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## Modest Improvement

Equity investors believe that the domestic and global economies are on the mend judging by their behavior so far. Since the end of September the US Total Market Index, S&P 500, and Dow are up 21%, 19.5%, and 18.5%, respectively. Global stocks as measured by the FTSE All-World ex-US index are up 11.3%. In contrast, investors are shunning the safety of Treasuries as the Barclay's 7-10 Index is down .25%. But last year the index soared 15% compared to a meager 2% for the S&P 500.

The improvement comes on the strength of improving US economic data and hopes that Europe has stemmed the risks of sovereign and bank credit defaults. Despite the reality of smothering debt and deficits as well as the apparent inability of policymakers to adequately address them, investors seem willing to favor the recovery theme, even though recovery is likely to be weaker than typical. This week the World Bank slashed its global growth forecast for 2012 to 2.5% from 3.6%. But 2.5% is not too bad given that economic recoveries following financial meltdowns tend to be weaker than usual. But it's not good enough to materially erode unemployment or provide sufficient tax revenues to address deficits and debt.

It is almost certain that Europe will fall into recession given the required austerity and deleveraging measures that must be taken. But Europe is a fairly closed economy, so impact on world exports will be fairly muted. The major threat from Europe remains the potential for another financial crisis/contagion.

The emerging markets, including China are still helping to carry the global economy. As reported by the Wall Street Journal, the JP Morgan Global Purchasing Managers Index ended 2011 at 53, a nine-month high and above the 50 line that divides contraction from expansion. The Chinese economy is growing at 8.9%, but it is slowing. Emerging markets' growth depends upon China as they feed the giant raw materials and resources. According to the WSJ, China is expected to generate one third of the world's economic output. The US may or may not take up the slack.

Indications that the US will do its part have been positive the last few weeks, particularly in the area of manufacturing. Industrial production in December posted a healthy gain of 0.4% after dipping 0.3% in November. The manufacturing component made a .9% comeback, following a 0.4% drop in November according to Econoday. Overall capacity utilization rebounded to 78.1% from 77.8% for November.

The NY Fed reported that manufacturing activity in that region rose more than 5 points to 13.48 with the 6-month outlook up nearly 10 points to 54.87. This level takes them back to where they were for the first half of last year, according to Econoday. The Philly Fed confirmed the trend, but less convincingly. That Pennsylvania region inched up five tenths higher to 7.3, well below consensus. It indicates moderate month-to-month growth in general business activity.

Manufacturing has carried the torch for this recovery since its naissance. But it has been and continues only a faint light surrounded by the darkness of a larger confused consumer economy stumbling to find direction. The outlook of most economists is that growth will not be sufficient to spark inflation. Even the prospect that the government might allow inflation to effectively reduce the weight of its debt has not prompted significant worry among the most skittish of investors - bondholders.

So far, price inflation at both at the producer and the consumer level remain tame by historical standards. At the producer level gasoline and food costs fell .1%, but the core which strips out these more volatile measures firmed up 0.3% from November. Econoday says a big part of the acceleration was due to reduced discounting for motor vehicles by dealers. Leading the core up were passenger cars, light trucks, pharmaceuticals, and tobacco. The overall PPI was 4.8% in December compared to 5.9% in November (seasonally adjusted). The core rate in December edged up to 3.0% from 2.9% the month before.

At home, inflation wasn't noticed at all. Both the headline and core levels were unchanged for both the months of December and November. Lower energy costs played a key role. Within the core, upward pressure was seen in medical care, recreation, and rent. Declines were seen in used cars & trucks, new vehicles, and apparel according to Econoday. Year-on-year, overall CPI inflation posted at 3.0%, compared to 3.4% in November (seasonally adjusted). The core rate held steady at 2.2% on a year-ago basis.

As suggested, bondholders are the most sensitive to inflation fears. Because they commit to longer holding periods their field of view is considerably longer and broader than that of equity investors who tend to focus on quarterly and annual earnings outlooks. When stocks rise on improving earnings (presumably from better economic prospect) some knee-jerk selling typically occurs in the bond markets, but order eventually returns as they resume weighing long-term economic realities against the likelihood that current risks will persist or evaporate.

As mentioned, the Barclay's 7-10 year Index is down .25% (yesterday's close) from the end of September as stocks have rallied 20% on average. The longest and hence, most inflation-sensitive index the Barclays Capital 20+ Year Treasury Index is down only 2% for the period. Bondholders seem to be unfazed by inflation at the moment thinking that the recovery will not be sufficiently strong to spark inflation.

If the anemic US recovery persists or improves, and if Europe debt doesn't blow up, and if China can maintain growth and . . . then maybe the stock and bond markets have it right - growth without inflation. But you'll note one big missing if. What will the US do with its massive debts and entitlement-driven deficits? To some extent, the elections will answer the 'if' the debt problems will be addressed, but the chances for innovative and significant improvement seem to be diminishing as each primary state makes its choice.