recessions were caused by lack of information.[1] Manufacturers had no early warning about slowing sales across their markets. By the time new orders slowed, they had built inventories on the assumption that good times would continue. To re-balance inventories they slowed or ceased production and laid off workers. Newly unemployed workers reduced their consumption, which caused problems for additional companies, and so on. Corporate profits suffered, leading to defaulted loan repayments and troubles among banks.

This time trouble began among financial institutions. Modern information technology has to a great degree vaccinated the economy against the old-fashioned kind of recession. The ratio of inventories to sales among manufacturing enterprises was near an all-time low as the recession unfolds.

Looking back at government activity. Many of the Federal government actions during the early stages of the financial crisis seem to have been effective in hindsight, while the success of others remains unclear. The Fed's participation in financing the forced mergers of Bear Stearns and Merrill Lynch went a long way towards maintaining functioning markets. These advances are being repaid at this time and may become profitable loans. The bailout of AIG also lubricated market functioning by assuring that contractual payments were made to other large investment banks by AIG's derivatives unit. It is not difficult to argue, however, that these recipients would have easily survived without these payments.

There have also been myriad other plans to assure that capital would be available for banks, credit

1 This explanatory section was adapted from our January, 2009, edition.

continued...

continued from page 1...

unions, government-sponsored enterprises, and on and on. Tracking each of them through to conclusion would be daunting. The St. Louis Fed posts on its website a timeline of the whole era. Each program is described briefly as it was introduced, and each major business failure is mentioned.

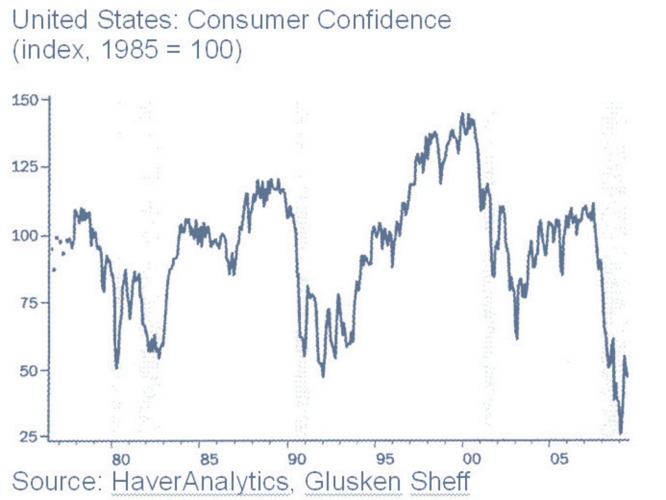
The TARP plan sounded like a good idea in its original form - which was to buy up troubled assets that were weighing down banks - but an implementation plan never gelled, and the money was spread around the country to a great many banks, some of which were forced to take their share whether they wanted it or not. This scheme probably had no real impact, but at least the banks have largely repaid and the Treasury has earned interest on the loans.

The $787 billion government spending stimulus plan incorporated funding for many worthwhile projects that other levels of government were unable to afford, but it is difficult to find any significant impact on general economic improvement. The American Recovery and Reinvestment Act of 2009 was signed into law on February 13, and the NBER last year declared that the recession had bottomed out in June, 2009 - by which time little of the appropriation had been spent. By August, 2009 - at least according to Wikipedia - only 19% had been allocated. Looking back through history, this is typical for government stimulus packages: By the time they get in gear, the recession is always already healing for other reasons.

With all this government activity, why is the recovery so sluggish? Answering this question requires some circularity. Consumer spending as measured by personal consumption expenditures in the GDP rose 4% in 2010's fourth quarter, a reasonable showing, but grew just 2% in this year's first quarter. We will be lucky to see much over 1% in the quarter just ended. A lack of momentum in consumer spending means slow sales growth for businesses, which means poor employment growth, which means slow growth in consumer spending.

Consumer confidence is a big part of the problem. The graph below depicts the Conference Board's version of confidence measures going back more than thirty years. The level of confidence during this recession is the lowest in that entire history, and the most recent reading was a downside surprise. At this stage in the average economic recovery stage, the number is 94. Now it is 58.5.

CONSUMER CONFIDENCE MIRED AT RECESSIONARY LEVELS



Confidence or the lack thereof comes from oscillations between security and uncertainty. If we believe our jobs are secure and we can reasonably predict our living costs, we are more likely to express strong feelings of confidence and to spend accordingly. If we see polarized, feuding politicians, out-of-control government deficits, rising food and fuel prices (despite low official inflation measures), and not-yet-understood changes in health care management and delivery, we lose predictability about our futures.

Eurozone troubles. The saga of Greece has become a story of one step forward, two steps back. After the first support payments to Greece from the rest of Europe, the Greek government failed to generate its promised spending cuts. Other members of the Eurozone, especially Germany, didn't want to throw good money after bad and demanded new austerity before releasing additional money. New money is now being made available after a new austerity plan did finally pass Parliament in Athens, but this plan brought increased demonstrations by citizens who have come to expect permanent government support. France is supporting a so-called voluntary re-structuring in which banks holding Greek paper will extend maturities in return for higher interest rates. This would serve both to increase Greece's debt and increase debt service costs - hardly a solution.

The Wall Street Journal editorially asked, "Why not let Greece fail (i.e., abrogate much of its debt) in order that it can recover faster?" The answer is the European Central Bank fear of contagion. If it works for Greece, would Ireland and Portugal take the same path? None of these three economies is large enough for this to matter much for the Eurozone or the world, but would losses from these events destroy banks in Spain or even Italy? Fear of those unknowns is freezing Eurozone officials into a most difficult path, adding to global uncertainty.

Bond markets have been handicapping the odds of failure of European countries through the interest rates they must pay. Here is a current update.

Yields as of July 1

	5-year	10-year
Germany	2.28	3.03
Netherlands	2.57	3.34
France	2.72	3.41
United Kingdom	2.09	3.39
Italy	4.10	4.85
Spain	4.59	5.35
Portugal	12.53	10.41
Ireland	12.56	11.15
Greece	17.78	15.65

When we last published this using late December data, the bottom three most risky nations were 3-4% lower in yield. Spain, on the other hand, was a bit higher. Markets seem to be less worried about Spain than central bankers are. The U. S. Treasury 10 year yield was 3.21% on July 1.

Risk premium. When you can buy a riskier investment opportunity cheaper, you expect higher return. In financial market jargon, that higher return is described as a risk premium - the added hoped-for return above safer investments, usually U.S. Treasury obligations. In Europe, bond markets are pricing riskier countries at substantial risk premiums to safer countries.

This concept lies behind our frequent comment that stocks are priced at unusually attractive levels. For the simplest explanation, let's compare the earnings yield - earnings per share divided by price - to bond yields. The earnings yield for the S&P 500 using 2011 expected earnings is about 8%. We have long believed that the U.S. Treasury five-year yield is the correct benchmark for stock prices. On July 1 that yield was 1.8%. Historically, stocks have been priced to generate an expected return 3-4% above the Treasury. Using 4% plus the five year Treasury rate, the S&P 500 is 25% underpriced.[2] In other words, 500 leading companies traded in the U.S. (Some of which are domiciled in other countries) are being collectively priced as riskier than the Spanish government.

What's the answer? For the reasons discussed above, developed economies are very slow to recover from the damage done in 2008-09. But at least there is recovery. In order to accelerate to escape velocity, the big risks must fall away like the fuel tanks on a space shuttle launch. The U.S., much of Europe, and Japan must find credible plans to cease adding debt, including clarity on any tax increases. In the U.S., a new consensus on the proper role of the Federal government in the economy and society would be very helpful. Any evidence that solutions can be found is likely to improve confidence, accelerate new business investment, improve consumer incomes, and loosen consumer spending.

2 Investment management theorists may point out that this explanation is insufficiently rigorous, but it gets to the right place in an understandable way.