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OVER THE HUMP
INVESTMENT STRATEGY
JULY 1ST, 2012

SUMMARY

Europe is now over the hump. As we expected, the Greeks voted to stay in the Euro- zone by voting into power the two parties committed to reform as requested by the European Union. In short, the Greeks voted for austerity with money, rather than austerity without!

The European leadership also acted as expected – albeit at the last moment – to put in place adequate support for Spain and its banks and for Italy and Spain and their bond markets. Preparing the way for ECB control over European banking policy, the leaders of Europe agreed to a Supervisory role for the ECB, which in turn lays the groundwork for creating a European-wide deposit insurance for bank depositors. In the meantime, Spain will receive 100 billion euros with which to recapitalize its banks which are seeing their capital destroyed by a real estate bubble proportionately larger than that in the US. Also, the Europeans agreed to permit purchase of bonds directly from governments by the European Stability Mechanism. This facilitates bond issuance and lowers interest rates. In short, Europe is taking another step in the gradual formation of the “United States of Europe.”

To be clear about it: European debt problems are not over, but the Europeans have shown that they are willing to do whatever is necessary to keep the Union together until the required reforms have had a chance to take hold, and economies have begun to expand. We are now convinced they will succeed.

The global slowdown has us concerned because of its impact on corporate profits, expectations for which have already been lowered in the US, China and other countries. But one has to keep in mind the response, both fiscal and monetary, of governments to such slowdowns.

In the US we expect the declining price of oil and gas to provide spending power to consumers that could add about 0.5% to GDP growth. The improvement in housing construction should also contribute to consumer income, spending, and GDP growth.

Finally, despite all the speculation to the contrary, we would expect Congress to delay the sequester and extend the “Bush tax cuts” until it can produce tax and spending reform during the first six-nine months of the “ new administration”. To not do so would be to risk tipping the fragile US economy into recession!

Thus, we continue as we have on the thesis that the global slowdown is just that, and that the cyclical recovery will continue and eventually accelerate.

David R. Kenerson, Jr.
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Europe is over the hump – the worst is over for now. As we expected the Greeks not only voted for the center left and center right parties to assure implementation of the EU's requirements for continued funding. We expect such continued support until the remaining PIIGS are no longer threatened by a Greek exit from the Euro-zone currency union. Then, and only then, can the EU consider letting Greece drop out, or at a minimum go through a second restructuring of their debt. Since the Greek government owns considerable assets that might be sold to reduce debt, we rather anticipate a sale of assets and a restructuring of debt (an exchange of debt for equity interests in selected assets). But for now, the Greek government understands that it needs to improve its tax collections, its labor laws, and the costs of doing business. As we anticipated, the Greeks have chosen austerity with money, as opposed to austerity without!

Furthermore, the European leaders have begun to focus sharply on Spain and the capital needs of its banks. Remember that Spain's sovereign debt is actually less than that of the United States at about 69% of GDP at the end of 2011. However, the bursting of its real estate bubble – where the ratio of house prices to family income reached 7.6 times (in 2007) in contrast to the norm of 3.7 times – is now obliterating the capital of Spain's banks who tend to hold more mortgages than US banks. Spain is in desperate need of a "TARP" program.

Prior to this most recent summit, European leaders were insisting that loans be made to the Spanish Government which could then provide capital (current need is 100 billion euros or about 7% of its GDP) to its banking system. However, that method would cause the Government's debt to GDP to rise by 10%. Thus, for most of June, Spanish bond rates rose from about 6.2% to about 7.2% - the level perceived to trigger a bail out of the Government, not just the banks. While the market place was happy that the Europeans were trying to deal with Spain's problems, it was not happy with the methodology.

This was corrected at the Summit last Thursday as Angela Merkel of Germany and the northern European countries agreed to allow the ESM (European Stability Mechanism), the permanent lending financing facility that comes into being today, to provide capital directly to European (read Spanish, Irish and Greek banks) rather than lending to the Governments.

The quid-pro-quo for direct lending to the banks is the establishment of a Supervisory Agreement between the European Central Bank and the European Banks. It will probably take at least six months to put this agreement in place at which point the ESM could recapitalize banks directly. In the meantime, the recapitalization will occur via a temporary loan from the EFSF to the Spanish Government without the subordination clause – that subordinates all other sovereign debt to the loans from the ECB. Although Spain's sovereign debt to GDP will rise by 10%, it will be temporary and should only modestly impact rates because the new loans do not turn the previously issued sovereign debt into a lower class of debt subordinate to the EFSF loan. The Supervisory Agreement is another step in the formation of a unified European banking system, complete with depositor insurance (not yet agreed upon) that is essential to the formation of the "United States of Europe," a process well underway, but not yet articulated or accepted as an objective. But it nonetheless what is and will be required for Europe to compete on a global scale.

Finally, the European leadership agreed that the ESM could be used to buy bonds directly from governments, something important to both Italy and Spain, which have had about 35% of their debt issuance purchased by foreigners who are now absent!

In recognition of the need for growth, Germany and its European allies agreed to provide 120 billion euro in support of growth initiatives. We were very pleased to see this as we noted some time ago that we had our reservations about only austerity measures.

To be clear about it: it is not that the European debt problems are over, but rather that the Europeans have shown that they are willing to do whatever is necessary to keep the Union together until the required reforms have had a chance to take hold, and economies have begun to expand.

Angela Merkel and her northern allies (the Netherlands, Finland, and to a lesser degree, France) are insisting on relatively uniform financial and economic policies, a pre-requisite for the "United States of Europe". This is the price, and justifiably so, for German financial support.

Global Slow Down:

While we have always been convinced that the Europeans would eventually solve their problems, we are concerned lest the global slowdown turn into recession. Europe's recession is exacerbating the slowdown in China because Europe is China's largest export market, and export businesses are far more profitable than domestically oriented ones in China. Furthermore, 20% of the earnings of the S&P 500 come from Europe, and thus we expect profit growth in the US to be much more modest than in the last two years. Overall, the best estimates we can find suggest that the European recession may cost the US about 1% in growth. Finally, other economies, particularly those that export to China, such as Brazil and Australia are feeling the impact of China's slowdown as well.

But one must be careful about straight line projections, and consider governmental responses to such slowdowns. China is prepared to stimulate its economy with both fiscal and monetary measures; the US is prepared to provide monetary stimulus if necessary, and Brazil is also lowering interest rates. Stock markets will probably react positively immediately to stimulative actions by any of the major central banks.

We note that the US housing recovery has begun, which for each new house being built provides three new jobs and with it renewed consumer spending. Despite the "large?" shadow inventory of housing, existing home inventory is now a normal six months as many have probably taken their homes off the market.

Furthermore, we note that the 20%+ decline of the oil price from over $100/barrel to about $80, has brought the gasoline price down as well from just under $4/gallon to ca. $3.30. This puts spending power in the consumer's pocket to the tune of about $70 billion, or an addition to GDP growth of about 0.5%. We would expect to see this boost in the second half, and thus,

- **because of the housing recovery and the boost to consumer spending from lower gas prices, we have not turned bearish on the US!**

US Politics:

Recently there has been much talk of the "fiscal cliff" on which the US sits as it approaches year end. If the sequester is allowed to take place (the automatic cuts in defense and other government spending), and if the Bush tax cuts are allowed to expire, the economic consequences are very adverse, and unless quickly changed, could tip the US over into recession.

Although political analysis is not our forte, we would expect the sequester to be postponed and the Bush tax cuts along with the current (lower) level of social security taxes for employees to be extended for some period of time (perhaps 6 months to a year) to give the new Congress a chance to come to a "grand bargain" over tax and spending reform. The sequester is too draconian, and an expiration of the Bush tax cuts would be too detrimental to the economy given how fragile it is. We think most politicians realize that the US economy is not going "gang busters" at 2% plus or minus, but whether we shall have another stalemate is not clear.

Stock Market Valuations:

Global markets continue to have very modest valuations. In the US, the S&P 500 Index has a current forward price-earnings ratio of 12.5-13.5 times 2012 operating earnings of $103-$108 with a dividend yield of 2% that is greater than the yield on the 10 year US Treasury bond. This continues to suggest that Treasury bonds are overpriced and stocks are underpriced. There are many other indications of investor fear which suggests to us, that it is time to be invested. However, the softness in global economies eventually must take its toll on US earnings which have already begun to produce some disappointments that may continue the trading range for another six months until the market anticipates next year's earnings growth?

Asian markets also offer considerable opportunity. Fears about China's slowdown have reduced the market to levels not seen since early 2009. India too has declined in terms of its stock market as well as its currency (by 12% since its recent peak in February.). When we saw its economy slowing and the currency weakening we held off making an investment in India, but think the time is coming.

We are looking for a deceleration in the rate of contraction in Europe during the next six months perhaps in the fourth quarter if austerity measures are implemented this year. If not the maximum contraction in European growth will occur in 2013.

What to Do?

We continue to maintain our cyclical focus as we can foresee many of the worries that have plagued the market subside over the next twelve months. Spain and its banks will continue to be a problem as the real estate market there declines further, but provisions now being prepared for them should blunt the impact on financial markets.

Given our moderately positive economic environment for the remainder of 2012 in the US, we would expect President Obama to win re-election. More importantly, however, will be the make up of Congress. This, we cannot forecast, but a repeat of a stalemated Congress will probably not be seen as a positive for financial markets?

Volatility may continue, although a stronger second half in the US and signs of stimulus elsewhere would give stock markets a lift. We continue in our trading range of S&P 500 at 1400 plus or minus 100 points.

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