

## Investment Commentary—July 2012

When economic indicators perked up toward the end of last year the question arose, were improving data harbingers of the long-awaited sustained recovery? Or would this prove to be yet another false start in the painful road back from the financial crisis? Three months ago we answered the question optimistically, writing that “it appears the U.S. economy is finally making a transition from a fragile recovery dependent on fiscal and monetary stimulus to a more stable, self-sustaining recovery.” Subsequent data have been more discouraging. Job creation, which had been rolling along at a clip just shy of 200,000 a month has fallen to less than 100,000 a month, a paltry pace insufficient to keep up with the growth in the labor market. Once again, the U.S. economy seems to be stuck in neutral.

What went wrong? For starters, we might look overseas. The European and Chinese economies have been slowing down (contracting in the case of Europe) for several quarters now, and it’s no surprise that this is finally catching up with U.S. exporters. Was that enough to account for the big spring decline in job creation? Unlikely. In that case poor job numbers would have been concentrated in the manufacturing sector; as it turns out, they were pretty widespread.

To be sure, Europe cast a pall on capital markets in May as Spanish government bond yields began to reach dangerous levels. Still, we’d look closer to home for further clues to the weakening U.S. economy—perhaps no further than your local gas station. There is a school of thought that says rising energy prices don’t hurt the economy unless prices surpass recent highs. If so, the seventy-cent surge in gas prices that began last December should have had minimal effects since last year’s peak was not exceeded. But we doubt it’s a coincidence that economic indicators began to weaken right around the time gas prices were approaching four dollars a gallon in early April.

In general, we’ve come to believe the economy is more sensitive to the price of gas than conventional economic wisdom would dictate. Whether it’s consumers reacting to having more or fewer dollars in their wallet or businesses anticipating what consumers will do, the price we pay at the pump seems to have loomed large of late. In both 2010 and 2011 activity picked up late in the year when gas prices were relatively low but flagged the following spring as the cost of gas climbed. The bad news is that short-term fluctuations in economic activity can hamper the ability of businesses to make decisions on long-term investments, serving as a general hindrance to growth. The good news is that gas prices have fallen about sixty cents since peaking in early April and should prove a modest boost to the economy over the next few months.

While gas prices fell over the course of the spring, home prices rose. Finally. From the peak of the housing bubble in early 2007 to what now appears to be the trough nearly five years later, home values declined by a bit over one-third. Metrics such as cost-to-own vs. cost-to-rent have improved dramatically. Further, foreclosures may be weighing a bit less heavily on the housing market as banks are increasingly using loan modifications and short sales to resolve troubled mortgages. All of the national indices of home prices improved, albeit modestly, over the first half of 2012. Stable-to-rising housing prices will help enormously in healing the housing-heavy balance sheets of consumers and banks alike. Meantime, residential construction, including both apartments and single-family, continues to climb. The increase in housing starts that began in the second half of last year hasn't yet translated into jobs. But that's because there is a lag of a year or so between when housing starts pick up and when construction employment starts to grow. At some point in the next several quarters the jobs impact will kick in and benefit the wider economy.

The good news from falling gas prices and rising home values may be tempered by a number of factors, and Europe is certainly one. Had the Greek leftist coalition Syriza triumphed in last month's elections, it could have accelerated the flow of deposits out of Greek banks and forced Athens out of the euro. That bullet was dodged, at least for now. Further the umpteenth<sup>1</sup> summit of European leaders on June 29<sup>th</sup> was encouraging. Partly because eurozone rescue funds will now be allowed to directly recapitalize banks. This change, along with steps taken to put banks under central supervision, should help to break the mutually destructive links between banks and governments, which has been playing out most notably in Spain<sup>2</sup>. Perhaps more significantly, Germany seems to have lost the upper hand to a coalition of France, under newly elected President Francois Hollande, together with Italy and Spain. Germany's ability to insist on austerity as the only path forward has been significantly weakened, and that it is for the good. To be sure there is no quick fix to the crisis, and the possibility of a major disruption will hover for many years. The weight of austerity may yet bring Syriza into power, for example, and at the other end of the spectrum there are rumblings from fiscal paragon Finland that *they* may leave the euro, albeit on very different grounds. Still, all things considered the June summit improved the odds that Europe will muddle through.

In a way, events in Beijing and Washington may determine the near-term course of financial markets to a greater degree than events in Berlin, Paris, Madrid, Rome or Athens. Cynically put, the Germans and the European Central Bank are in way too deep not to use all of their financial muscle to salvage Europe. All the rest, including the predictable drama of what will be another umpteen future summits, will be theatrics.

---

<sup>1</sup> Nineteenth actually.

<sup>2</sup> As always, the devil's in the details. Just a few days before this commentary went to press German Finance Minister Wolfgang Schauble suggested that governments would retain liability for repayment of capital injected into their struggling banks. Adding to the liability of weak governments would seem to defeat the purpose of the injections. We suspect Schauble's comment amounted to wishful thinking, but it repeats the frustrating pattern of Eurosummits, whose bold announcements are tarnished as specifics get worked out.

Meantime, growth in China has slipped to eight percent (perhaps less if government statistics are, as many argue, goosed), and it's not clear that efforts to halt the deceleration are yet bearing fruit. Beijing does have vastly greater fiscal flexibility than Washington and a more efficient means to deploy it, namely, the vast array of state-owned enterprises (SOEs). So, it's a bit hard to imagine a "hard landing." But we would have hoped to see expectations of GDP growth picking up a bit by now. They haven't and that's of some concern. China also has a daunting array of long-term challenges including corruption in the SOEs, overinvestment in infrastructure, devastating pollution, and water shortages. And perhaps most troubling of all, Beijing's long-standing one-child policy has created a looming and irreversible demographic problem--the working-age population will begin to decline in 2015. We're hopeful that China will engineer a soft landing in the short run and successfully tackle some of these deep-rooted problems in the long run. In any case we'll be paying close attention.

Compared to the difficulties engendered by Beijing's one-child policy, Washington's fiscal problems are easily fixable. In each case the challenges stem largely from the demographics of an aging population. But unlike China our working-age population will continue to grow indefinitely. To be sure the ratio of workers to retirees is going down, but that can be addressed with modest changes to the retirement age, as reflected in the plan offered by the Simpson-Bowles Presidential Commission. Of course, that assumes Washington is capable of political compromise. Which brings us to the so-called "fiscal cliff."

As has been widely reported, absent Congressional legislation to the contrary, a series of tax increases and spending cuts amounting to as much as five percent of GDP takes effect at year-end and could deliver a kick in the gut to the economy. Some observers believe the threat of the fiscal cliff is behind the slowdown in hiring. We're dubious--while many consumers may be vaguely aware of the issue, we don't think it's received enough attention to affect behavior. Further, the average Joe likely believes it will all get fixed in a last-minute deal. And he's probably right, though the deal probably won't occur until after the election and not without a lot of drama.

For all of the challenges facing the global economy, corporate profits remain robust. It's possible they've peaked for the cycle but there's little to suggest any dramatic decline. The one exception would be a major banking crisis in Europe. We view that as an unlikely, albeit not remote, possibility. Happily, with steps such as the direct recapitalization of banks from European rescue funds, the odds are gradually declining, even if subject to periodic, painful spikes. In addition to healthy corporate profits, stocks are bolstered by rock-bottom interest rates, which make the yields on stocks look gargantuan. Rates will eventually go up but not without better news on the economy which itself would provide some measure of encouragement to equity investors.

*July 12, 2012  
Boston, MA*