Infomail

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UNENDING PESSIMISM

Financial markets respond to news and the media exaggerates that news to stimulate attention and generate their income from advertisers. Turn on your TV, listen to the radio, read a newspaper, or search the internet and you can find a story about Greece, the Euro collapsing, JP Morgan losing $2 Billion, labour unrest, austerity, student riots, serial killers, California going broke, the disastrous Facebook IPO…… and so on. Just about every piece of coverage is negative.

Replace the current list with the Arab spring revolts, Egypt, high oil prices, China slowdown, foreclosures, Ireland, austerity, Dubai, Tsunami, Portugal and that goes back for almost three years of relentlessly bearish news.

And while markets have done little since the great bounce in 2009-2010, they have not collapsed either in the face of this constant wall of unending pessimism. That's because even with the headwinds of bad news and a perceived anti-business US President, we have on our hands a sustainable self-reinforcing economic recovery, occurring despite having one hand tied behind its back. What's holding it back from a better, full blown recovery has been bad policy out of Washington D.C., political dithering in Europe, and uncertainty about future taxes and regulation.

To say the last four years since the Great Recession/Financial Crisis broke out in 2008 has been atypical would be an understatement. Central banks around the globe have reached deep into the toolbox – first by dropping interest rates to zero, and then by using "unconventional" measures aimed at keeping rates low at the long end of the curve by buying Government bonds.

In my opinion, world Governments and commercial banks have absorbed so much of the credit that the private sector, traditionally the risk-taking/job creating/ profitable side of the economy, has been cut off from its oxygen – Credit, and instead are portrayed as villains, are over-taxed and over-regulated.

On Friday, the 10 year US Treasury bond yielded 1.45% at one point, the lowest yield in history and investors are seemingly lined up to buy the "perceived" safety, despite yielding less than the inflation rate. (Just an FYI, 10 German bund bonds are 1.35%)

In Europe, the bad news is rearing its head again in Spain and Italy, as Spanish 10 year rates are at 6.70% or so. This has refocused investors on too big to fail Countries. Last week all economic data out of the USA was negative.

Equity funds continue to bleed assets while bond funds are overwhelmed in cash. In my opinion, the next bubble in the making. The rush to avoid risk and another 2008-2009 is underway again. Gold has surged higher last few days again. Oil prices have dropped over 20% in 5-6 weeks. The world is moving at an even more rapid pace, but I don't think that means investors should react accordingly to every twist and turn. The world's great investors like Benjamin Graham, Sr. John Templeton, Buffet in his earlier years – all understood sticking with the right investments and the virtue of patience. Yet what continues to happen before our very eyes is investors (and institutions!), continue to allocate OUT of assets that can grow and INTO assets that cannot. This will haunt these investors at the first sign of inflation and rising interest rates. Maybe it takes months, maybe even a couple years, but it is inevitable following a 30 year bull market in bonds that has some bonds at hundred year lows.

I think the most positive outcome for Europe (and investors) would be a speedy exit by some countries not capable of keeping up with Germany and doing it ASAP. That probably means realistically most of Southern Europe. Had Greece made that call in April 2010, they would probably already have seen some upside. It has eroded 20% of its GDP fighting a losing war. Look at Iceland. It bit the bullet some time ago and it is already on the rebound.

The news out of Europe is of course bad and is there anyone still left who believes that Greece is not long lost? (And most likely Portugal?) The experiment of just a monetary union in Europe is in shambles, and Germany and Germans cannot and will not pay for the excesses of Greece, Spain, Italy, Portugal et al. The Euro will most likely transform into something else – perhaps single currencies in the peripherals and maybe a Northern Euro of some sort. The hit, when it comes, will require the ECB to be recapitalized from all Euro nations. The number will be $1.5-2.0 trillion in total, Greece will go back to the Drachma, and thumb their noses at their creditors who lent in good faith.

The Greek elections take place June 17th and the latest polls show the right of centre conservatives (who favour austerity) leading.

The biggest issue right now in my opinion, is not Europe. It is China and India. There is a great growing fear these nations are starting to skid hard. One only has to look at commodity stocks and see them down 30-50% when overall markets are down 8-10%.

On this side of the pond, Canada continues to plod along. The US recovery hit some speed bumps this past week, but overall housing looks like it has bottomed, retail sales are "ok" and the decline in oil prices will act like a tax cut with more disposable income in consumer pockets. There is still discussion as to whether the Federal Reserve might engage in additional easing measures (a "QE3").

Since 2009, Germany's stimulus was about $103 billion to the USA's $800 billion (China about $586 billion) yet the German economy has fared better growing about 3.5% versus 2% for the US because German stimulus spending actually went to job creating stimulus rather than political agendas. German unemployment last week was 6.7%, a post unification low. US unemployment rose to 8.3% and now has been over 8% for over 40 months, the longest streak since the 1940's. But still President Obama is trying to use the pain of people as a reason to implement an agenda that based more on the notion of fairness, than sound economics. The irony of course is in the end the idea of spending even more money, especially money countries don't have, ends up hurting even more people down the road. For all the talk about lack of growth, this crisis is about debt, and more specifically, runaway spending.

The Obama mantra which is rapidly becoming in the US these days is, "the harder I work, the more I owe, the less I work, the more that's owed to me", and now the goal is to take that mantra global but the Germans, and rightfully, so want no part of that. In the end, if Obama wants Europe to spend money it doesn't have, American's are going to have to foot the bill. And they are no longer in a position to do so.

Last week on CNBC the brilliant Lee Cooperman, captain of hedge fund Omega Advisors, said "You can have cheap equity prices, or you can have good news, but can't have both!"

Clearly we have had plenty of bad news, which has resulted in historically cheap equity prices. Bad policy and Government spending have been robbing the economy of potential. I think that is going to change in the very near future.

There are several items over the next few weeks which may signal a change:

- The recall election on June 5th for Governor in Wisconsin. Governor Walker made drastic reforms for Government workers and created political backlash. A Walker victory could set the stage for larger reforms in other states.
- Late June, the Supreme Court ruling on Obamacare. A loss for the President will have huge implications. A victory would signal further growth in Government spending and regulation.
- Scheduled tax hike on income, capital gains and dividends in 2013. Has created a lot of uncertainty for business investment.
- The US Presidential election November 7th. It is basically a referendum on the size and scope of Government.

Despite the bad news, the economy keeps grinding forward, while markets tread water. That's the real news to be reported here – how unending pessimism is being defeated by the entrepreneurial spirit.

Stay Tuned,

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