

Investment Commentary—January 2012

Last summer and early fall markets plunged as investors lost confidence in the ability of political leaders in the U.S. and Europe to address their respective fiscal woes. Fears of a global double-dip recession were widespread. It now appears that western economies are on divergent paths. While a significant contraction has likely begun in Europe, the U.S. economy has strengthened.

Let's start with the good news. After grinding to a virtual halt in the first half of the year (an annualized rate of 0.9%), growth in U.S. GDP perked up a bit in Q3 to 1.8% and appears to have accelerated further in Q4 with most analysts estimating growth at around 3.0%. Much of the pickup in growth is simply a recovery from twin external shocks that arrived early last year. First the price of oil spiked as a consequence of uprisings that came to be known as the Arab Spring. Then, not long after the turmoil in the Middle East had begun, the massive Japanese earthquake and subsequent tsunami struck and wreaked havoc with global industrial supply chains.

Auto sales in the U.S. illustrate the effect of these shocks as well as the snapback. Light vehicle sales had plunged from just over sixteen million during 2007 to a low of nine million or so¹ in early 2009. They climbed steadily from there, reaching just over 13 million by April, but sank precipitously in May as parts shortages in Japan constrained production. After bottoming out at 11.5 million in June, sales increased sharply over the summer and early fall and ended the year at a post-crisis high².

Rumblings that the economy may be operating at "stall speed" have stilled, at least for now. But is there more at work here, or are we simply returning to the tepid pace of growth that has characterized the recovery from the financial crisis? Some of the data are tantalizing. Consider one of our favorite economic metrics, first-time jobless claims. Claims had been declining steadily prior to the oil and supply chain shocks but surged in April. They resumed their decline in the late spring and early summer up to the point of the U.S. debt ceiling/debt downgrade debacle. The spectacle of dysfunctional politics lifted the claims numbers for a few weeks, but the decline resumed in September and continues as of this writing, having reached the lowest level since June of 2008.

The picture that jobless claims seem to paint is of a fragile but steadily improving economy that remains vulnerable to outside shocks. If the rate of decline in claims over the last eight months continues for another three months, they would reach a

¹ All figures are annualized.

² Excluding one month in 2009 that was artificially inflated by the cash-for-clunkers program.

point which has been a strong predictor of significant job growth—i.e. something north of 150,000, which would feel like a real recovery to the average American. Alas, we wrote the same thing exactly one year ago (with the appropriate caveats) just as oil prices were beginning to surge!

What sort of outside shocks might be in store for us this time? Before we turn our gaze across the Atlantic to espy an answer, let's stay positive for a moment. Two major drags on the economy are gradually turning around. Housing starts (single family and multi-family dwellings combined) for November of last year were higher than at any time since October 2008³. Even three months ago it wasn't at all clear that housing starts had bottomed, but the most recent data strongly suggests just that. As we've noted in the past, residential construction is usually a critical factor in the strength of a recovery, so this is excellent news.

Somewhat more speculatively, it appears that the drag on the economy from reductions in expenditures by state governments may end by the middle of next year as state tax revenues are now recovering quickly enough to prompt state legislatures to put their budget axes away. But now we come back to the three steps forward, two steps back nature of the recovery. While state finances are finally beginning to improve, the worst is yet to come for municipalities, which depend on property taxes. Property taxes are based on assessments which tend to lag and don't yet reflect the full extent of house price declines. Hence, local tax revenue (and consequently local expenditures) will decline for some time to come. Nor will the federal budget be of help to the economy any time soon. While the payroll tax cut and unemployment benefits may be extended for all of 2012, that would merely prolong existing measures without providing any new stimulus. Three steps forward, two steps back.

And now we come at last to Europe. The latest act in the debt crisis began when investors stampeded out of Italian bonds in late October and early November as Prime Minister Berlusconi struggled to pass an austerity program. The legislation passed but not before investors sent the yield on 10-year Italian sovereign debt up 130 basis points in less than two weeks to a very dangerous 7.5%. Bond markets calmed considerably when Berlusconi and Greek Prime Minister Papandreou (facing similar problems) resigned in near unison and were quickly replaced by Mario Monti and Lucas Papademos, respectively, both perceived as competent technocrats.

With the locus of the debt crisis moving to Italy whose outstanding debt dwarfs that of Greece, Ireland and Portugal combined, European leaders understood that dramatic action was required. *De facto* euro zone leaders Angela Merkel and Nikolas Sarkozy decided to put all of their chips on fiscal union. Specifically, the seventeen members of the euro zone⁴ agreed in principle on much tighter rules governing permissible fiscal deficits. Aside from forestalling the immediate crisis,

³ Excluding April 2010 which was impacted by the expiration of the first-time home buyer tax credit.

⁴ European leaders initially cast a wider net, hoping to include all twenty seven members of the European Union (EU), not just the seventeen members of the smaller euro zone. The entire EU, save for the United Kingdom, was ready to proceed. British Prime Minister David Cameron, however, with an eye one presumes on domestic politics, presented very stiff demands and the deal was struck only among the members of the currency union.

we're highly skeptical that this fiscal union accomplishes anything positive⁵. In fact, enforced, synchronized austerity may be counterproductive. Unconstrained spending does lead inexorably to excessive deficits and debt. It's tempting to conclude that sharply curtailed spending will inexorably deliver the cure. If only it were so. The unfortunate fact is that if a country's debt reaches a certain point, it's almost impossible to bring it down to manageable levels without meaningful economic growth. If you had to do one thing to inhibit economic growth across Europe for an extended period of time, you might insist that governments across the continent drastically cut budgets in unison without any assurance of coordinated measures to stimulate growth⁶. Sadly Europe seems hell-bent on running the experiment.

Due to German resistance, European leaders continue to avoid a solution pushed by many investors and economists—the creation of Eurobonds that would provide desperately needed breathing room to Greece, Italy et al. As conceived by their proponents, such bonds would be backed collectively by all of the countries in the euro zone, which would agree upon guidelines for their issuance. Subject to the guidelines, struggling euro zone countries could issue Eurobonds, which due to their collective backing would pay a much lower rate of interest. In addition to lowering interest costs for the likes of Greece and Italy, Eurobonds might just put an end to the macabre dance in which capital markets tell Europe to jump (Italian bond yields spike to 7.5%) and Europe asks how high (will Berlusconi's head be sufficient?). But Germans generally and Merkel specifically won't hear of it. She insists that the euro must remain intact, heavily indebted nations must pursue austerity with full vigor, investors must not bear the brunt (outside of Greece where a fifty percent haircut is being negotiated), and Germans likewise mustn't pay for the profligacy of their neighbors. We're highly dubious that these four desiderata can long be sustained. One or more of them will have to give.

Meantime it appears that Europe entered a significant recession in the fourth quarter of last year. Research consultancy Capital Economics, whose track record in recent years has been impressive, estimates that the euro zone contracted during the quarter at an annual rate of around 2.0%. Will a recession in Europe work its way across the Atlantic? Probably not. The ECB, in a move that didn't receive sufficient attention, put together a package in late December of up to €489 billion in three year loans to European banks at a rate of one percent. This dramatic step would seem to take off the table the risk of a major banking crisis in Europe, which would have been the surest

⁵ To our mind it's not even a fiscal union, which would imply that fiscal decisions are made jointly as part of a single economic strategy—that's not what the new rules are about.

⁶ What might such measures consist of? Labor reform in the countries in the "periphery" (the ones struggling with excessive debt) would be a good place to start. The objective would be to ease the regulatory burden associated with job creation and also to increase productivity, thereby decreasing labor costs. Some economists have argued, persuasively by our lights, that the dramatic differences in unit labor costs between the "core" (Germany et al.) and the periphery (Greece et al.) is at the root of the crisis. If each country had its own currency these differences, which are the result of vastly higher productivity in the core, would be adjusted automatically by exchange rates—i.e., if the Greek factory worker produces half the widgets produced by his or her German counterpart, the value of the drachmas he or she receives goes down accordingly and unit labor costs (measured in currency neutral terms) decline. But of course that's not the world in which we live.

way for economic woes to hit U.S. shores. The ECB's actions gave support to an earlier suggestion from Gavyn Davies of the *Financial Times* that the crisis in Europe might be moving from the acute phase to the chronic phase.

Still, even if we've entered the chronic phase, problems in Europe will have some negative effect in the U.S. At a minimum demand for U.S. exports will weaken, not a welcome proposition when exports are already threatened by the slowdown in China. European woes could also hurt the U.S. by impacting general business confidence or by prompting banks, especially those who might have European exposure (whether directly or via derivatives), to tighten credit.

In all, we expect the fundamentals of the U.S. economy to continue to gradually improve over the course of 2012. But we also expect progress to be halting, impacted from time to time by a long list of ongoing problems, including the debt crisis in Europe, dysfunctional politics at home, the ongoing surge of foreclosures, and consumer balance sheets that remain stretched. Three steps forward, two steps back.

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