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Economic Commentary

MARKET MUSINGS & DATA DECIPHERING

Breakfast with Dave

WHILE YOU WERE SLEEPING

Equity markets are up sharply to start off the week. The MSCI Global index is up 0.8% in the early going and set for the fifth straight session of positive action. Emerging markets are up 1.4% — a winning streak, believe it or not, last put together in October 20. It's tough to find a solid reason why especially with a flight to quality bid in the bond market still evident as last week drew to a close. However, perhaps it is in reaction to the just-released Eurozone industrial production data for April, which showed a healthy 0.8% gain — the consensus was closer to +0.5%. Perhaps it was the Moody's report suggesting that European banks have sufficient capital to weather the storm. Maybe investors put more credence in a survey of U.S. consumer sentiment than in the actual spending data, which tumbled in May. Maybe markets are taking Ben Bernanke's forecast to heart — moderate recovery intact, marginal risk of a double-dip. Either way, credit default swaps on European corporate bonds are narrowing — down 18bps today in the high-yield sector to a 10-day low of 578bps.

In the FX market, the yen is soft but the emerging market currencies are firm (led by the Koran won as the government there is delaying the imposition of capital controls) in a sign of heightened investor risk appetite. The Sterling is rising on the back of some chatter that the Bank of England could begin to raise rates in the second half of the year (sure). We are starting to see some significant reversal of the recent gains in the USD — down a full point so far today — and that symbolizes improved global liquidity conditions and a key reason why commodity prices are recovering right across the board; and in turn a critical reason why the Canadian dollar has nudged its way back above 97 cents. Dr. Copper is making it five up-days in a row — the longest rally in five months — and oil has made its way back above $75/bbl.

Within the safe-haven sphere, government bonds are selling off as risk appetite improves but gold is hanging in very well (even if the bull ring is crowded at the current time). The reason for this is that the markets live in the here-and-now and no longer look ahead — imagine that the S&P 500 peaked in 2007 in the same quarter the recession started. The markets are too pre-occupied with the still-solid coincident indicators and not enough attention is being paid to the fact that leading economic indicators have begun to roll over. There are lags between global financial shocks and the real economy — it took about a year for the Asian crisis in 1997 to be transmitted across the Pacific and it took about a year for the crisis in the subprime mortgage market to be felt on Wall Street and the real economy.

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- No sails in retail sales: U.S. retail sales came in far weaker than expected in May

We discuss the ECRI weekly leading index below and recall how it dipped below zero in August 2007 and Mr. Market still rallied for another six weeks and hit the all-time peak six weeks later. The message here: keep your eyes on the road in front of you; let the folks on Bubblevision gaze at the rear-view mirror.

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THE GOOD AND THE BAD

Let's start with the good. The Nasdaq became the first major average to reclaim its 200-day moving average level to close out the week (the small-cap S&P 600 index did so on Thursday). According to the Investor's Business Daily, new highs outnumbered new lows for just the second time in the past two weeks; and, the market closed near the highs of the day for the second straight session. But … the rally last Friday was on extremely low volume — for the Nasdaq, it was actually the low-water mark of the year. The market is still devoid of follow-throughs on big volume — that is a problem for the bulls.

GOLD MAY BE NEAR-TERM OVERBOUGHT

Don't get me wrong, I'm still very bullish on a long-term basis; however, there is a herd mentality now that is a little disconcerting. Far too many front-page headlines like *Growing Demand for Bullion Hands Banks Golden Opportunity in Storage* in the weekend FT (another article on this topic surfaced on page 15 — *Demand For Bullion Puts Strain on Vaults*) and *Financial Uncertainty Restores Glitter to an Old Refuge* in the Sunday NYT.

In any event, if you like gold, and we do indeed still see this as a secular bull market (thankfully, so does Louise Yamada), then you have to come to Canada because precious metals now account for 13% of the TSX market cap (up from 5% five years ago) compared with the miniscule 0.3% share in the S&P 500.

WHY THE U.S. STATES ARE NOT PIIGS

There are several reasons why the comparisons of the State and local governments to the nanny states in Europe are unfair. For one, the U.S. does have a central government that has already been directing large blocks of cash to the lower levels. Second, as we have seen in the latest round of GDP and employment data, the State governments are cutting spending and jobs aggressively. Third, unlike the Club Med nations, the State governments are also taking action towards restructuring their expensive social contracts: see *State Pension Cuts Face Test* on page B3 of the weekend WSJ (state pension funds are reducing their payouts to retirees … facing the knife that private sector workers have already endured) and *Taking on the Unions in California--and Winning* on page 15 of today's Investor's Business Daily.

The comparison that people are making between the U.S. State and local government and the nanny states of Europe is a bit unfair

CONSUMER SENTIMENT UP A TAD

It's a little strange that the equity market would be looking more at a survey than in the actual spending data. Maybe Mr. Market was looking at neither — but consumer confidence (University of Michigan) did rise 1.9 points to 75.5 in June (the consensus was at 74.5) — the best tally since December 2007. But to put 75.5 into perspective, it is just about in line with the average levels we have endured in past recessions.

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DOUBLE DIP, ANYONE?

Double-dip watch: The ECRI weekly leading index has now swung from +0.3% to -3.5% for the week ending June 11

The smoothed ECRI leading economic index fell in the opening week in June for the fifth week in a row and now down in nine of the past ten. The index, went from +0.3% to -3.5%, the weakest it has been in a year. After predicting the V-shaped recovery we got briefly in the inventory-led GDP data when the index soared off the bottom in late 2008, at -3.5%, we can safely say that this barometer is now signalling an 80% chance of a double-dip recession. It is one thing to slip to or fractionally below the zero line, but a -3.5% reading has only sent off two head-fakes in the past, while accurately foreshadowing seven recessions — with a three month lag. Keep your eye on the -10 threshold, for at that level, the economy has gone into recession … only 100% of the time (42 years of data).

Suffice it to say, when the ECRI was drifting lower in 2007, it got to -3.5%, where are we are now, in November and unbeknownst to the consensus at the time that a recession was only one month away. Remember that the economics community did not call for recession until after Lehman collapsed — nine months after it started; and go back to 2001, and the consensus did not call for recession until after 9/11 and again the economy had been in recession for a good six months). We should probably point out here that real M3 has contracted at the fastest rate since the early 1930s, as John Williams has published, and declines in the broad money measured has foreshadowed every recession in the past seven decades.

Yes, the Fed has not raised rates and the U.S. yield curve is steep, but there are visible signs of tightening in financial market conditions that poses a significant risk to this fragile U.S. economy

To be sure, the Fed has not raised rates and the yield curve is steep but there has been a visible tightening in financial market conditions that poses a significant risk for what has been a very fragile recovery in dire need of recurring rounds of policy stimulus. The widening in credit spreads and decline in the stock market represent a sizeable increase in the debt and equity cost of capital. The Fed has stopped expanding its balance sheet (and now we have Fed presidents Hoenig clamoring for rate hikes and Plosser for reducing the size of the Fed's balance sheet) and end of the housing tax credits implies a major withdrawal of federal government support at a time when restraint is accelerating at the State and local levels (the States have a $127.4 billion aggregate deficit to close for the fiscal year beginning July 1st so right there we have a one-percentage point drag on baseline GDP growth).

The data suggest that we are now seeing the consumer sputter with what looks like a very weak handoff into the third quarter. The housing sector is collapsing again. The export-import data are pointing to a sudden deceleration in two-way trade flows. Commercial real estate is dead in the water. Bank credit is in freefall right now (down 0.3% or $32 billion in the first week of June — the third decline in a row and has now contracted in six of the past seven weeks and at an 11% annual rate. In the last three weeks, bank credit has contracted a total of $119bln, which is the steepest decline since the week of November 19, 2008 when the economy was deep in recession.

There is still something left in the tank as far as capex and inventory investment is concerned, but by the fourth quarter, we could well be looking at a flat or even negative GDP print. This is exactly what happened in the second half of 2002, when by the end of the year real GDP converged in real final sales near the 0% mark after a sharp but truncated mini-inventory cycle. That may not have been classified as a double-dip recession, but it was a growth collapse nonetheless — an aborted recovery for a consensus that went into the second half of that year, much like this one, with a consensus forecast of 3% real economic growth. The lesson, is that expectations had surpassed reality to such an extent that it didn't even take another recession to take the equity market down to new lows, which happened in October 2002 (not October 2001!), fully 11 months after the downturn officially ended.

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Not only are the economists calling for 3% real growth, which would imply something close to 4-5% nominal GDP growth, but the consensus among equity analysts is that we will end up seeing over 30% operating EPS growth to a new high of $95.59 for 2011. But there are a couple of points worth making here. The bottom-up crowd is never that good at predicting where profits are going to be heading at the best of times, but at turning points in the economy it is awful — overestimating earnings by an average of nearly 20%. So we could easily be closer to $75 for next year's EPS than $95. And, even $75 may be a stretch when you consider that there is not a snowball's chance in hell that we are going to see earnings outstrip nominal GDP by a factor of six in the coming year. This type of earnings is always possible at the trough in profit margins, but we are coming off the third highest level on record — coming off the trough, historically, corporate earnings jump 17% the next year. At the peak, profits actually tend to decline 6% in the ensuing 12 months — imagine what that number becomes when you come off peak margins and head into a recession at the same time. It's not a pretty picture.

A double-dip, admittedly, is not yet a sure thing but I am definitely warming to the view. As an aside, I spent a memorable weekend with Gary Shilling, Nouriel Roubini and Marc Faber, and not even these "bears" believe the economy will double dip. I should add that we were joined by Louise Yamada and Fred Hickey — all legends.

Suffice it to say that there is probably a greater chance that profits go down than meet the consensus estimate, especially considering the deflationary shock out of Europe as well as the tremendous headwind for foreign-derived corporate earnings from the recent surge in the U.S. dollar. So from our lens, slapping on a 12x forward multiple on a range of corporate earnings of $60-75 leaves quite a bit of downside potential in a market that is still priced for too much growth, and 20% overvalued on a Shiller normalized real P/E basis. Judging by Felix Zuluaf's comments in the Barron's Roundtable, we would have to assume that his math would not be far off — he sees book value justifying a move towards 500!

NO SAILS IN RETAIL

U.S. retail sales came in far weaker than expected in May with a 1.2% MoM decline, the worst print since last September. As we had warned, much of the pickup in unit auto sales last month that got everyone excited was in fleet sales (government buying) so we actually saw a hefty 1.7% decline in motor vehicle receipts (could have been some deflation as well).

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Apparel sales is getting clobbered — mirroring what we saw in the recent CPI numbers, apparel sales were down 1.3% MoM on top of a 0.7% drop the month before. After two huge stimulus-led gains, home improvement posted a record 9.3% plunge. Department store sales sagged 1.8% for the second month in a row. Restaurant activity was basically flat.

As bad as the data was, the "core" number (retail sales excluding autos, building supplies and gasoline station sales) that goes into the consumer spending part of the GDP data did manage to eke out a 0.1% MoM gain — soft, but hardly a disaster. There were a few bright spots that held this metric up, including furniture/appliances (+0.8% MoM); food and pharmacies were both up 0.3% too — steady-as-she-goes sectors.

But overall, it was clearly a disappointment to see that in a month when households spent 3.3% less filling up their cars and posted a nice (though less than expected) 431k gain in employment that the rest of the retail spending pie was trimmed 1%. Maybe frugality is back in, and the savings rate is heading back up. When the economy is not in recession, declines in gas station receipts coincide with gains in ex-gas retail sales more than 80% of the time. Maybe something funky is starting to go down here.

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Gluskin Sheff at a Glance

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For further information, please contact questions@gluskinsheff.com

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