

Topics: Market and economic risks still tilted to the downside

With weak US personal income and German business surveys rounding out September, if the US and Europe avoid a mild recession in 2012, they will do so narrowly. Our sense is that a recession is more likely in Europe, given the continued collapse in the periphery. As a result, markets now spend a lot of time waiting, wondering, postulating, tea-leaf reading and hoping for further assistance from the official sector. On most days, investment professionals come to work and first check to see what the Federal Reserve, European Central Bank, Bundestag, German Constitutional Court, Bank of Japan, Bank of England or Bank of China did overnight. In doing so, investors are *Waiting for Godot*: as in the play, investors don't know what he looks like; they don't know what he would do if he got there; they might not have ever seen him before; they just hope he shows up soon.

The US Godot is unlikely to offer fiscal stimulus (quite the opposite, as shown in the chart on p2, 2012 US fiscal tightening), but might offer monetary stimulus instead, via the possible Fed strategies below. I put an asterisk next to the ones mentioned in Bernanke's 2002 speech "*Deflation: making sure it doesn't happen here*"¹, so you don't think I got them from a Ouija board.

- More purchases of long-duration treasury or agency bonds (*), or a cap on long-term interest rates (*)
- Attempts to lower perceptions of future real interest rates, perhaps by doing one of the following: inflation targeting, GDP targeting, or by stating that rates would be zero until unemployment falls below a given threshold
- Purchase of private credit (corporate or municipal bonds), assuming funding can be obtained from Congress (*)
- Direct or indirect loans to businesses, with the goal of targeting a given percentage loan growth
- Purchase of European government bonds (*), although Bernanke probably meant "riskless" bonds when he wrote it
- Fixed-term loans to banks at low or zero interest, with a wide range of private assets such as corporate bonds, commercial paper, bank loans, and mortgages deemed eligible as collateral (*)
- The Fed could in principle target an *even lower* dollar, but this is more of an anti-deflation policy than a pro-growth policy, which is what the Fed faces now. The growth benefit would be muted given that trade is a small % of US GDP (~15%).

In Europe, a modestly larger version of the sovereign bailout mechanism was approved in Germany (the EFSF). But the more positive tone in Europe last week resulted from rumors coming out of the IMF meetings in DC that Godot had showed up there. When you cut through the haze, a European Godot would take the form of a policy decision that either jeopardizes the inflation-targeting mandate of the European Central Bank, or jeopardizes French/German AAA credit ratings. **I am not sure the US or European versions of Godot will show up until there is more pressure to do so, either from a further deterioration in financial markets, in the real economy, or both.** As a result, market risks still appear more to the downside than upside, despite the apparent cheapness of global equity markets, and the prospect of another quarter of double digit earnings growth in Q3. Perhaps Godot will show up sooner; if so, we would consider such policy measures an unexpected windfall. We expect some interesting opportunities ahead, but as things stand now, we maintain the cautious outlook we have held all year.

The most discouraging outcome has been in Asia, where equity and currency markets have been clobbered despite superior economic performance. **As shown in the chart, positive economic surprises in Asia continue to outpace the G10, but for the first time in years, the economic outperformance has coincided with underperformance of Asian equities.**

Among the opportunities we are looking at right now: European subordinated bank debt at yields of ~8%; US bank trust preferred stock trading at or below Par; short dated high yield bonds; the Brazilian Real, after an 18% decline; EM currencies more broadly, which are down ~10% since May, roughly half of their Spring 2009 decline; and equity strategies which provide downside protection, paid for by taking advantage of the doubling of equity market volatility since May 2011.

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Chief Investment Officer

Despite better economic performance, Asia underperforms



Source: GaveKal, Citigroup, MSCI, Bloomberg.

¹ The irony of the timing of this November 2002 speech: it's when the Fed cut rates to 1.25%. This step was arguably one of the three heads of the housing boom-bust Cerberus, which resulted in the very de-leveraging Bernanke always feared. The other two heads: [1] underwriting lapses by banks, broker-dealers, mortgage underwriters and rating agencies; and [2] the unintended consequences of Housing and Urban Development policies which by 2002 required banks to make 50% of all loans to low and moderate income borrowers, and pushed GSEs to underwrite hundreds of billions of non-standard loans despite having 1% in capital (see *Eye on the Market*, May 3, 2011).

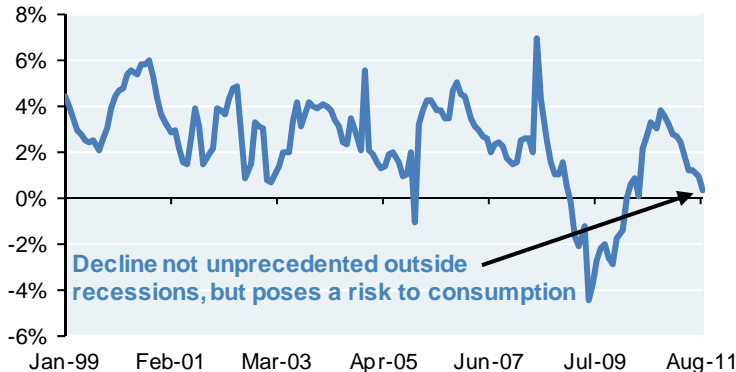
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Charts of the week

For the US, weak disposable income, and the fiscal tightening projected in the US for 2012. In Europe, note the weakness in German surveys of financial market participants compared to surveys of non-financial businesses (not so bad). In the past few years, the ZEW survey has led the IFO; if this trend is maintained, there may be more weakness ahead for Germany. The 3rd chart shows Germany's "vendor financing problem" [e.g., German banking sector loans to the Periphery]. While such exposures are declining, they still represent around 3 times the level of capital in the German banking system. Last two charts: the spike in equity market volatility, and the selloff in emerging market currencies, both of which are around half of what took place in 2009.

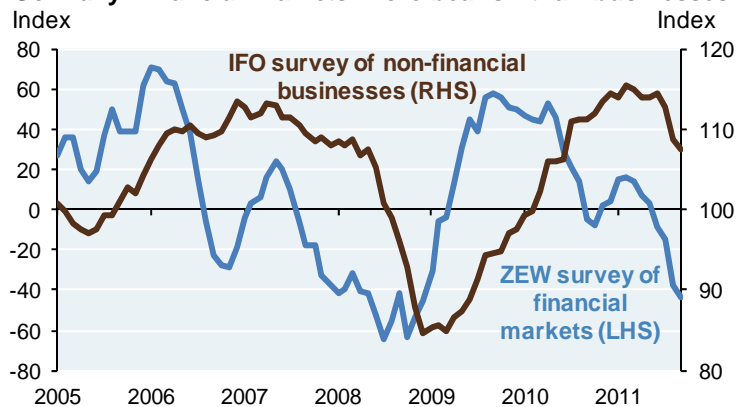
US: sharp decline in real personal income

Percent, YoY



Source: Bureau of Economic Analysis.

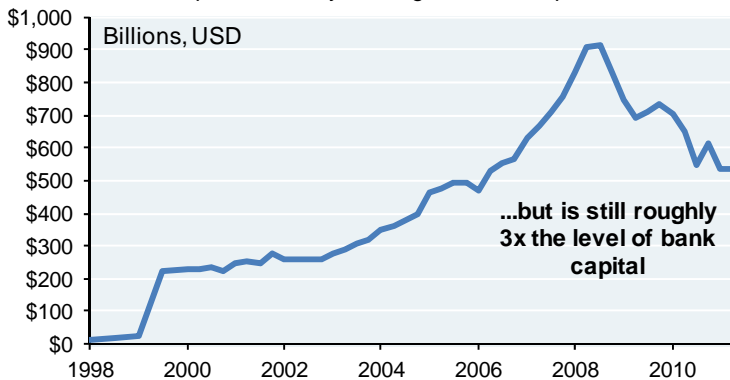
Germany: financial markets more bearish than businesses



Source: Bloomberg.

Germany's vendor financing problem is declining

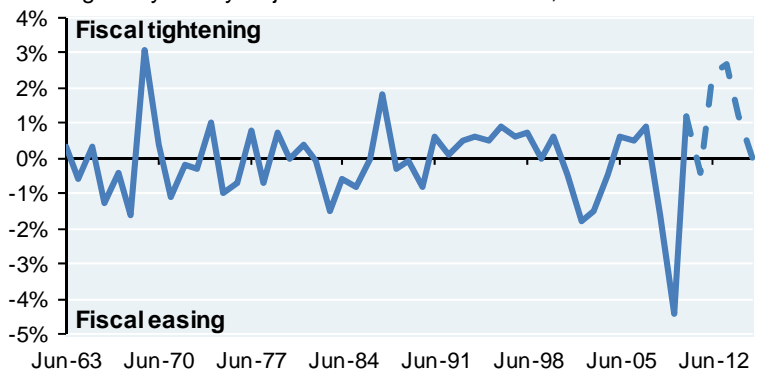
German bank exposure to Italy, Portugal, Ireland, Spain and Greece



Source: Bank for International Settlements.

US will feel fiscal pain in 2012

Change in cyclically-adjusted federal fiscal deficit, Percent of GDP



Source: J.P. Morgan Securities LLC.

Sharp selloff in EM currencies

J.P. Morgan Emerging Markets Index, level



Source: J.P. Morgan, Bloomberg.

Spike in equity market volatility

Implied vol. on 12-month at-the-money call options on the S&P 500



Source: Bloomberg.

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EFSF	European Financial Stability Facility
IFO	Institut für Wirtschaftsforschung An der Universität München (Institute for Economic Research at the U of Munich)
ZEW	Zentrum für Europäische Wirtschaftsforschung (Centre for European Economic Research)

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