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ECONOMIC REVIEW & INVESTMENT STRATEGY: 2014/II

Is Europe's Crisis Over?

The European Union is the world's largest economy. It is America's largest trading partner, surpassing even Canada. McDonald's earns more revenue in Europe than in the U.S. Coca-Cola makes more of its profit from Europe than from North America. Clearly, Europe is critical, even to primarily U.S.-focused investors. But for the past several years, Europe's economy has suffered a severe downturn, and seemed many times to be teetering on the edge of an even greater catastrophe.

Over the past year, however, there has been a growing sense that Europe's crisis has stabilized, and its economy is on the mend. The main stock indices for Frankfurt, Paris, and Madrid rose 25.5%, 18.0%, and 21.4% respectively in 2013. Yields in Europe's once-jittery bond markets have fallen, in some cases dramatically. These and other signs of improvement recently prompted ECB President Mario Draghi to label the Eurozone an "island of stability" in the global economy.

	10-year Sovereign Bond Yields		
	Feb. 2012	Feb. 2013	Feb. 2014
France	3.02%	2.24%	2.25%
Italy	5.55%	4.49%	3.65%
Spain	5.11%	5.22%	3.56%
Greece	29.24%	10.95%	7.70%
Ireland	7.02%	3.78%	3.24%
Portugal	12.81%	6.40%	4.94%

Source: Eurostat

So has Europe truly turned the corner? Only in part. Europe's incipient recovery has three facets: The Good, The Bad, and The Ugly.

1. *The Good.* Some of Europe's hardest-hit countries, including Portugal and Spain, have enacted tax and labor market reforms that have made them more competitive, generating a surge in exports and a return to positive growth. Others, like France and Italy, are showing a new determination to push through similar reforms. By doing "whatever it takes" to support bond markets and keep interest rates under control, the ECB has given these countries much-needed breathing space to make critical changes to their economies.

2. *The Bad*. Despite (or arguably due to) strict austerity measures, debt levels for most Eurozone countries are actually rising relative to GDP, not falling. Unemployment, particularly among young people, remains painfully high and is unlikely to abate anytime soon. Not only does this aggravate social tensions in the short-term, it poses a longer-term crisis of human capital: given their aging populations, European countries simply cannot afford to have such a large portion of their workforces lying idle. The Eurozone's inflation rate has fallen to 0.5%, which suggests the ECB is not doing enough to spur internal demand. At the same time, ambitious "green energy" policies have saddled Europe with energy costs twice as high as in the U.S., as well as leaving it alarmingly dependent on supplies from Putin's Russia.

3. *The Ugly*. Under a single currency, the Eurozone is torn in two directions. German surpluses tend to strengthen the Euro, making it that much harder and more painful for Europe's debtor nations to regain their competitiveness. But a weaker Euro only further inflates Germany's surpluses. Unable to fix its internal imbalances, which lay at the very heart of the "debt" crisis, the Eurozone can only grow by shifting the weight of those imbalances abroad, drawing demand from elsewhere, including the United States. It's no coincidence that in 2013, even as the U.S. improved its global trade balance in goods by $38 billion, its trade deficit in goods with the Eurozone rose by $4 billion. U.S. goods exported to Germany actually shrank.

At a forum last month in Brussels, President of the European Council Herman Van Rompuy was asked whether the Eurozone crisis is over. "The existential crisis is over," he answered, "though economic problems remain." We would argue precisely the opposite. Faced with a spiraling financial crisis, the Euro had to be preserved-in-place to prevent Europe's economy from unraveling out of control. Now that the crisis has been contained, the existential question – whether a single European currency makes economic sense – needs to be put back on the table. Without a revised currency arrangement, however heretical that notion may be, it's hard to see a lasting solution to Europe's troubles.

The recovery in Europe is real, and will likely continue and strengthen. But it is also fragile, and that fragility may give rise to new episodes of uncertainty, like the mini-shock that resulted from last year's Cyprus bailout. More importantly, the internal imbalances that gave rise to the Eurozone crisis have yet to be resolved, which places a serious limit on the contribution that Europe can be expected to make to global growth.

China's Crisis Is Just Beginning

In contrast to Europe, markets appear increasingly cognizant that China's economy is headed for trouble, and afraid what the consequences will be. A steady stream of defaults has raised awareness of China's mounting bad debt problems, which we've been calling attention to for some time now. The abrupt decline in China's currency, the Yuan, in recent weeks indicates that at least one of the following must be taking place: (a) China's central bank is furiously printing money in a bid to stave off a painful, but long overdue, economic adjustment; (b) China's export surplus is collapsing, as rising labor and other costs render it less competitive, and/or (c) capital is leaving China, as risks become more evident. All three

may be in play, but any one of them is a red flag that China's existing growth model has reached its sell-by date.

The economic adjustment China is facing has three major implications for investors, even if they have little or no direct exposure to China:

1) *Growth*. Market pundits often refer to China as a "global growth engine," and wring their hands over what would happen to the rest of the global economy should its astonishing growth rate falter. In fact, much of China's growth is predicated on drawing on demand from other economies. For years, China has produced more than it consumes, as a way of turbo-charging growth. It can afford to consume more than it produces. The $3.8 trillion in foreign exchange reserves it has accumulated cannot (as many imagine) be used to prop up China's own economy, but they do represent global buying power that the Chinese can draw upon to cushion themselves from a downturn. Far from signifying a catastrophe, this capacity to run trade deficits (which China may, in fact, already be doing) could unlock much-needed demand and turn China into a *true* driver of growth for the U.S. and other trading partners.

2) *Commodities*. China's existing growth model has been a boon to certain countries and industries that were positioned to feed into its credit-fueled investment boom, which drove global demand (and prices) for iron ore, copper, energy, and heavy equipment – not just for end use, but as collateral to secure more and more loans. The end of that boom will undercut those markets and create deflationary pressure, though not for every commodity. China's shift toward consumption will continue to support rising demand for food and farmland on a global basis.

3) *Fund Flows*. Capital has already been flowing out of China to the tune of about $250 billion per year, in search of greater safety and less volatile returns. In the event of some sort of panic, that outflow could surge into the trillions. So far, these funds have flowed mainly into real estate (in gateway cities like New York, London, and Vancouver), gold, art, wine, and corporate acquisitions. But should those outflows accelerate, a broader range of USD-denominated assets such as stocks and bonds also stand to benefit (as would the value of the dollar itself).

There are many misconceptions about what China's rebalancing means for the rest of the world economy, but one in particular needs to be highlighted. Many analysts – even some prominent economists – argue that as trade deficits or capital outflows draw down on China's FX reserves, the sell-off of China's holdings of U.S. Treasuries will crash the market for our debt, driving up U.S. interest rates. This is not correct. When China sells its Treasuries, the dollars it receives don't disappear. They are traded for goods, services, or investments, either with the U.S. (we earn it back) or with another trading partner (which now has USD reserves to invest). Those funds may or may not find their way back into Treasuries, but if they don't, it's hardly a tragedy. After all, the whole purpose of rock-bottom interest rates is to encourage people to move into more productive investments, and if rates rise because that's happening, that's a good thing. In any event, fears that a downturn in China could tank the U.S. Treasury market are simply misplaced.

Investment Strategy: Home Truths

It is telling that the main driver of markets these past few months has been events outside the United States. Steady. Lackluster. Soft. Choose whatever phrase you like to describe the uninspiring, two-steps-forward-one-step-back momentum of the U.S. recovery, whether due to inclement weather or some more chronic factor holding it back. Even the Fed seems reluctant to depart from its pre-set game plan based on any sense of conviction, positive or negative. No wonder the market keeps looking to news from afar, whether it be a disappointing PMI number out of China or the latest base seizure in the Crimea, for some hint as to which way to jump.

In late January, the S&P 500 index plunged over 5% on an assorted grab-bag of fears concerning emerging markets. By mid-February, it had regained all its lost ground, then proceeded to dance an erratic jig over the crisis in Ukraine before ending the quarter barely 1% higher than where the year began. All the while, the market barely reacted to a stream of lukewarm and/or contradictory data releases on U.S. housing, jobs, and retail sales.

Perhaps the most ironic development was the bond market response to the Fed's long-awaited tapering of QE (quantitative easing). The well-founded assumption all last year was that, as the Fed throttled back on its bond purchases, U.S. interest rates would rise. Instead, the start of Fed tapering touched off a crisis of confidence in emerging markets, driving investors to (once again) seek refuge in U.S. Treasuries, pushing their yields *down* not up. In other words, the tail wagged the dog.

This skittish search for a storyline shouldn't distract us from a few home truths that served us well throughout last year, and continue to be valid:

- The U.S. recovery may not be anything spectacular, but it rests on increasingly firm foundations. The U.S. federal budget deficit has been nearly cut in half, from $1.3 trillion in 2011 to $680 billion in 2013 (falling to 4.0% of GDP last year, from a peak of 9.8% in 2009). The U.S. trade deficit declined by $63 billion last year, falling to 2.8% of GDP from its peak of 5.6% in 2006. U.S. corporate balance sheets are the strongest in recent memory, with loads of cash on hand. Debt service payments have fallen to their lowest share of U.S. household income since measuring began in 1980. That means companies and families aren't spending as freely as before, but it also means the U.S. economy is a lot less fragile, and far more resilient and adaptable in the face of whatever challenges or opportunities lie ahead, in what we've all come to realize is a rather unpredictable world. All of these factors bolster our confidence in the case for holding U.S. equities, compared to other asset classes.

- Periodic shocks may scare investors into seeking safe harbors, suppressing yields and boosting bonds in the short-run. But with 10-year Treasury rates near their lowest point ever, in broad historical terms (comparable only to the rates prevailing in the immediate aftermath of World War II), the past 30 years' bull market in bonds has hardly anywhere left to run. Eventually interest rates will turn up; the only question is when. Bond investors don't need to panic over inflation or the Chinese dumping Treasuries to recognize this reality and plan accordingly, either by keeping their

money in short-duration instruments or ones whose credit quality stands to improve alongside rising rates.

Last year's 30% rise in the S&P 500 index was driven in large part by a run-up in P/E multiples, from a trailing P/E of 14.7x at the start of 2013 to 17.2x at the end. Many people argue that these valuations are too rich, and that the market has reached its peak. We remain cautiously optimistic on U.S. stocks, but agree with skeptics that future gains will have to rely on actual earnings growth, more than further multiple expansion. In 2013, U.S. corporate profits rose to an all-time high of 11.1% of GDP. It would be unwise to expect profit margins to widen further, but with real wage growth flat, we do not expect them to narrow either. As a result, we forecast that S&P 500 earnings-per-share (EPS) should grow by 4.0-4.5%, in line with revenue growth, reflecting nominal GDP. We believe our end-year S&P 500 EPS of $112 is significantly more realistic than consensus forecasts of $118-120, but still leaves the market reasonably priced, at a forward P/E multiple of 16.7x at the end of Q1.

One last word, on bubbles. A quick scan of the financial press the other day brought up the following stream of headlines: "Are We in a Tech Stock Bubble?" "Is the IPO Market in a Bubble?" "Is the U.S. in a Housing Bubble?" "Is China in a Credit Bubble?" "Anatomy of a Biotech Bubble?" "Inside the Pot Stock Bubble." So why aren't we more worried? Bubbles form when people are smug and complacent; right now they're anxious and confused, and ready to believe the worst. We take each of these warnings seriously, as risk factors to be conscious of. But collectively, we see this tendency to find a bubble under every bush as the best assurance of all that the rising U.S. stock market remains tied to *terra firma*

April 3, 2014

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U.S. Economic Forecast

(As of April 3, 2014)

	2011	2012	Estimated 2013	Projected 2014
Real GDP (Y-O-Y)	1.8%	2.8%	1.9%	2.6%
Consumption Expenditures	2.5%	2.2%	2.0%	2.6%
Business Fixed Investment	7.6%	7.3%	2.7%	6.0%
Inventory Investment (Billions)	$33.6	$57.6	$81.5	$50.0
Residential Investment	0.5%	12.9%	12.2%	6.0%
Government Spending * (Billions) (a)	$2,992.3	$2,963.1	$2,896.9	$2,907.0
Trade Balance-Goods & Services (Bil.)	($556.8)	($534.7)	($474.9)	($450.0)
Federal Budget*: Unified (Billions)	($1,299.6)	($1,087.0)	($679.5)	($607.4)
Gross Federal Debt* (Billions)	$14,764	$16,051	$16,719	$17,740
Consumption Price Deflator	2.4%	1.8%	1.1%	1.8%
Producer Price Index (Finished Goods)	6.0%	1.9%	1.2%	1.0%
Consumer Price Index	3.1%	2.1%	1.5%	1.8%
Industrial Production	3.4%	3.6%	2.6%	3.5%
Real Disposable Income	2.4%	2.0%	0.7%	2.7%
Hourly Compensation	2.5%	2.6%	1.6%	2.3%
Unit Labor Cost (Non-Farm)	2.0%	1.2%	1.1%	0.6%
Productivity Growth (Non-Farm)	0.5%	1.5%	0.5%	0.9%
Personal Savings Rate (% DPI)	5.7%	5.6%	4.5%	5.0%
Capacity Utilization – Total Industry	76.5%	77.6%	78.2%	79.0%
Trade Weighted $ Exchange Rate (b)	(4.6%)	2.8%	1.2%	2.1%
Vehicle Sales (Million Units)	12.7	14.4	15.5	15.9
Housing Starts (Million Units)	0.612	0.783	0.929	1.150
Civilian Employment (Millions)	139.9	142.5	143.9	146.6
Civilian Unemployment Rate	8.9%	8.1%	7.4%	6.4%
Corporate Profits – After Tax – NIPA	0.6%	19.2%	5.1%	5.0%
S&P-500 Earnings-Operating	$96.44	$96.82	$107.30	$112.00
S&P-500 Dividends	$26.43	$31.25	$34.99	$39.50
90 Day U.S. Treasuries-Yield (%)	0.00-0.16	0.01-0.11	0.02-0.12	0.10-0.50
10-Year U.S. Treasuries-Yield (%)	1.70-3.74	1.39-2.38	1.55-3.00	2.60-3.50

**Fiscal Year-end 9/30. (a) Federal, State, and Local; in 2009 dollars; (b) Fed Broad Exchange Rate.*

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