

Today's Notes:

1. Fear

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Fear has returned. Even Larry Summers, one of President Obama's suggests that this is a statistical recovery not a real or fundamental one. Thursday the news of a failed government debt auction in Portugal and the worsening situation in Greece where a Sovereign default is a possibility really ratcheted up the fear quotient around the world. The shoe is on the other foot or so it seems. In the fall of 2009 this type of fear was so evident here in the United States. Now the virus is emanating from Europe. Greece is on Euro Union life support and the question is whether the patient will live or die. In addition, there is so much deleveraging that necessary in the developed world that headwinds are strongly suggesting slower economic growth.

And then Friday morning, a miracle occurred. News came from the BLS in Washington that unemployment fell from 10.4% to 9.7% in January. U-6 unemployment ticked down to 16.5% from 17.4%. It is always so interesting how good news seems to magically appear when we are on the precipice of a steep global slope. I am being cynical of course – but why not. Does anyone really trust the government statisticians anymore?

Further the geopolitical world including the Iranians, Greeks and members of the European Union from the south are in terrible shape. Bill Gross said, this AM, that the difference this time is that we are entering a long period of deleveraging and re-regulating versus most of the past 5 decades when recovery from a recession meant levering up (adding debt) and deregulating.

The recent (January 2010) McKinsey study made a very strong case that the top 5 developed countries will be deleveraging for 5 to 7 years. The company estimates that a debt to GDP ratio of anything above 80% is unsustainable and in fact that such a leverage to GDP ratio will drag down GDP growth by 1%. Below I show the current status of the debt to GDP ratios for a number of companies. These debt ratios must be reduced – markedly. That will take years and be extremely painful.

I think that PIMCO's Bill Gross is absolutely on the right track. There is a "new normal" and we had better learn to invest in that new normal environment. I will provide my presentation on the web site on this topic.

In the meantime here are a few caveats from the McKinsey report and a very important NBER research paper from Harvard's Rogoff and The University of Maryland's Reinhart.

The McKinsey report suggests:

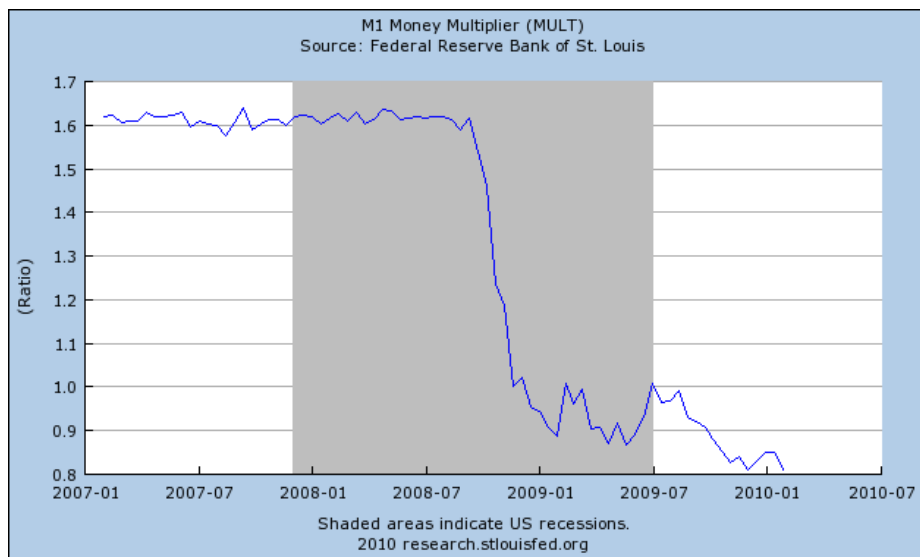
- "Leverage levels are still very high in some sectors of several countries—and this is a global problem, not just a U.S. one."

- “The analysis has identified ten sectors within five economies that have a high likelihood of deleveraging.”
- “A long period of deleveraging nearly always follows a major financial crisis.”
- “Deleveraging episodes are painful, lasting 6 to 7 years ... reducing the ratio of debt to GDP by 25 %. GDP contracts during the first several years and then recovers.”
- “If history is a guide, many years of debt reduction are expected in specific sectors of some of the world’s largest economies ... a significant drag on GDP growth.”

In their paper (now also a book) Rogoff and Reinhart make the following suggestions. In hindsight their reflections seem on the mark.

- The true legacy of banking crises is greater public indebtedness, far beyond the direct headline costs of bailout packages.
- On average a country’s outstanding debt nearly doubles within three years following the crisis.
- The aftermath of banking crises is associated with an average increase of 7% in the unemployment rate, which remains elevated for 5 years.
- Once a country’s public debt exceeds 90% of GDP, its economic growth rate slows by 1%.

Friday’s market action showed a decline for most of the day. Then once again, miraculously, the Dow Jones Industrial average soared more than 120 points in the last hour to end the day just slightly above the magical 10,000 market at 10002. Perhaps, more important, many of the companies whose shares were ravaged on Thursday made nice gains back on Friday. Goldcorp was one of those companies that retraced its entire loss on Thursday. Still the M1 money multiplier seems ready to touch new lows and the St Louis Fed’s velocity time series still has not turned up. In short we think there is more downside in this market as deleveraging proceeds apace. Fear in the capital market is a powerful force.



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