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The Weakest Link

As Europe wrestles with its own version of 'too big to fail,' speculation is rising that the Euro might not survive the sovereign debt crisis. Greece may not be able to repay its debt in full, but the problems of fiscal irresponsibility are broader and may take more than the almost \$1 trillion already pledged.

Former Fed Chairman Paul Volker said "the essential element of discipline in economic policy and in fiscal policy that was hoped for" has "so far not been rewarded in some countries." Germany and other countries fear that Greece has become a proxy for the Euro. In other words, the weak link threatens the chain; that is the European Union.

Volker asks the question "will economic and financial distress finally be resolved by looking toward more integration in a closely integrated Europe, politically as well as economically?" Experts point to the need for much tighter political and fiscal integration. Bank of England Governor Mervyn King notes it is "very clear" that the currency region needs a fiscal union "to make the monetary union work" while Volker says that without it, the region's problems would be considerably worse.

The question for the broader economy is how badly will the debt crisis impact European growth and possibly the nascent global recovery? Bloomberg reports that Sony, the world's second largest electronics manufacturer, said it may suffer a "significant impact" if Europe's deficit spreads. Chinese Premier Wen Jiabao said the foundations for a worldwide recovery aren't "solid" as the sovereign-debt crisis deepens.

The US economy continues to plow ahead and in Archimedes fashion, 'the lever that moves the world' has been manufacturing, comprising only 12% of the economy. Today the government reported that industrial production rose .8% in April, the most in three months.

Output at factories, mines and utilities increased 0.8 percent last month after a 0.2 percent gain, figures from the Federal Reserve showed today. Production at manufacturers rose 1 percent for a second month. Capacity utilization rose to 73.7% last month, the highest since November 2008, from 73.1 percent in March. The gauge averaged 80% over the past 20 years.

The recovery is becoming more broadly based with business and the consumer increasing their spending. First quarter GDP growth of 3.3% was driven by the biggest increase in consumer spending in three years and a 13% rise in business investment in new equipment.

Retail sales climbed in April for a seventh straight month according to the Commerce Department today. The 0.4% gain follows a 2.1% increase in March. Automobile dealers and building-material stores led the way.

At this point, 439 of the S&P's 500 companies are now in the books for the first quarter. They are 55% higher than the same quarter last year and 39% higher with financials excluded. The big winners are consumer discretionary, financials, and materials, up 216%, 212%, and 132%, respectively. A full 77% of companies beat analysts' earnings.

While reports continue to fan optimism for US recovery, economists and investors (as evidenced by the latest market declines) worry that a deepening sovereign debt crisis might further dampen European economic growth, reducing US exports. The Wall Street Journal notes that GDP growth of 3.3% in Q1 falls far short of the 7% to 9% recoveries of our recent past which helped to grow businesses and restore jobs at a much faster pace than is projected this time.

Even though our recovery is solid as defined by many economists they agree that it will take as many as seven years to get the unemployment rate back down to the 5% rate last seen in December 2007. This span suggests the longest and toughest period since the Great Depression and it keeps our economy vulnerable to outside shocks far longer than usual.

Domestic markets will likely trade in a range for the coming weeks until much more is known about the European crisis and what domestic companies' expectations are for their future earnings prospects. Balance sheets are clean and productivity is high, but analysts wonder how much more profits can be squeezed without growing sales. They will let us know in the next few weeks.

Have a nice weekend.

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