BLUE WATER'S Market Perspective

September/October – 2011

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We wish a Happy Thanksgiving to all of our readers, and in addition we extend a warm welcome to those who are new readers. We will present our usual review of the economy (authored by Wilson), market trends (authored by Sivalingam), followed once again by a brief discussion of a special topic (authored by Wilson). **This time the special topic for discussion will be "Three Economic Theories That Frame the Debate."** We hope that this issue's offering will prove useful to a wide range of investors and will help explain more completely our opinions on what should be done under current market and economic conditions. For new readers, please note that each issue going forward will feature a special topic for more detailed examination, plus a bi-monthly economic and market review. There will only be room for a brief discussion of each topic, so even the busiest reader ought to be able to glean something from this report with a minor time commitment. Please feel free to send us an e-mail or call with questions, comments or suggestions..

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Economic Summary:
October Head-Fake

By Kevin M. Wilson

Overview: Economic Activity in 3rd Quarter Improved, But Leading Indicators Negative

The preliminary GDP estimate for 3rd Quarter came in at 2.50% as the consensus expected, but there are real problems with interpreting this positive outcome as evidence that we have dodged a recession. For example, economist David Rosenberg has pointed out that the Index of Coincident Indicators appears to be peaking; if so, this would be a fairly reliable, but ominous portent. This index peaked right before, or at the beginning of the onset of, the last six US recessions.[1] Examples of coincident indicators include things like the total miles driven per month by consumers, the total volume of truck traffic, and the amount of shipping activity at major ports; all of these have fallen sharply in the last few weeks.[2] It is also now obvious that unemployment is not improving enough to change the dynamic, and housing is still in big trouble in the U.S. Although consumer spending has held up ok, it is still on a downward trajectory, and it can be shown that recent increases in spending came from household savings, since household income has been falling for months.[3] Various global leading indicators such as manufacturing production, new manufacturing orders, and service sector activity are falling sharply as well.[4]

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October Head-Fake (Continued)

Those who think that recession risk has faded because we have seen a few good economic reports lately are ignoring how things really work. Most economic data reported as positive lately are lagging indicators, and the lag observed is very commonly at least 13 weeks (one quarter). Since the ECRI Weekly Leading Indicator and the Hussman Recession Warning Composite each signaled a recession only a few weeks ago, it is still too early for economic data to degenerate into their likely recession configurations. Late October and November coincident and leading indicator economic data will be much more diagnostic of the macro-environment than are current lagging indicators.

The European Experiment Will Survive (But Won't Thrive) For a While More

We have just experienced the strongest October stock rally in 20 years, and a sense of relief has gradually overtaken the markets over the last few weeks. In October consensus opinion determined that the Europeans finally "get" it and will avert financial catastrophe with respect to the sovereign debt crisis. However, over the three market days since the announcement of a definitive bailout deal regarding Greece, the market gave back half its gains. My readings and intensive study of the data suggest that the sovereign bond, Credit Default Swap (CDS), currency, and US money markets have all strongly disagreed with the hopeful thinking of the stock markets. CDS, a form of bond insurance, for Portugal, Hungary, Belgium, and France are higher again this week (October 31) compared to just a few days ago, and much higher than in mid-August; note that CDS for Greece are no longer quoted. It now costs $1.03 million per year to insure a $10 million Portuguese sovereign 5-year bond. Quoted government bond yields are now 205% (!) for the Greek one-year bond, and 95% for the Greek two-year bond. These yields indicate imminent default. Portuguese two-year bonds are now carrying yields of 19.4%, which indicates any Greek default would be followed almost immediately by contagion that would spread at least to Portugal, if not throughout the EU periphery. Euro currency trade data now indicate massive

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outflows based on central bank, commercial bank, equity market, bond market, and currency market cash flow data. Finally, the mass exodus of U.S. money market funds from Europe has continued, with tens of billions of dollars exiting in just the last month. Banks have been exiting their sovereign bond positions as well, in spite of taking substantial losses.

Paying attention to the "ball" rather than the "pitcher" in this game is critical, I think. If the equity rally's story from the last month is true, then why don't other markets reflect the euphoria? The answer is that they don't see it the same way at all, and they operate on much longer time scales than the stock market, in general. Here's one major reason why fixed income and currency markets are still unconvinced by the optimistic statements of Europe's politicians. The proposed Euro-TARP bailout of Europe's hyper-leveraged banks is probably doomed to failure because of its unrealistic and risky proposed structure. According to Lance Roberts of Streettalk Live,[5] the complex solution being discussed for the banks in Europe involves the following: 1) the European Investment Bank (EIB), owned by the EU member states, would take money from the European Financial Stability Facility (EFSF) and use it to capitalize a Special Purpose Vehicle (SPV); 2) the SPV would issue bonds to investors (banks), using the proceeds to purchase sovereign debt from countries like Greece, Italy, Spain, Portugal, and Ireland; 3) the SPV's assets could then serve as collateral for borrowing from the European Central Bank (ECB), allowing weak and over-leveraged European banks to borrow funds from the ECB. Under this crack-headed plan under-capitalized banks would buy bonds from bankrupt EU countries through the SPV. They would then stick the ECB with these bonds as collateral for further loans to themselves. Their indebtedness would thus go up, not down. All of this circular lending is just an attempt to avoid facing the music. The banks themselves don't want to do this; instead they would prefer to sell assets in order to meet their required reserve and capitalization goals.

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October Head-Fake (Continued)

It gets better. Only about $200 billion would be given to the SPV, which is not nearly enough to handle the problem, as I have written before. The proposed solution (suggested by that paragon of fiscal probity, Timothy Geithner) is to lever-up the SPV by a factor of 5x its assets, giving it $1.4 trillion of effective capital. So now they're levering-up sovereign junk bonds to solve a debt crisis. Does this remind anyone of the subprime lending fiasco? No doubt this monstrosity will have a "AAA" credit rating piggy-backed off the French and German ratings, but that is silly given the profound credit problems in France's banks. Effectively this idea will transfer massive levels of toxic debt to the ECB, which can only be supported by French and German taxpayers (everyone else has no money). In response to this convoluted and dangerous plan, I can only say that sovereign default is still certain either way, but it might be mildly less destructive to the financial system under this approach. However, the chances of financial contagion are still real, and may be considerably increased by this proposed solution.

Perhaps we have a year or two until the potential collapse of the European financial system, or perhaps we have only a few weeks. And of course the ECB, the IMF, or the Federal Reserve could intervene to save the day...

Another factor to consider is that the German Bundestag (parliament) just voted to limit future German expenditures on bailouts. They previously capped the German contribution to the EFSF (EU bailout fund) at $294 billion. They also expressed opposition to the continuing (illegal) program of asset purchases by the European Central Bank (ECB), although this is not binding on the ECB. The German negotiating position with its EU partners is now based on a firm demand for much bigger "haircuts" (write-downs of losses) of at least 50-60% on Greek sovereign debt, essentially triple what was agreed to by the banking industry back in July. The Germans are also demanding much more severe austerity plans throughout the EU. They have agreed in principle to leveraging up the EFSF to expand its power, but the above-mentioned votes and demands mean that the

Germans won't themselves be adding any more funds, so only non-Europeans (e.g., China, Japan) will be in a position to do this (no one else has money or is interested, not even the IMF). This is probably a major turning point, as has been suggested by private intelligence firm Stratfor in a note to clients.

The reasons why this sequence of events is significant include: 1) that it precludes several alternative ways of dealing with the crisis; 2) that it requires that write-downs of losses on Greek debt by EU banks will somehow not lead to a general banking panic, even though there is insufficient capital to keep these banks solvent; and 3) it requires that EU governments act for the collective good of all member states at their own considerable political and economic cost. Alternative methods for handling the crisis could have included additional massive payments into the EFSF, money printing activities by the ECB, or a planned (but forced) Greek default. Now apparently, none of these options will occur. Since these were the realistic options, we are now left only with unrealistic options.

For example, the Germans expect to apply a 50-60% haircut to Greek debt without triggering an official default, but there are some problems with this. The first problem is that resistance to a much bigger haircut than previously agreed is nearly universal on the part of the banking lobby, and it certainly would be stretching the point a bit to call it voluntary, which is what's required for it to avoid being deemed a default. The second problem is that such a huge haircut would

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October Head-Fake (Continued)

drive most of the big banks in Europe under, since they have only partially provisioned for the 21% losses agreed to in July, and are not prepared for the nearly triple amount of losses they would realize under the German plan. They still carry many of these bonds at full face value (due to the accounting "rules"), and they are still very thinly capitalized. In fact, the largest banks are leveraged about 53:1, which is considerably worse than the 35:1 leverage at Lehman Brothers when it failed.

The third problem is that the Credit Default Swaps (CDS) on the debt, a form of insurance against default, will apparently not be deemed as payable due to the implied default associated with a 50% haircut. This defeats the entire purpose of the CDS form of insurance. The markets may react to this by discontinuing the purchase of CDS and instead demanding higher bond yields as compensation for risk This is a scary scenario because in trying to fix things the authorities have probably made them worse. Higher yields will naturally increase the stress on the system and force the financial system towards contagion. The fourth problem is that the plan to re-capitalize the biggest European banks only contemplates about $150 billion for that project, in spite of many estimates of the cost that range as high as $278 billion, or even higher. The fifth problem here is that no realistic provision is being made for dealing with a potential contagion. When Greece's bonds get their haircut (or absent that, when Greece defaults), there is a good chance that funding will dry up for Portugal, Ireland, Italy and Spain as well. Their bond yields may very well soar so high that preventing contagion (by means of bond purchases to stabilize prices) could cost the EU or the ECB $3 trillion or more.

Yet another problem with the German approach is that the various European governments must now cut expenses deeply under austerity budgets, which can only be done by cutting public services, personal retirement benefits (pensions), and social security benefits. This requires sacrifices by many millions of people for the good of all Europeans, which history would suggest could be a stretch for many governments. Call me cynical, but I think many Europeans would be resistant to losing their benefits in order to help out foreigners. To summarize then, the German plan, as modified by negotiations with France and others, is unrealistic and will fail at some point along the way. Perhaps we have a year or two until the potential collapse of the European financial system, or perhaps we have only a few weeks. And of course the ECB, the IMF, or the Federal Reserve could intervene to save the day, but the risks and costs of such interventions would be enormous. In the event of contagion, it will all come down to how willing various governments are to satisfy the demands of the bond markets. Based on what I'm seeing in the data, the bond markets are already pretty unhappy.

It seems to me, based on the writings of serious economists and market analysts, that the real solution is 1) a substantial equity-based (not bond-based) recapitalization of major European banks, followed by 2) an orderly Greek default, possibly accompanied by Portuguese and Irish debt restructurings. Measures short of these are probably not going to work, but they will raise the ultimate cost. When the equity markets realize that the debt game is up in Europe, and that recessions in Europe, the U.K., and the U.S. will make the situation even worse, we will finally find a bottom to this bear market.

Market Summary: The Tactical Response to a Global Bear Market

By Dheenu V. Sivalingam and Kevin M. Wilson

The problem for investors who allocate under buy-and-hold strategies is that the market, as represented by the S & P 500, is at the same level (1258) now that it was in January of 1999, so there has been no net change in price levels for over 12 years.The problem for investors who allocate tactically rather than using buy-and-hold strategies, is that uncertainty has made it very difficult to get excited about stocks right now, and trends have been difficult to identify. There are certainly a few reasonably cheap stocks out there currently, but the notion that index valuations are cheap assumes that earnings will continue to increase for most firms at about a 14% rate even as we head into a recession, and that profit margins will be maintained near their all-time highs. In fact, markets are still estimating that earnings for the S&P 500 will reach $107/share this year. A more reasonable estimate of earnings this year might be $95/share, which would produce a valuation (P/E) ratio of about 13.1 at current prices. That is cheap relative to the last 12 years, but it is not cheap relative to bear market lows of the last 100 years, which typically come in at P/E ratios of less than 10. We are in a bear market, so we think it's practical to expect bear market behavior with respect to valuations. Given the huge uncertainty inherent in P/E ratios during market sell-offs (due to falling earnings), a normalized or "cyclically-adjusted" P/E ratio (CAPE) is more useful than trailing or forward earnings estimates. According to analyst/blogger Doug Short,[6] the CAPE ratio is now 19.7, compared to a current trailing P/E ratio of 13.1; this indicates that markets may still be over-valued by about 20% relative to the long-term average. Alternative measures suggest even higher relative valuations.

Given all of this, does it make sense to buy stock on the dips now that a 20% discount (to a still-inflated valuation) has been priced in? Perhaps it does, especially if the stock in question has fallen appreciably more than the index and can be shown to have maintained its intrinsic value. If the stock is really a compelling buy, it will have a strong balance sheet, good free cash flows, good earnings visibility, a growing dividend, good management, and low debt; it will also possess a catalyst for upward price action in the near term, independent of the markets. However, with all the uncertainty regarding Europe's banking system and currency, and the very high likelihood of a U.S. recession, there isn't much urgency to act on individual stocks right now. What's interesting to observe is that you would think stocks would be down lately, given the level of volatility since July. Instead, a very strong rally that started in early October has resumed after a short (but violent) pause right at the end of the month and into the beginning of November. Why is that? We think there are several reasons for it, and investors may profit from understanding these driving factors behind the markets over the next few weeks or months. First, let us stipulate that the market's direction often has no correlation to anything going on in the economy, as you may have observed from our previous comments. As famous trader Bob Farrell once said, "The news doesn't make the market; rather, the market makes the news."

We believe the stock markets are going up (in the short term), in spite of impending recessions, for these inter-related reasons:

1) Earnings season was fine for the most part

2) Lagging indicators of U.S. economic health have been ok lately

3) The Euro zone's problems probably won't explode right away

4) A cursory examination suggests stock are reasonably priced, mostly

5) Market momentum is often upward at year-end, especially after decent earnings

6) Technical indicators support an uptrend of some duration which initiated recently

7) The year has been tough on investors and they need some positive action.

All of these reasons depend on assumptions that are arguably invalid. Indeed, we could argue pretty effectively against believing that most of the above are either informative, useful, or correctly interpreted going forward, if you just look at real economic and market data and project ahead a few months. But contrary to conventional wisdom, the markets as a whole don't look forward past a few days any more. Most of the action is on a 60-minute or shorter time scale due to massive computer trading by big firms. This means that technical analysis dominates over fundamentals or stock picking at the moment. In fact, the correlation of component stocks in the S&P 500 to their index is now 82%, and was 90% two weeks ago, the highest ever recorded; however, last July this correlation was briefly below 55%. This indicates that in July, stock picking would have made a difference, but by mid-August when correlations climbed above 75%, few advantages would have been derived from picking stocks.

We will implement some hedging strategies if we see a prolonged economic slowdown and the greenback strengthens due to the fear trade.

In response to this we are temporarily concentrating on using ETF's which track various indices, rather than trying to pick additional individual stocks to buy. This will change when correlations drop back down again, or when market valuations fall to more typical bear market levels (say at 950 points on the S&P 500), whichever comes first. We do see a technically supported upward trend now that has broken through resistance just in the last few days. We intend to exploit this, and we hope that it may prove to be of help in growing portfolio assets.

Special Topic:

Three Economic Theories That Frame The Debate

By Kevin M. Wilson

Financial Repression as De Facto Economic Policy

Several authors, including hedge fund manager John Mauldin (www.frontlinethoughts.com), have recently pointed out that there are three economic theories in competition for policymakers' attention as the long global financial crisis that began in 2007 again enters a critical phase. These theories reflect the ideas of John Maynard Keynes, Milton Friedman, and Irving Fisher. It appears from their statements and actions that most Federal Reserve members, including Chairman Ben Bernanke, are monetarists of the Friedmanite school. This means that they tend to view economic issues such as recessions as problems in consumer demand that are best dealt with by changes in the money supply. This belief drives their collective decisions to "fix" the economy by establishing loose monetary policies designed to re-invigorate lending activity. Unfortunately, this approach can only be shown to work in typical inventory-cycle recessions, not in the massive balance sheet recession and recovery (involving debt, deleveraging and deflation) seen globally since 2007. Massive interventions in the economy and markets by the Federal Reserve may have staved off financial Armageddon in the short term, but they have not really solved the problem of insufficient private sector demand, which is still weak in spite of everything the Fed has done. Therefore this approach cannot work as a stand-alone solution to the weak recovery problem.

In contrast many people in the Obama administration are Keynesians, tending to view the financial crisis and Great Recession as solvable only with massive government spending designed to replace falling consumer and corporate demand. Unfortunately, there is a vast array of evidence showing that the impacts of Keynesian stimulus packages on the economy are really transitory at best, and ultimately destructive at worst. New Keynesian stimulus via fiscal policy must (in actual practice) be repeated almost indefinitely in order for aggregate demand to appear to stabilize. But even then the price is very high, because private sector demand is thereby gradually crowded out by ever-increasing artificial demand that is dependent on massive government outlays. One proof of this lies in the dismal Japanese experience of the last 20 years, which saw 19 huge stimulus packages enacted by government, but no actual cure to the problem. The result has been a steadily diminishing economic picture throughout the period, with essentially zero growth in GDP over two decades, rising unemployment, and falling asset prices. The Japanese real estate market ultimately lost about 90%, and the Japanese stock market lost 75% over the 20 years since their asset bubble burst. This is hardly an advertisement for the Keynesian approach.

If we do not act on a solution like this in our highest councils, perhaps we need to throw the bums out, regardless of party.

A small group of economists, including Nobel Laureate Robert Barro, Australian academic Steve Keen, American academic Nouriel Roubini, and well-known financial industry economic pundits like Gary Shilling, David Rosenberg, and John Hussman take a radically different view of events. Some are advocates of a newer "post-Keynesian" economic school, others are advocates of the "Austrian" economic school established by von Mises many years ago, and still others are advocates of Irving Fisher's model for debt-deflation cycles developed in the late 1930's and early 1940's. It is this last point of view that is getting the most attention in the current debate. There is some difference in the approaches taken by the Austrian school and the Fisher debt-deflation school (i.e., they are supply-side and demand-side aspects of the same problem, respectively), but they agree that it is the debt-deflation process that is the key. Irving Fisher, whose reputation was damaged because he could occasionally be spectacularly wrong (as he famously was in 1929), has recently been restored to favor as a theorist. He is increasingly viewed as the one major economist whose work could explain the cause of balance sheet recessions such as the Great Depression, the Japanese Lost Decades, and now the Great Recession.

Fisher's theory, which was improved on by economists Hyman Minsky and Charles Kindleberger in the 1970's, takes as its starting point the notion that debt is an important consideration in any theory of how depressions occur, and in economics generally. This is a radical departure from Keynes, Friedman, and most modern economists like Ben Bernanke, who belong to the "neo-classical" school. Neoclassical economists explicitly or implicitly deny any significant role for debt in driving economics, even in a consumer-driven economy like ours. But this is an assumption, not reality, as Steve Keen has observed (www.debtdeflation.com), and makes no sense at all when one considers how people actually behave. Adherence to this strange assumption is a partial explanation for why so many economists (at least 95% of the profession) missed the danger signs that appeared prior to the 2008 collapse, and have been essentially clueless ever since on how to end the crisis. The same mentality appears to prevail in European economic circles as well, unfortunately. Now, in order for Fisher to include debt in his economic theory, he also had to make an assumption: that there is no equilibrium state in economics. Given the history of economic disaster in many countries over the last 800 years or so, and the universal occurrence of cyclical (typical) recessions as well as balance sheet recessions, I find this assumption relatively easy to believe.

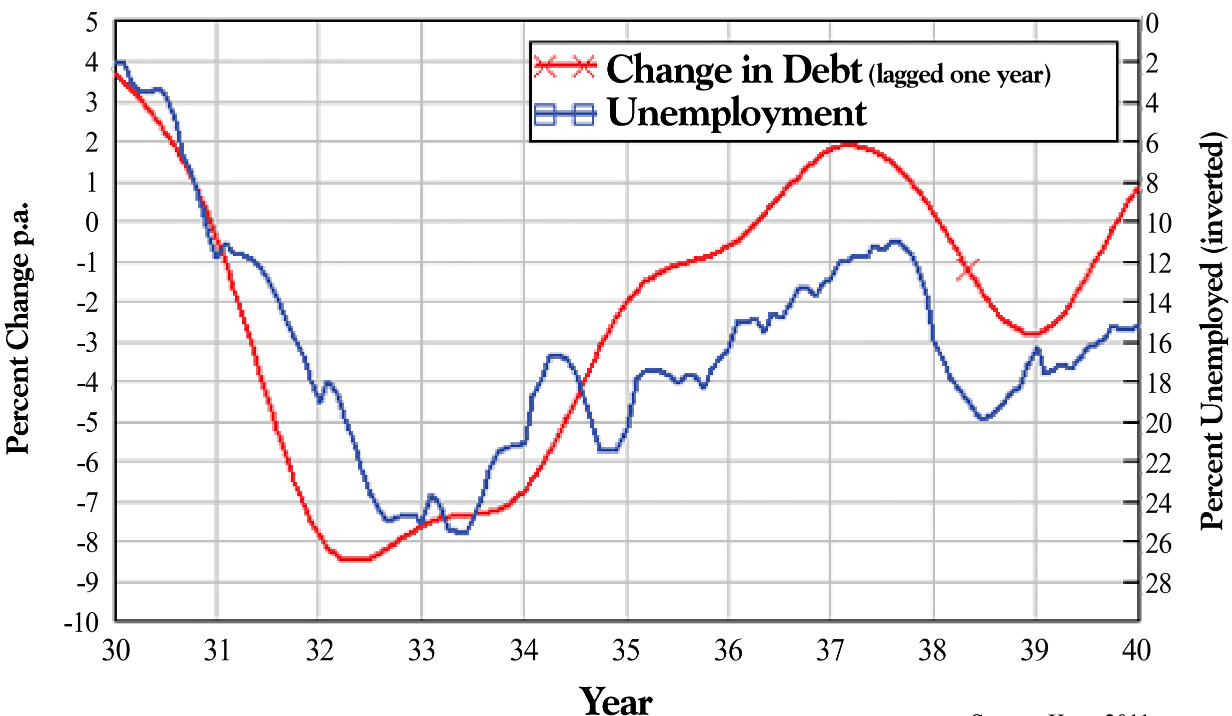
Three Economic Theories (Continued)

Fisher observed in analyzing the Great Depression that certain conditions can establish what he called a debt-deflation cycle, consisting of a credit/asset bubble, a predictable collapse of the bubble at some point, and a kind of reactionary deleveraging following the collapse that produces deflation over many years. The debt burden itself is the main driver of what happens under this theory, and nothing much can improve in a depressed economy until the original causative factor in the decline (i.e., excessive debt) has been removed from the system. Casual observers might find it reasonable to ask, "Why then, have the Japanese not recovered from their Lost Decades, since we know that their private sector debt has shrunken dramatically as they have delevered?" The answer in part is that their aggregate debt still went up, and the government portion alone is now 220% of Japanese GDP, the highest government debt ratio in the world. Their only close rival in this is Greece. Thus the solution chosen by the Japanese did not address the ultimate cause of the problem, which was excessive debt. Their ad hoc approach over an extended period has seemingly trapped them in an endless negative feedback loop in which their economy never really recovers.

Under Fisher's theory then (as modified by Minsky), aggregate demand is the sum of GDP plus the change in debt. In practice this means that once a credit bubble has expanded, its collapse is guaranteed because the new credit generated during the bubble phase is often used for non-productive purposes (e.g., speculating on real estate), which means that income cannot keep pace with the level of debt service required. The deflation cycle that follows is massively destructive because the debts taken on in the bubble become even larger as ongoing deflation increases their relative importance. This is the opposite effect seen under inflationary regimes, when debts decrease in value over time as they are paid with ever less valuable money. Von Mises and his Austrian school maintained that nothing could be done about this deflation impact, except in the fullness of time. Fisher and Minsky suggested on the contrary that a probable solution was economic reflation and debt relief.

Hussman, who is a follower of Fisher to some degree, has written extensively (www.hussmanfunds.com) about the need for debt relief in solving the current housing crisis. Although there is not yet a consensus, it is likely that a combination of debt write-offs, consumer debt forgiveness or re-structuring, tax incentives to small businesses, an end to government support for failed financial institutions, and reflation of the economy to end any deflationary tendencies would be both effective and theoretically justified by the works of Fisher, Minsky, Kindleberger, Barro and Keen. This can be done any time the Administration and Congress agree to do it (try not to laugh). If we do not act on a solution like this in our highest councils, perhaps we need to throw the bums out, regardless of party. The alternative is probably continued deflation, followed eventually by hyperinflation.

Correlation of Change in Private Debt and Unemployment



Source: Keen 2011

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Please attend our next "Monthly Market Forum" if you can; we'd love to see you, your relatives, and your friends there. Scheduled meetings will be held at 5:00 p.m. - 6:30 p.m. on November 17, 2011 at The Kitchi Gammi Club, Duluth; and December 15, 2011 at a Location TBD. Please RSVP to Blue Water. Business casual attire suggested.

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