Investment Commentary—July 2010

In late April the stock market's rapid ascent from its 2009 lows came to a sudden halt. The proximate cause of the sharp turn was a Greek debt crisis that had been simmering for several months. The powers that be in Athens behaved recklessly for many years, deceiving Europe's fiscal watchdogs along the way. Once the Great Recession took hold, a day of reckoning was inevitable. With tens of billions of euros worth of debt maturing this spring the issue was forced. By early April it was clear that refinancing the maturing debt would require explicit backing from Europe's larger countries and possibly the IMF. As the weeks wore on, the bond market became increasingly concerned that the reaction of Germany, France et. al. lacked appropriate force and speed. Ominously, the crisis was rapidly increasing the cost of borrowing for Portugal, Italy, Ireland and Spain (financial pundits have labeled these four countries, together with Greece the PIIGS.)

In early May European leaders were finally able to get ahead of the curve by announcing a massive borrowing facility—nearly $1 trillion--that would be available to any of the weaker countries in the Eurozone. In Greece's case, the bailout, together with the concomitant austerity measures, should keep the country solvent for at least a year, probably closer to two. Whether Greece will achieve sufficient deficit reduction in that time to be able to return to the capital markets is anyone's guess. Perhaps the more important question for global investors is whether Portugal, Italy, Ireland and Spain can make enough progress in the next year or two that an eventual Greek default would be—and would be perceived to be—an isolated event. Italy and Spain are particularly crucial due to their size. The good news is that each of the countries involved is moving very aggressively to implement the kind of austerity budgets required to restore fiscal balance.

Of course, austerity budgets are not all good news; budget chopping has some potential to derail Europe's nascent recovery. More likely, the weakness in the euro brought on by the debt crisis will sufficiently crank up Eurozone exports to compensate for the coming austerity. In any case, the alternative to painful fiscal probity (at least for the PIIGS[1]) is worse, especially insofar as it puts European banks at risk. A Spanish debt crisis, for example, could have a crippling impact on Spain's large banks. If some of these banks went under, or looked likely to do so, their debt

[1] Whether countries like Germany, France, the U.K. and the U.S. should be reining in deficits is a matter of some controversy; economist and New York Times columnist Paul Krugman, for example, believes that slamming on the fiscal brakes is likely to cause a depression. We're dubious of that assertion, but do believe that the austerity programs that seem to be underway in Germany, France and the U.K are ill-timed.

would plunge in value, which could in turn drain the capital of French banks. German banks would then be forced to mark down any holdings of either Spanish or French bank debt, depleting their capital. At that point, few large Western banks would be spared massive losses. Fortunately, European regulators are moving quickly to emulate U.S. Treasury Secretary Geithner's highly successful approach to shoring up the U.S. banking sector—transparent stress tests accompanied by mandatory capital injections. Transparent stress tests of European banks are long overdue, but better--much better!--late than never[2]. Results are due July 23rd, which should prove to be an interesting day for capital markets around the globe.

Not long after the troubles in Europe arrived, early signs of a slowdown in the U.S. economic recovery began to appear. The most striking indicator was May's employment report that showed a paltry 20,000 jobs created (excluding temporary Census hires), a sharp drop from the 160,000 and 248,000 created in March and April (again ex-Census) respectively. June bounced back a bit, to 100,000 ex-Census but not enough to make May look like an anomaly. Six months ago I suggested that the recovery would fade in the back half of this year and wrote that "for several quarters or more the economy will languish in a netherland between recession and real recovery." Unfortunately, that characterization is becoming increasingly apt.

The economics team at Goldman Sachs, who we think is the best on Wall Street, has been predicting for some time that growth in the U.S. economy would fade in the second half to about 1.5%. We're encouraged that with the slowdown apparently on our doorstep, Goldman has not lowered its forecasts and continues to anticipate a gradual re-acceleration to 3% by the end of 2011[3]. As far as the possibility of a double-dip recession is concerned, Goldman attempted recently to forecast the likelihood of the U.S. being in recession six months hence. Using several approaches they came up with probabilities ranging from 2% to 24%--unlikely but not out of the question.

Three percent growth during a recovery is hardly something to get excited about, but at least the economy will be re-accelerating by some time next year if this forecast is right. What would bring about such an acceleration? What are the reasons for optimism no matter how modest or cautious in the face of seemingly intractable problems from unemployment to deficits to the war in Afghanistan to oil gushing in the Gulf? The simple answer is that much of what plagues the economy will eventually run its course. Consider three examples: housing, state fiscal woes, and the credit crunch.

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[2] At this writing, there is some question about whether disclosure of the results can be compelled without the agreement of the banks in question. However, the best positioned banks will want their results published. Once it is clear that some banks will disclose, others will fall in line, as the market would assume the worst in the event of silence. Of more concern, some reports have indicated that the key assumptions involved in the stress scenarios are overly optimistic; other reports suggest that the stress scenarios are appropriately dour.

[3] The Goldman team cautioned that there is downside to the 3% forecast for the end of 2011 if Congress pulls back too quickly on fiscal stimulus.

Residential construction (homebuilding) is typically one of the key engines of an economic recovery, but it's stalled right now and may in fact be heading further south. The problem is that we built way too many houses in the previous decade, creating excess supply. The good news is that homebuilding is so tepid right now that it isn't keeping pace with the natural growth in housing demand (from population growth). This disparity eats into the excess supply, eventually causing supply and demand co come into line. At that point, homebuilding will perk up and the economy will get a shot in the arm. It may be a couple years away or more, but it will happen.

State fiscal woes are forcing legislators to enact painful budget cuts which exert a drag on the economy. But state and local tax revenues tend to lag the economy. Just as the economy bottomed out in the summer of 2009 and then began to grow, sales and income taxes are just bottoming now. A year from now revenues will be perking up and state and local spending will be back on the upswing, providing a modest boost instead of a drag.

As much as politicians like to make speeches imploring banks to increase lending, the fact is that bank regulators are preaching the opposite message. Caution on the part of bank regulators is causing a credit crunch for small and medium-sized businesses that can't access the capital markets[4]. But, guess what? With banks paying next to nothing for deposits and only lending to the most creditworthy customers, loans made in the last couple of years are very, very profitable. As most banks finish putting the bad loans behind them in the next year or two, regulators are going to be very happy with bank balance sheets[5] and will permit underwriting standards to gradually loosen.

Waiting for these various worms to turn will test one's patience and stock returns are bound to be choppy in the meantime. But when a genuine recovery finally arrives, the stock market may well be the first to notice and will respond favorably.

July 14, 2010
Boston, MA

[4] Lack of loan demand is also an issue. But tighter credit conditions are certainly having a negative effect.
[5] To be sure bank closures are still on the rise, but that is a lagging indicator, reflecting a large number of banks who were so wounded in the Great Recession that even the more auspicious current conditions are insufficient to overcome the ill-effects of bad loans made in the middle of the last decade.