Capital INVESTMENT SERVICES of America, Inc.

# Perspective

A Quarterly Publication

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***In This Issue . . .***

- ✓ Fears of a 2008 repeat of financial troubles and recession have triggered a nasty decline in stock prices and caused stock market volatility to soar.
- ✓ The European Union (EU) may indeed be in the midst of financial woes similar to those which triggered the 2008 financial panic in the U.S.
- ✓ But, the current state of the U.S. financial system and economy are not vulnerable as they were in 2008.
- ✓ Collectively, corporate balance sheets are in their healthiest shape since the 1950s.
- ✓ Consumer financial obligations have returned to levels that prevailed more than 15 years ago.
- ✓ The magnitude of the EU debt problem is big but not without solution.
- ✓ **Signals of stress consistent with contagion of Europe's problems are not evident in the U.S.**
- ✓ The economy continues to grind forward, albeit at a slow pace.
- ✓ Stocks are "cheap" while Treasury bonds are "incredibly over-valued".
- ✓ Historically, low stock valuations have been the launch pad to high subsequent returns.
- ✓ The Appendix details why the EU will muddle through its debt troubles.

## It May Be 2008 in the EU . . . But Not Here


In 2008, financial events resembled tumbling bowling pins. The '08 pins were bowled over in roughly the following sequence:

U.S. sub-prime debt securities that had been rated AAA and regarded as "safe", moved towards default. As losses in these "toxic" securities mounted, several major U.S. financial institutions were either vaporized or nearly suffered such a fate. Policy-makers groped for solutions.

A few money market funds that had investments in the vaporized institutions were feared unable to fully meet redemptions. Stock prices exhibited "off-the-charts" volatility and registered sharp declines from August through September of 2008. The intensifying fear, uncertainty, and doubt (FUD) became panic during October of that year. The interconnected global financial system went into a hard freeze as worry about exposure to the toxic securities and toxic institutions spread.

The prices of most asset classes (commodities and many bonds included) and global stocks around the world moved in near lock step with the falling S&P 500 Index. At a time when it was needed most, true investment diversification became elusive.

Deep recession set in. Corporate earnings were crushed. Policy-maker actions appeared still more desperate and ineffective.

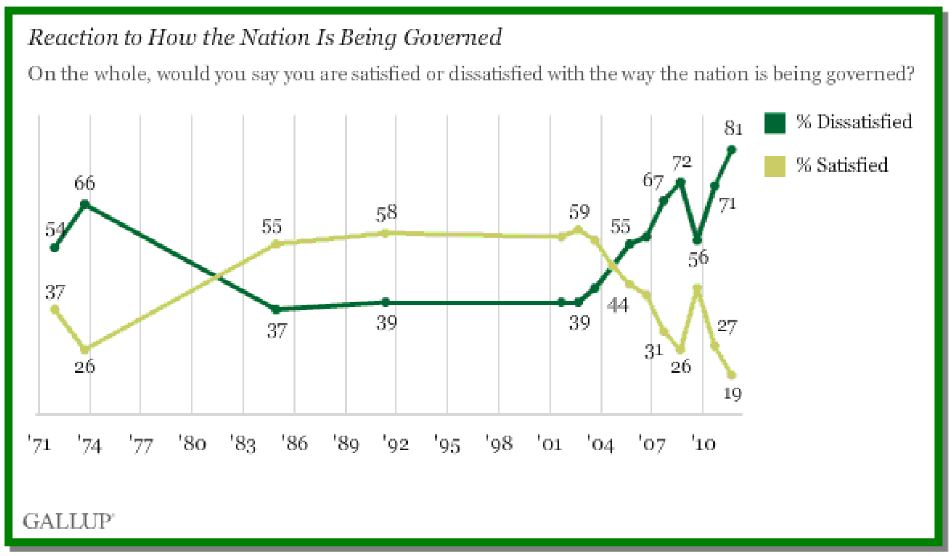
Fast forward to the present. Only this time move the epicenter of trouble from the U.S. to Europe and replace sub-prime toxic debt with European "sovereign debt" (bonds issued by the governments of the so-called "PIIGS"--Portugal, Italy, Ireland, Greece, and Spain).

Next, consider that European Union (EU) banks have investment portfolios stuffed with the formerly high-quality-but-now-toxic sovereign debt. Impairment or outright default by even the weakest of EU countries would erode the value of the banks' bond holdings. This could then potentially blow major holes in the EU banking system.

Furthermore, like '08, the integrated global financial system provides a potential transmission mechanism making contagion from the EU to the U.S. financial system a risk. This puts contagion on the table even though direct exposure to PIIGS' sovereign debt by U.S. financial institutions is very modest.

To further stoke FUD, throw in the fiscal debate here in the U.S., the recent loss of the AAA rating on U.S. Treasury debt, and growing dissatisfaction with the country's direction (see Gallup Poll chart above). Just for good measure, add growing concern that the world's perceived growth engine—China—is undergoing an economic slowdown that could soon become a "hard landing".

And in case that's not enough, consider the 2011 calendar progression. Stock prices falling sharply and in off-the-charts volatile fashion in August and September, with the historically ominous October still ahead. It's almost identical to what transpired in the stock market of 2008!




**A tumble is indeed a risk, but . . .**

So that's the bowling pin set up. And while it may appear that their tumble is inevitable, other inevitable tumbles in the past failed to happen.

As economist Brian Wesbury notes, a similar set up of the pins involved Latin American debt in the early 1980s. Except then our banking system had *direct* exposure to the toxic securities to the tune of nearly 300% of total US bank capital.

The pins wobbled mightily, but that inevitable collapse never happened. And what was a regular headline of the day can hardly even be recalled today.

Our assessment of the EU debt situation is as follows:

- The magnitude of the EU debt problem is big but not beyond solution.

- Because of disparate politics involving 17 EU nations, policymakers will continue to only stumble towards a muddle-through solution.

- Despite a tortuously slow progress, they will be pushed to adopt measures that largely defuse the threat of tumbling global financial bowling pins.

- Presently, stresses within the credit markets underlying our financial system appear elevated but not alarmingly so. We do not expect, for the reasons detailed in following sections, that the stress indicators here will become troubling. **(However, should they do so, we are prepared to take more defensive portfolio measures.)**

- U.S. stocks and bonds appear more closely priced for a U.S. recession, despite the fact that the economy itself continues to grind forward (albeit at a slow pace).

- This may be yet another instance when the "stock market has predicted 9 of the last 5 recessions". (See page 5.)

- The last such instance was just last year, when EU debt worries also triggered a sharp stock sell-off. Then as "double-dip recession" fears proved overblown, stock prices recovered sharply and delivered very rewarding returns for the year.

- Stock prices have moved from "inexpensive" to "cheap", while Treasury bonds have moved from "over valued" to "incredibly over valued".

- "Cheap" and "over-valued" conditions may not mean much in the short run. But for investors with a time horizon stretching beyond the immediate—these conditions should directly impact longer-run investment returns—to the benefit of stock investors and detriment of unwary Treasury investors.

- The *tumbling bowling pins of enduring significance may actually be occurring within governments that exert too much influence on their respective economies.* These tumbling pins may be the prelude to a return of economic policies that foster an environment conducive to healthy economic and employment growth.

**It might be 2008 in Europe, but not in the U.S.**

For our markets and economy the heart of the sovereign debt matter really boils down to contagion risks. This in turn, rests on the health of EU banks—particularly the German and French banks.

Contagion risk can be defused via a recapitalization of the banking system, much as the U.S. did with the so-called TARP measures taken in 2008 and 2009. As we point out in the Appendix, where we detail the size and scope of the sovereign debt issue, a bank recap program roughly the same size as TARP (nearly $1 trillion U.S. dollars) would go a long way towards alleviating fears about the adequacy of EU bank capital cushions to absorb sovereign debt losses.

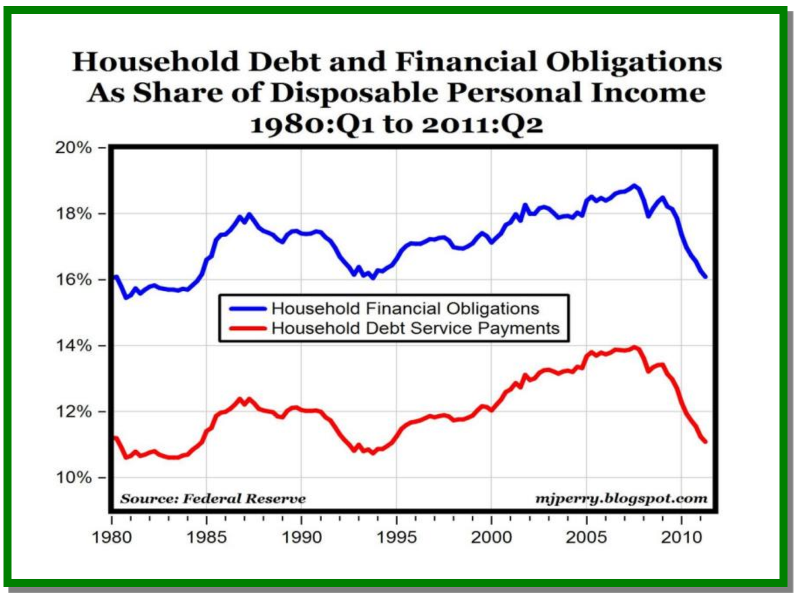
How likely is it that such a measure will be adopted? Predicting the twists and turns of highly political events—especially involving so many politicians from many countries—is impossible. However, there are encouraging signs they are inching closer towards such action, and cascading stock markets only up the pressure.

It's also important to recognize that our TARP program—despite being much maligned—did in the end help shore up confidence in our financial system. But also recall that TARP[1] as originally conceived did not intend to add to bank capital cushions. It evolved to that point only after what at the time seemed like a fumbling, stumbling process.

While on the topic of domestic bank capital levels; it is important to emphasize key distinctions between the relative health of the U.S. and European financial and economic systems. Since 2008, U.S. banks are more liquid and more strongly capitalized than they have been in many decades.

Likewise, it's important to note that corporate balance sheets are (in aggregate) more strongly positioned than they have been since the 1950s. Earnings and cash flow remain robust. In addition, factors that could make vulnerable the earnings/cash flow dynamics, like bloated inventory levels, remain modest. And consumer balance sheets are also in significantly better shape than probably is generally believed (see Chart 1).

**Chart 1: Consumer health in better shape than generally recognized**




Moreover, Federal Reserve policy remains ultra-easy as it has since 2008, and traditional warning signs of recession vulnerability (like a declining leading indicator, and an inverted yield curve shape) are lacking. And while budget cutbacks and the Treasury debt downgrade may be psychologically disconcerting, their potential drag on economic impact is likely to be modest.

Although at first blush the following sounds like something from *Ripley's Believe It or Not*, we're also already years into the process of cleansing the excesses of the housing bubble. With demographics (we do have a growing population) and replacement demand requiring the country's stock of residences to expand by over a million new units a year, current production remains some 50% below this level. The current inventory of unsold homes is being depleted and at some point new home construction will have to be ramped up. The housing dynamics could turn within the next year or so.

Putting all this together, yes the EU problems looms large. However, because our economy has already been taken through the grinder of the financial panic of 2008 and subsequent events, the economy is generally lacking the degrees of financial leverage and private sector excesses that make it vulnerable to a foreign financial calamity and a significant economic downturn. In 2008, the U.S. economy and financial system may have been bowling pins ready to topple. But at present they are sufficiently rooted and better able to withstand trouble. They no longer even resemble bowling pins!

[1]The Troubled Asset Relief Program (TARP) was initially designed to have the US government fulfill a 'lender of last resort' role by buying toxic assets from the banking system. When the purchases proved infeasible, TARP morphed into direct investment in the banking system by the government. In effect, the government helped create a bottom in the banking industry by buffering bank capital cushions while at the same time taking an investment position in an essential industry. Buying "low" has its advantages! And the return generated to the government by the program has significantly minimized the cost of the program.

If the EU simply avoids a financial meltdown, which we expect it will, the intense FUD weighing on the stock market could lift, triggering a 2010 market rerun.

**The stock market as recession predictor**

The economist Paul Samuelson once quipped long ago:  The "stock market has predicted 9 of the last 5 recessions".  We do have great respect for market-based signals that can incorporate the wisdom of many. However, markets do get it wrong, sometimes in a big way—"upside errors" include: tech stocks in the late 1990s, housing prices a few years back and, we suspect, Treasury bond prices today.

Table 2 reflects periods when the stock market as economic forecaster got things wrong in the other direction.

Note the entry for 2010 that we referred to earlier. Like last year, if the current double-dip recession fears and EU debt meltdown contagions fears prove overblown, the current stock market swoon could be yet another entry in this table.

Table 2:  Markets also get it wrong by being too pessimistic

***"The stock market has forecasted 9 of the last 5 recessions"***

Nobel Laureate, Paul Samuelson

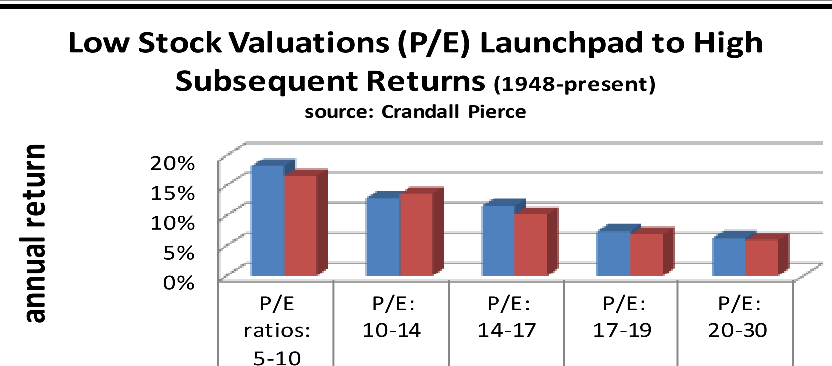
**Significant S&P 500 corrections not associated with recession**

| | Correction | Next 6 mos. | Next Year |
|---|---|---|---|
| 12/61-6/62 | -18% | 20% | 32% |
| 2/66-9/66 | -18% | 15% | 24% |
| 4/71-11/71 | -14% | 22% | 29% |
| 12/76-3/77 | -18% | 22% | 10% |
| 10/83-5/84 | -12% | 10% | 25% |
| 8/87-12/87 | -30% | 14% | 19% |
| 7/97-1-/97 | -18% | 27% | 37% |
| 4/2010-7/2010 | -16% | 18% | 25% |
| average | -18% | 18% | 25% |

Table source: ISI Group

With fear of potential tumbling bowling pins escalating, the valuation of stocks has been pushed significantly lower.  This is reflected in valuation measures like the price to earnings (P/E) ratio. Long term average P/E levels are in the range of 15 to 16. With general P/E levels currently below 14 and many stocks trading at P/Es in the single digits, the expectations of recession exerting a significant decline in "E" (earnings) appears already reflected in stock prices.

**Chart 3:  When stocks are cheap subsequent returns are highest**




| | P/E ratios: 5-10 | P/E: 10-14 | P/E: 14-17 | P/E: 17-19 | P/E: 20-30 |
|---|---|---|---|---|---|
| Next 5 years | 18% | 13% | 12% | 7% | 6% |
| Next 10 years | 17% | 14% | 10% | 7% | 6% |

However, if these earnings fears prove too gloomy, as we expect will be the case, material recovery in stock valuations can and should occur.   Furthermore, as Chart 3 reflects, in historical instances with modest P/E levels like those prevailing at present, subsequent multi-year returns have proven very rewarding.

"Cheap" stocks can, of course, prevail for some time (they already have). But with so much fear baked into the stock valuation cake, the potential returns ought to make the angst of the volatile ride along the way worth it all. We suspect little has to go right for this to happen, just avoid the worst.

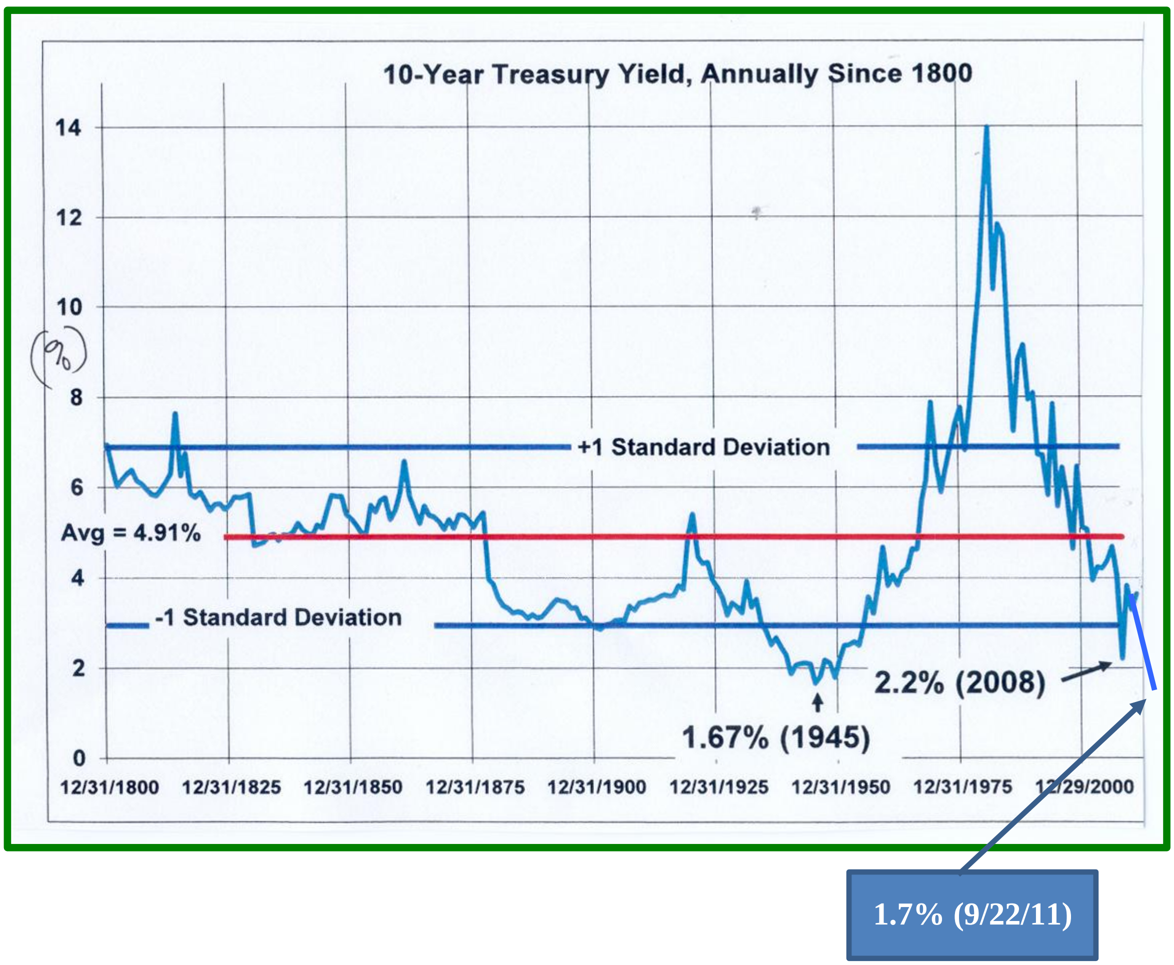
**Bonds**

Treasury bonds seem to have priced not just *recession* into yields and prices, but a *depression*. With 10-year Treasury yields broken below 2%–a level below the trough in yields at the height of the 2009 panic–bonds have moved into a rare zone as Chart 4 reflects.

At current price levels 10-year Treasuries provide almost no protection against even a little uptick in yields or inflation. Fortunately, other segments of the bond market (investment grade corporate bonds, select bank preferreds, muni bonds) are not as valuation stretched. We continue to concentrate bond assets in these other areas.

**Chart 4: 10-year Treasury yields implicitly reflect deep pessimism about economic prospects!**

(Chart Source: WJB Capital)



***In early 1948−nearly two decades after the Crash of 1929−the Federal Reserve surveyed 3,500 investors nationwide about their attitudes toward stocks. Only 5% were willing to invest in equities, and 62% were opposed. Asked why, 26% said stocks were "not safe" or "a gamble". Just 4% felt that stocks offered a "satisfactory" return. Only in the mid-1950s as one of the biggest bull markets in history roared ahead, did individuals return to stocks in earnest. By then stocks were roughly twice as expensive as they had been when individual investors told the Fed they were a "gamble".***[2]

**Government spending = the *real* toppling bowling pins**

Most of what has occupied the collective attention and, in fact, what we've addressed throughout this piece, have been investment trends that have been mired in *cyclical* economics. It's important "stuff" and the attention is, of course, warranted.

However, what is being largely masked by the intense focus on cyclical factors are incipient trends that are likely to shape the investment climate for years to come. And these trends, if they continue to emerge, could establish a foundation for a *significantly* rewarding investment environment.

For example, most of us would regard the EU situation as only "bad news". Our own analysis suggests that avoiding economic Armageddon is likely to be the most positive outcome. Or is it? Consider the view through the following broader perspective.

Since the founding of our own country, there has been a constant tension between where the "dial" should be set between the power of the government and its citizens.

The tension is evident in the very words of our 4th President, James Madison, regarded by many as the "Father of the U.S. Constitution":

> *"What is government itself but the greatest of all reflections on human nature? If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself."*[3]

Recast in economic terms, there is an associated tension about where the dial should be set between the *visible hand* of government and the *invisible hand* of the private sector. Some level of government involvement in the economy is a good thing and essential for a healthy economy. But beyond some not-so-clear point, it represents a failure to control itself, and it becomes no longer a *visible hand* but a feared *fist* that stifles the good that can flow from the *invisible hand*.


"THE WEDNESDAY MORNING MEETING OF THE ECONOMIC OPTIMIST CLUB WILL NOW COME TO ORDER."

[2] *Will Small Investors Ever Warm Up to Stocks Again?* Jason Zweig, Wall Street Journal January 22, 2011
[3] Federalist Papers, 51

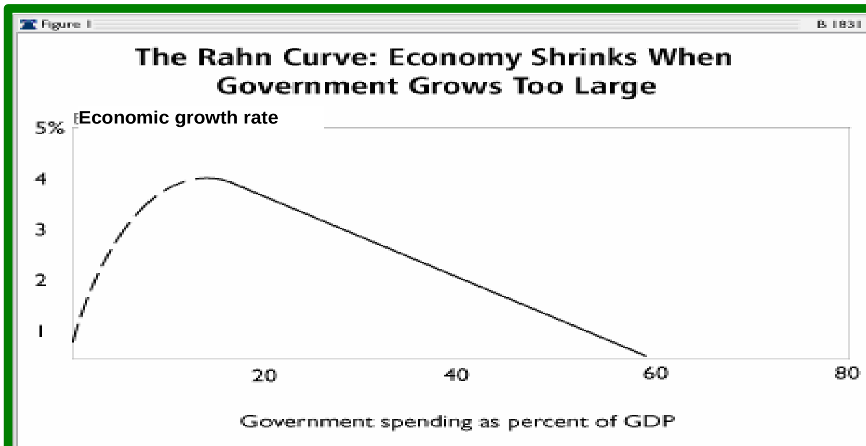
Across time, there have been many real life experiments in economic "dial setting". Relatively recent instances where the dial was set to extremes in the direction of government have resulted in economic misery (Soviet Union, Maoist China, modern day North Korea). Private Sector initiative was, indeed, smothered with little or no net economic progress; stagnation or outright declines in the general standard of living was (is) the result. And, while small isolated communist nations may be able to hang on (North Korea or Cuba), the larger experiments in communism proved unsustainable.[4]

Experiments where the dial was turned in the extreme other direction are few in number. But where such conditions have come close (Hong Kong, Chile), economic growth has been nothing short of impressive.

We presented some time back the work of economist Richard Rahn and his "curve" (Chart 5). The curve depicts the relationship between various dial settings in terms of government intervention (via government spending) in the economy as measured by GDP (Gross Domestic Product).[5]

Most of the PIIGS of the EU have dials set far along the downward slope of the Rahn curve. These countries[6] have experienced little in the way of economic growth and suffered chronically high unemployment for years—and that was before the economic downturn!

**Chart 5:**
**Countries learning about the Rahn Curve the hard way?**




Source: Peter Brimelow, "Why the Deficit is the Wrong Number", Forbes, March 15, 1993.

Massive government intervention in their economies has rendered them unstable as spending and borrowing prove unsustainable. Their structure renders them bowling pins about to topple.

To this end, the downgrade of U.S. debt from its AAA status is a warning shot across the domestic bow. The dial setting in our country is not at the PIIGS level, of course. But we're well into the downward sloped portion of the Rahn curve and expanding entitlement spending threatens to take us further into the economic morass.

The good news here is two-fold. First, consider the case of Canada that not so long ago suffered the loss of its AAA sovereign debt rating. A financial journalist[7] documented the Canadian situation earlier this year (months before the U.S. downgrade actually occurred):

> *"I asked Nikola Swann, the primary credit analyst on the report, about recent parallels (between the U.S. and Canada). He told me that, in the mid-1990s, both S&P and Moody's downgraded Canada's credit rating (from AAA to AA+ and Aa2, respectively), as a result of the country's deteriorating fiscal situation, the lack of a plan to deal with it and a reliance on external borrowing."*

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[4] China of course moved the dial allowing the private sector to emerge to some degree and staving off—at least for now—a fate similar to the old Soviet Union.
[5] *The Visible Hand*, 2nd quarter 2010, *Perspective* archived at capinv.com
[6] Ireland is a notable exception. Its current fiscal woes flow from its recent de facto nationalization of its banking system.
[7] *Give Me Life, Liberty and a Tank of Cheap Gas*, Carolyn Baum, Bloomberg April 26, 2011

> *"Canada's deficit as a share of gross domestic product had, in the early '90s, ballooned to 9.1 percent, and public debt had risen to 68.4 percent of GDP. By comparison, the U.S.'s publicly held debt is expected to reach 72 percent of GDP this year, according to the White House Office of Management and Budget.*
>
> *Canada worked hard to regain its AAA status in 2002. "Canadians felt embarrassed by the downgrade, which helped build grassroots support for fiscal discipline," Swann said.*
>
> *The groundswell of public support to do whatever it would take to get Canada's fiscal house in order started with the ouster of the ruling Progressive Conservative Party and the installation of the Liberal Party. Prime Minister Jean Chretien and Finance Minister Paul Martin slashed federal spending by 20 percent. Provincial and local governments came to see balancing the budget as a virtue. By 1998, Canada went from chronic budget deficits to a surplus."*

Canada today has an economy that is the envy of many. Although other factors played a role in their turn of economic fortune, the taming of the government—as the Rahn curve would predict—helped pave the way.

Canada is not a solitary example. The Nordic countries in recent decades also experienced much improved economic fortunes when unstable fiscal predicaments required them to turn down the dial several clicks away from the government and towards the private sector.

In the U.S., the expansion of government spending that's built up for many years and threatens to go even further has reached a tipping point. It now contributes mightily to the giant wet blanket on economic activity of the much subdued *invisible hand*.

There is still time to push the dial back in the direction of the *visible hand* in the U.S.. The budget fights in Washington (and Wisconsin, Ohio, etc.) are profoundly important in this regard, even if unsightly. The debate about where the dial should be set is setting up what could be one of the most consequential elections from an economic and investment perspective since 1980.

Lifting the wet blanket by turning the dial even a few clicks away from government, we suspect, would yield surprisingly favorable results. Economic and employment growth could easily enable the U.S. to become once again the envy of much of the rest of world.

The potential for a significantly more favorable investment climate is considerable, even if uncertain. Until then, there is still enough growth being generated by the dynamism of the *invisible hand*—due to amazing innovation that's going on all around us, robust productivity growth, and, yes, even globalization—to carry the economy on its back, wet blanket and all.

## Appendix

Why Europe will ultimately muddle through its sovereign debt troubles:

Some perspective:

| | gdp ($US billions)* | | debt as % | debt ($US billions) | |
|---|---|---|---|---|---|
| Portugal | $ | 229 | 83% | $ | 190 |
| Ireland | $ | 204 | 65% | $ | 133 |
| Italy | $ | 2,055 | 118% | $ | 2,425 |
| Greece | $ | 305 | 142% | $ | 433 |
| Spain | $ | 1,409 | 63% | $ | 888 |
| subtotal | $ | 4,202 | | $ | 4,068 |
| | | | | | |
| Germany | $ | 3,316 | 83% | $ | 2,752 |
| France | $ | 2,583 | 82% | $ | 2,118 |
| Belgium | $ | 466 | 97% | $ | 452 |
| Netherlands | $ | 591 | 63% | $ | 372 |
| Austria | $ | 284 | 72% | $ | 204 |
| Finland | $ | 180 | 48% | $ | 86 |
| Slovakia | $ | 66 | 41% | $ | 27 |
| Luxembourg | $ | 42 | 18% | $ | 8 |
| Slovenia | $ | 36 | 38% | $ | 14 |
| Cyprus | $ | 17 | 61% | $ | 10 |
| Estonia | $ | 14 | 7% | $ | 1 |
| Malta | $ | 6 | 68% | $ | 4 |
| | $ | 7,601 | | $ | 6,049 |
| | | | | | |
| | $ | 11,803 | 86% | $ | 10,118 |

*2010 Sources: IMB, Wiki

**Things to note**:

- The sovereign debt outstanding of the ‘PIIGS’ (5 countries at top of table 1) is $4 trillion.

- Greece is 10% of this debt.

- Italy and Spain are of course the ‘biggies’ of the ‘PIIGS’.

- The French and German banks are the heart of the whole matter.

- To the extent that concerns are now centering around French and (to a lesser extent) German banks, the whole issue is drawing to a head.

- The economy (GDP) of EU is smaller--but very close to—the size of US GDP.

- TARP here in the US was roughly $1 trillion.

- A similar sized TARP—or something equivalent--across the EU banking system is feasible. Its initial price tag, if it were $1 trillion, would add 10% to the EU aggregate public debt load—big but not impossibly big.

- And, if it worked like our TARP did, actual costs in terms of losses would likely be only a fraction of initial outlay.

- The problem is indeed a big deal, but not so big that it cannot be defused (as some pundits claim).

**Such an initiative may be a very large pill to swallow, but its cost would be but a fraction of the cost of unleashing a systemic EU banking problem or the collapse of the Euro.**

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