



# CUMBERLAND

## ARE WE DOOMED?

Have the markets gone MAD or is it just MACRO? Let me contrast the difference between micro and macro. Earnings estimates are micro and corporate profits are going up. So, if you are buying a business, things actually look pretty good, provided we're not headed back into a recession which is currently the big macro concern.

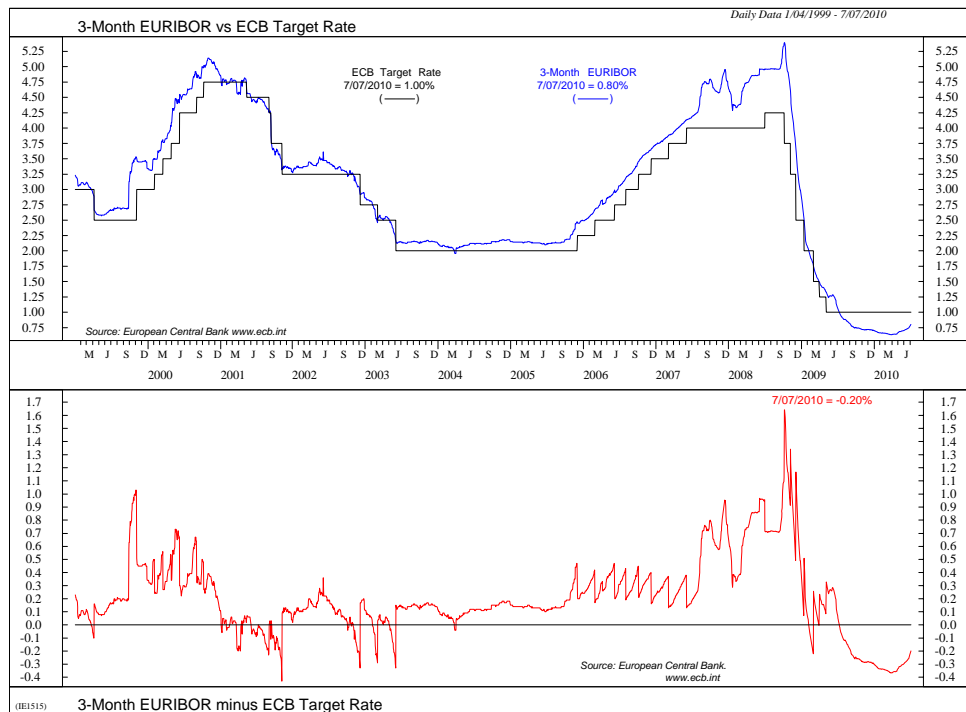
Macro issues are the state of the economy and Sovereign Debt concerns and right now, they are the issues that have investors' attention. They are serious issues, and unfortunately, won't be resolved in the near term. So, they are likely to hang around for awhile and limit any market advance.

But let me delve into these issues in an attempt to provide a little colour beyond what you read in the headlines.

### Macro Issues

The two big ones are the Euro mess and World GDP growth.

By now, most everyone is aware that a 720 bn Euro Stabilization Fund was created to deal with the Sovereign Debt risk. Right now, no one knows if it will ultimately be successful, or if it is just postponing the inevitable (i.e. a Greek debt restructuring). Regardless, it won't be a uniform result. Some countries, like Germany, will do just fine while others will experience severe dislocations. But for the time being, it would appear that this issue is on hold. Gold isn't breaking out to new 'highs' and the Euribor rate, which is the inter-bank rate in Europe, has only increased modestly.



As seen in the top clip of the previous chart, the Euribor rate has increased to 0.80% but is nowhere near the 5.25% rate it reached in 2008 at the height of the Lehman induced financial crisis.

Furthermore, Moody's did a stress test on more than 30 European banks and concluded that they could absorb a severe loss of 20% on their Sovereign debt exposure without having to raise additional capital.

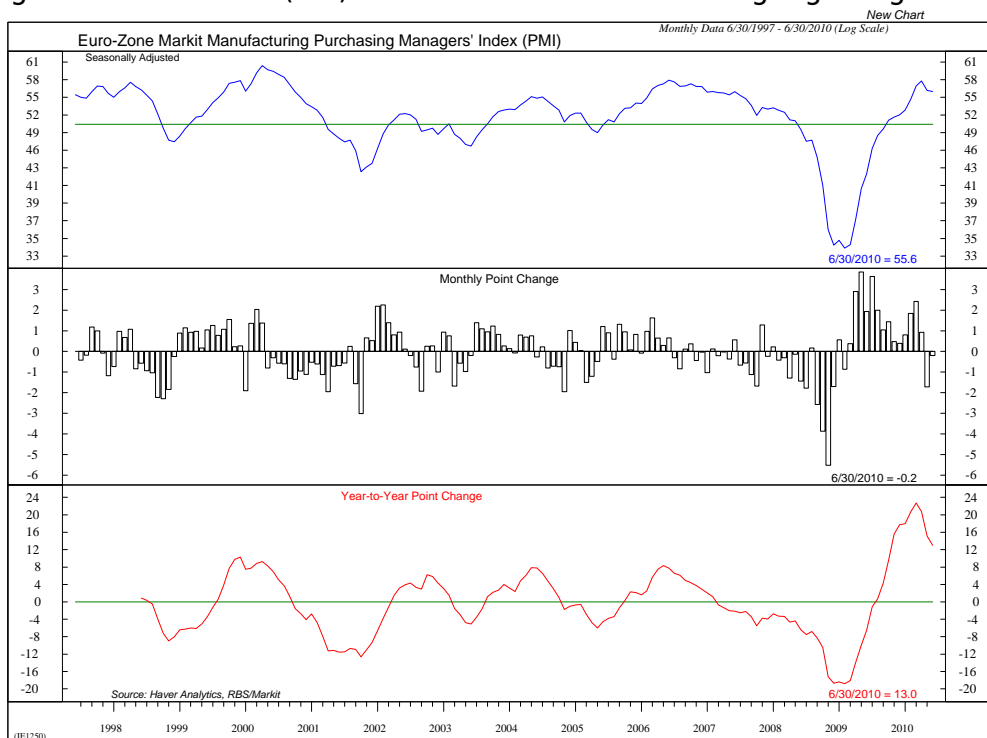
So, if we put Sovereign Debt aside for now, the issue becomes one of GDP growth and how badly government initiated "austerity" programs are going to hurt the European economies.

Morgan Stanley's economist calculates that fiscal belt-tightening will shave 0.4% off Euro area growth this year and as much as 1% in 2011. However, I'm not sure I buy this. First, I think sentiment may be worse on this side of the Pond than over there. Consider how you might feel if our newspaper headlines reported that our government was going to freeze civil servant wages and possibly terminate some of their benefits. I don't know about you, but I wouldn't be disturbed by that kind of news.

Right now, that view seems to be shared across Europe. In June, Euro area economic sentiment rose to 98.7%. Spain was up. Portugal was down a bit, but even Greece was up, albeit from an exceptionally low level.

Second, much of what I see in the "austerity" measures are freezes, extensions of the retirement age and budgetary cuts that are phased in over several years. There is very little that is an immediate detriment to the economy except for tax hikes. So the fiscal drag that everyone expects may be less than anticipated. Meanwhile, the decline in the Euro has an immediately beneficial impact on international trade. In terms of magnitude, the benefits to the economy combined with a very accommodative monetary policy seem to be larger than the drag from curtailed social spending programs.

The Purchasing Manufactures Index (PMI) in June also seems to confirm ongoing strength.



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As indicated in the top clip of the previous chart, the EU index is off its 'high' and for June, it came in at 55.6 down from 55.8 the previous month. Anything over 50 indicates growth, so what we're seeing is a diminished rate of growth but an improvement nonetheless. By country, Germany remained a strong 58.4 in June. France slipped a little to 54.8 vs. 55.8, while Italy actually rose to 54.3 from 54. In the U.K. a similar index dropped to 57.5, down from a 15 year high of 58.0

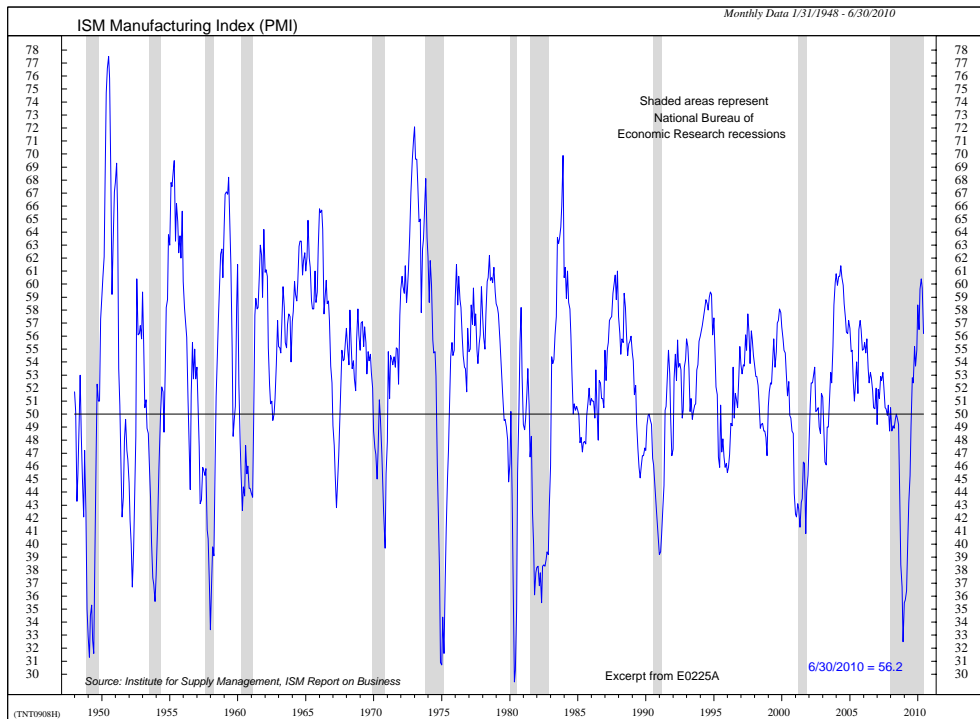
Although there is no guarantee that these numbers will remain positive, it is encouraging that they are holding up during the peak of Sovereign concerns.

For sure these European numbers are off their 'highs', but they are likely to remain positive as an accommodative monetary policy and currency devaluation trump the fiscal austerity drag.

So much for Europe, but that still leaves the United States and China where indicators also seem to be sliding.

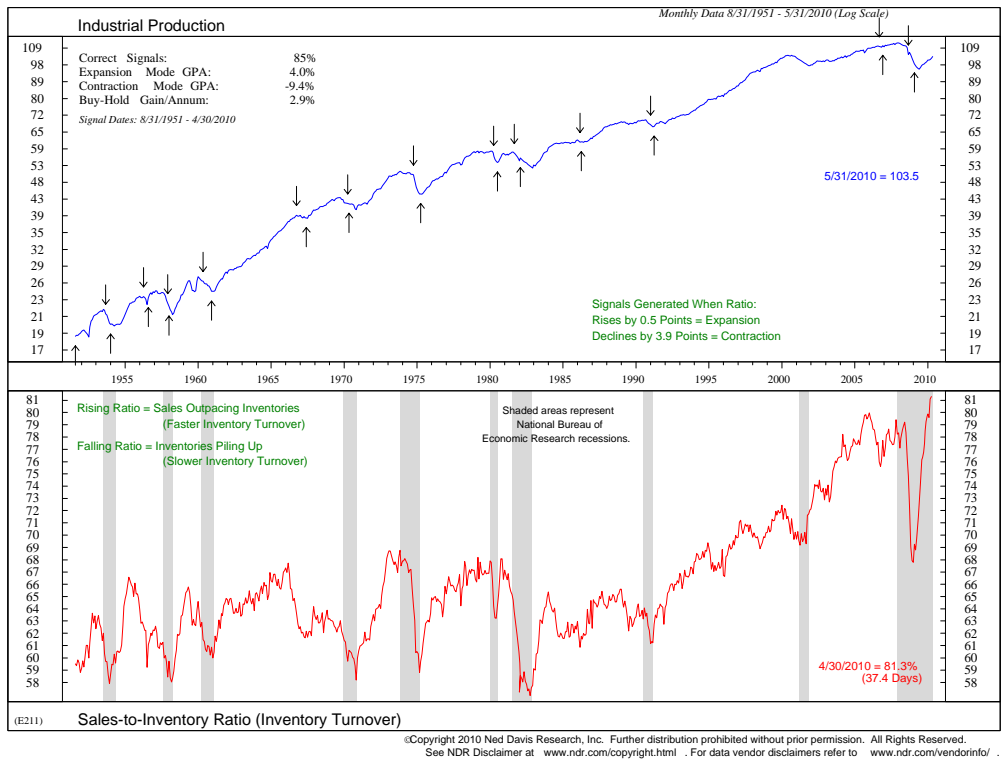
I've said repeatedly that GDP growth in the second half of this year will be challenging in the U.S. but would probably remain positive, and that if there is a "double dip" that it is a 2011 story. Unfortunately, the stock market isn't at all about today but rather about how things will be six months to a year from now, and although we've got some challenges coming at us, I'm not convinced that they are conclusive.

The June PMI shows a similar pattern to what we're seeing elsewhere in the world, slowing but still positive growth, as PMI falls back to a respectable 56.2.



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More encouraging is the inventory to sales ratio.



As one can see in the bottom clip, final sales are still outpacing production, so there is room for further production expansion. Only in the last month have customer inventories recovered from a record low. So it is unlikely that this element will contribute to an economic pullback.

The employment front remains challenging and slow to recover, as it did initially in the past two recessions.

Regardless, employment is increasing, albeit at a very slow rate. On this front, the most encouraging statistic is the hours worked per week. Although last month was down modestly, in each of the three previous months there was a 0.1 hour improvement in hours worked to 34.2 which is equivalent to 315,000 jobs.

Furthermore, we are seeing a huge profit recovery which should lead to business expansion and further hiring.

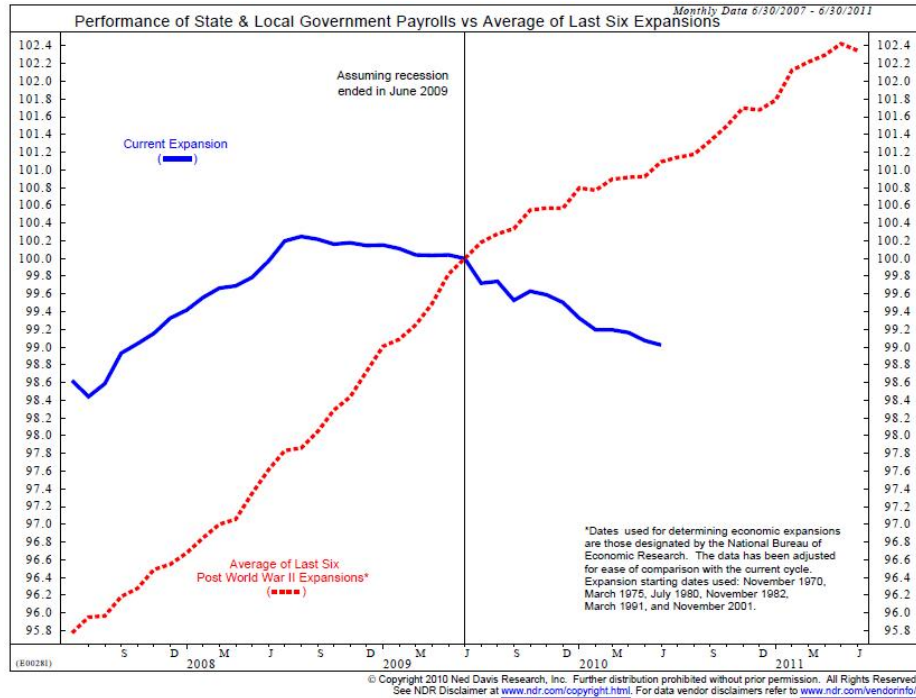
Finally, monetary policy is going to remain very accommodating while interest rates continue to fall. Although there is little left to come from fiscal policy, the U.S. still has the option to monetize its debt (i.e. quantitative easing) and eventually, I believe, they will experience the benefits of a lower currency.

The negatives that have to be overcome in the U.S. are:

1. The expiration of the mortgage tax credit at the end of April resulted in a lot of home purchases being pulled forward resulting in a collapse of 36.3% in new mortgage applications in the first three weeks of May. Mind you, not all of this affects home construction as this program also covered existing homes. Nonetheless, we will have to be vigilant to some recovery in housing sales going forward.

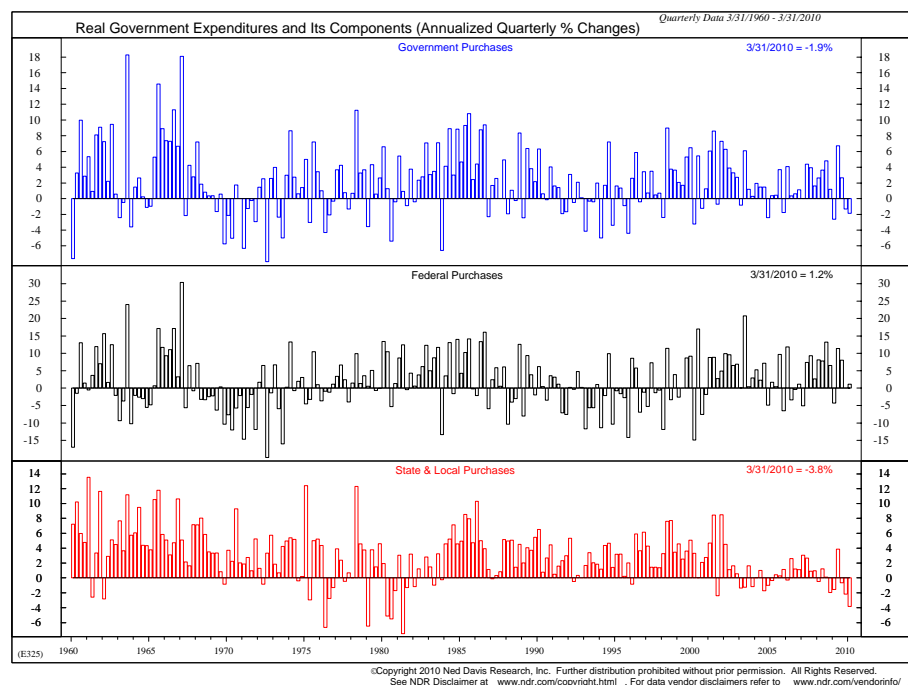
- The next big problem on deck for the U.S. will be the resolution of state and local budget deficits. 45 out of 50 states begin their fiscal year budgets in July. Not unlike some of the Euro country members, these states will have no option but to cut spending in order to balance their budgets. Ultimately, the Federal government is going to have to come to their rescue.

Collectively, the states are facing budget shortfalls of nearly \$300 bn for 2010 and 2011. Plus there are hundreds of billions more in unfunded pension obligations.



As can be seen in this chart, the process of cutting expenses is resulting in employment cuts just as the U.S. needs more jobs.

State and local purchases have also fallen the most since 1982 as seen in the bottom clip of this chart.



The details by state are less important than their overall impact, but the headlines are only now turning to the next "onus" that will cast a further shadow over the recovery.

3. And lastly, there is the ongoing deleveraging by consumers that will dampen consumer spending. Although this issue is going in the right direction, it is likely a multiyear resolution especially with tax increases likely next year.

And finally, what about China? Again June's PMI declined from 53.9 to a still healthy 52.1. It is well established that their government wants to cool the speculative increases in housing prices but it is highly unlikely that they will risk sending their economy into recession.

The bear case for China is that excesses have led to "bubbles" that will soon be broken leading to an uncontrollable economic hard landing with all the contingent consequences to other economies and commodities.

I wouldn't totally dismiss their concerns, but I'd sure bet heavily on China remaining a growth engine for the world. That said, it's always good to know what the downside risk is.

In this regard, The Bank Credit Analyst attempted to quantify the impact on the world GDP of the Chinese economy collapsing from 10% annual growth to Zero.

To paraphrase this report, China accounts for about 8% of global GDP so a collapse would directly reduce global growth by about 0.8%.

China imported about \$1 trillion in goods and services in 2009. As a share of global GDP, this is not especially large at 1.8%. The U.S. and Europe, for example, export only 0.5% and 0.7% of their respective GDP to China.

The annual value of the imports that would be influenced by domestic economic trends is probably about \$750 bn or 1.1% of global GDP. Chinese import demand is about twice as volatile a GDP, so all things being equal, a 10% decline in GDP growth would likely reduce imports by 20% of \$750bn on \$150bn. Applying a generous spending multiple of 2.5, this implies that a severe Chinese slowdown would reduce global demand outside of China by about \$375 bn or 0.6% of global GDP. All together, global growth would decline by 1.4% on an expected 4% world growth. Not inconsequential, but not a death blow either.

Compare this to Japan in the 1990's, where the economy accounted for 14% of Global GDP. Between 1988 and 1991 Japan's economy grew by an average of 5% per year. In the next four years, this growth rate dropped to 1% yet there was no discernable decline in the trend rate of global growth during the 1990's.

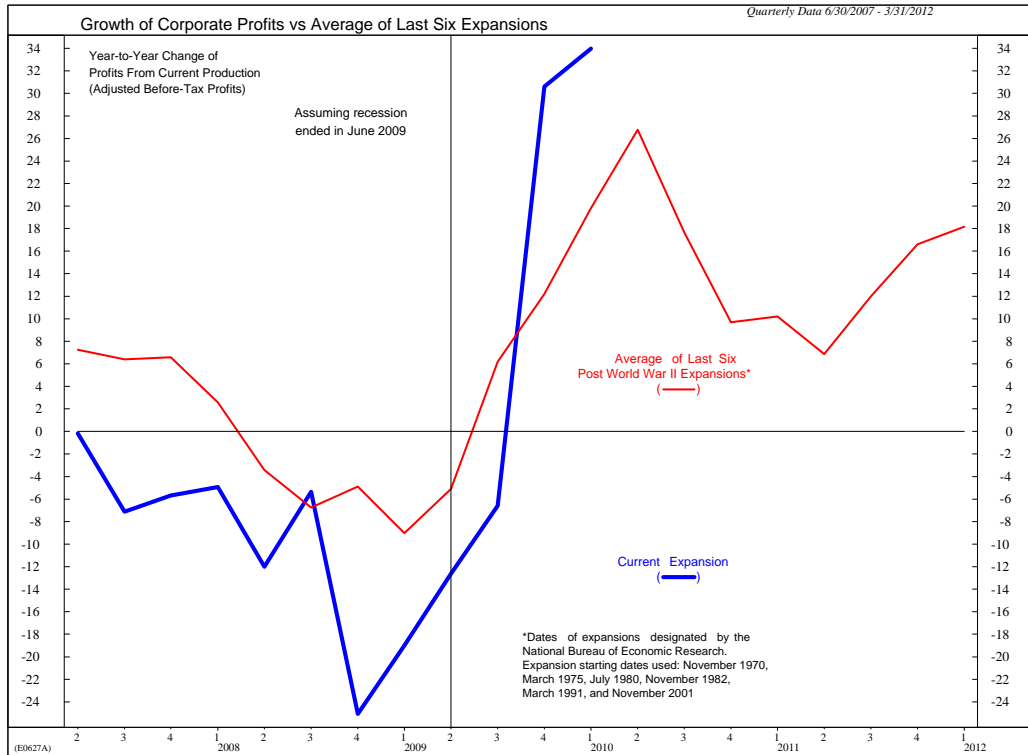
The point here is that the worst case may not be as devastating as the market seems to feel, and the likelihood of such an outcome is limited.

So, that's the big picture stuff that has the market worried. The trouble is economic predictions are notoriously inaccurate and the market will quite often do something quite contrary to what one might expect. In other words, the correlation between stock markets and economic growth is quite inconsistent and if anything inverse.

Although, it is important to have a view on the economy and, be assured, that if the current recovery seems to falter we will change our strategy, it is also very difficult to go out and buy 1,000 shares of economy. They don't exist, so sooner or later you have to look at company fundamentals which brings us to the "Micro Case".

Micro Issues

In the most general sense, corporate profits are doing exceptionally well as seen in this chart.



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As can be seen, corporate profits are performing better than average for this point in the recovery cycle. Year over year corporate profits are up 34%, the fastest pace in 26 years.

The S&P 500 earnings consensus estimates for 2010 is currently \$82.00 while the projection for 2011 is \$96.30. I have no doubt that this will be revised many times and probably lowered, although analysts have recently been too conservative. Regardless, if these numbers hold, the S&P is only trading at about 12.5 times this years earnings and 10.7 times next year's, which historically would be on the cheap side. So a lot of bad news is getting priced into this market and only falling back into recession would likely justify a much lower price.

At the company level, the anecdotal evidence for continued growth is pretty good.

Master Card - "There is what we read in the newspapers about debt crises and sovereign debt issues. On the other hand, if you look at volumes on the ground, cross-border volumes in Europe" are being maintained.

The CEO of Fed Ex Express – the largest unit of Fed Ex said on June 16<sup>th</sup> that the world's biggest air cargo courier has "seen solid growth in Europe." It hasn't seen a business slowdown in Europe despite recent

financial turmoil. Further, they said that shipments from Asia rose 41% and U.S. ground delivery volumes rose 7% in the quarter ended May 31<sup>st</sup> and expect inventory restocking to continue.

Texas Instruments - On June 8<sup>th</sup> said that the second biggest U.S. chipmaker hasn't "seen any changes yet in the demand out of our European region".

Societe General S.A. estimates that a 10% drop in the Euro would, after a year, typically boost economic growth as much as 0.7%.

Volkswagen A.G. Europe's largest car maker said on June 16<sup>th</sup> that the Euro's decline helps sales abroad and that operating profits and deliveries may rise "significantly" this year.

Club Mediterrance S.A. said on June 11<sup>th</sup> that summer bookings rose 18% in the previous eight weeks.

As a result, German unemployment fell in May twice as much as economists had forecast and the European Commissions Business Climate Indicator rose to the highest level in two years.

Oil consumption is another reasonable indicator. It's no surprise that new world demand through May hit new highs driven by demand in China, India, Brazil and OPEC. However, demand from the developed countries also, finally turned up after falling every month for the previous 22 months.

So, on balance it's an interesting challenge to reconcile the negative Macro views of many economists and the more upbeat comments and forecast of Global companies that are operating in real time.

### Strategy

The failure of gold to break out to a new high suggests that there is more concern about a global economic slump morphing into a deflationary, self-liquidating debt spiral than a Sovereign Debt Crisis. In other words, the sentiment seems to suggest that the 720 bn Euro salvage plan will at least defer, if not solve, the debt crises while government austerity measures will drag down GDP.

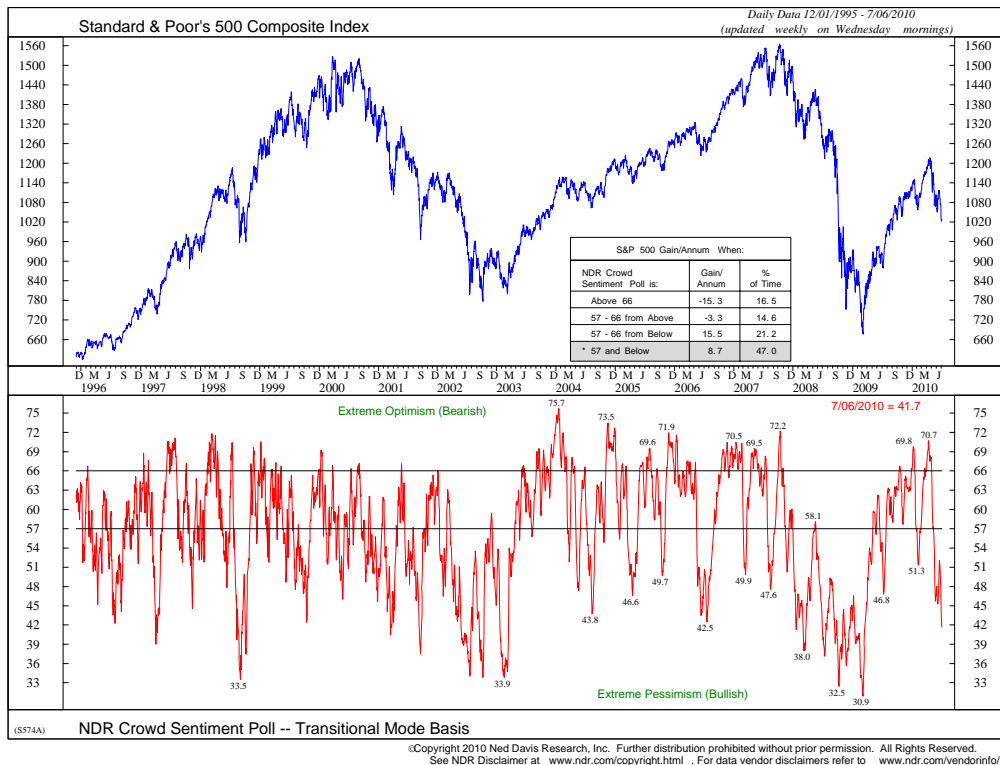
The likely outcome, in my opinion, is shallow and uneven growth where countries like Germany may do well with the help of a devalued Euro while austerity measures in some of the sicker countries, such as Greece, will cause a further decline in their economic growth.

However, I don't see this becoming a coordinated and all encompassing recession similar to the shock induced recession of 2008.

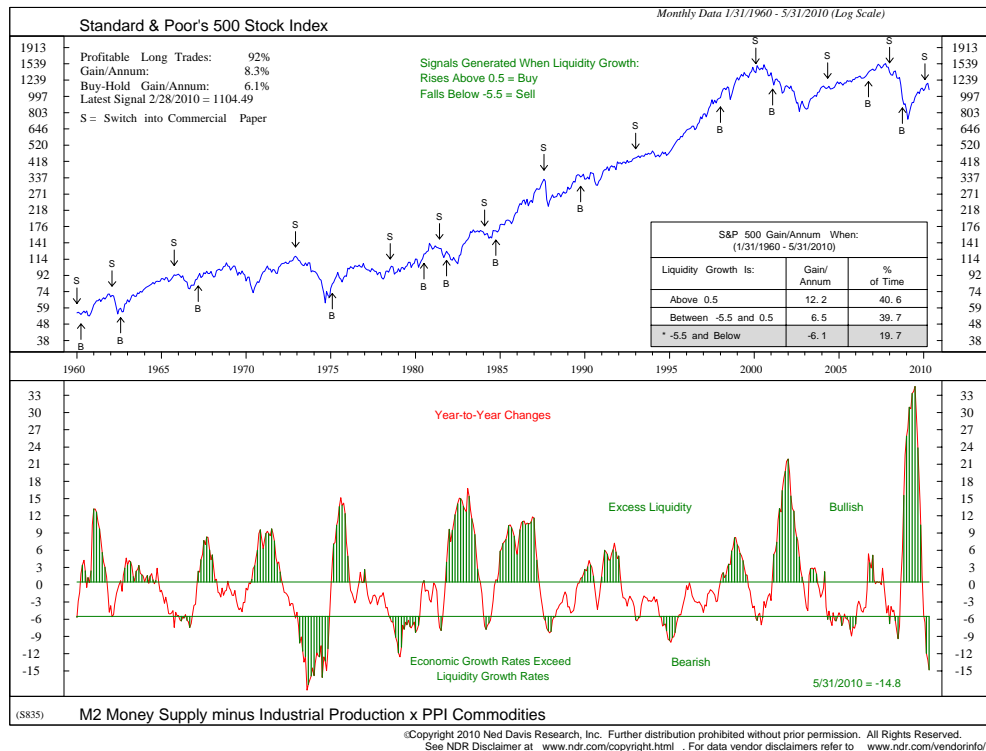
Overall, I would still go with a moderate global recovery driven by very strong corporate earnings and a continuing accommodative monetary policy which should be especially good for equities and their future valuations.

The current market correction in the U.S. is about 16% off the highs which isn't significantly different than the 13.7% average correction since 1945.

Market Sentiment, as seen in this chart, is very oversold and suggests that we could be setting up for a summer rally.



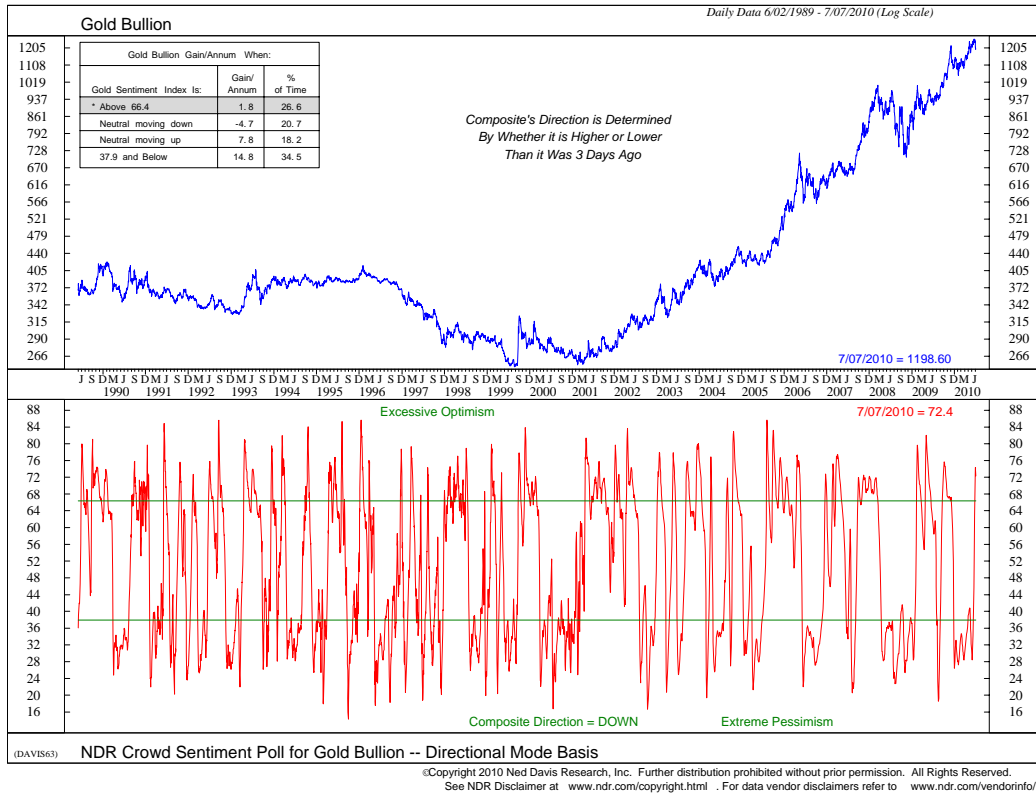
Liquidity is still an issue as the economy is strong enough to compete for surplus funds as seen here in the bottom clip.



However, this is mostly due to zero  $M_2$  monetary growth. Things would feel better if bank lending picked up, but there seems to be no demand for funding except from the government. Nevertheless, it feels like there is sufficient liquidity around and low government bond yields seem to support this.

Our strategy in this environment is to underweigh resources. Economic demand isn't likely to falter, but commodity prices have a hard time advancing after worldwide PMI indexes peak. So the exposure we have to resources is either through income trusts with high, maintainable yields or in energy service providers that could benefit from the Gulf of Mexico disaster.

We also hold a position in gold stocks as hedge, although in market parlance, it is a very "crowded trade". In other words, there is probably an excessive amount of optimism towards the metals as seen in this chart.



Otherwise, the emphasis is on high quality, dividend-paying stocks and companies that benefit from infrastructure spending in the U.S.

Other investments could best be described as special situations as to either the company's fundamentals or ability to withstand Euro issues or economic slowing.

Bottom line, I don't think we're doomed but there won't necessarily be a generally rising market trend to ride either. Stock selection will be the key as corporate earnings for appropriately positioned companies should continue to do well which is a lot easier than buying or selling "Economy".

GRC/amh  
July 4, 2010

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