

## Europe



Are you tired of reading about the situation in Europe and how it affects investing? I blog about it almost every day it seems. But, we have to give attention to it again because it is still the primary driver behind stock and bond movements.

The EU meeting starts Friday and will run through the weekend. So far, Merkel of Germany and Sarkozy of France have agreed in principle upon amending the EU treaties to put automatic sanctions into place for countries whose annual deficit exceeds 3% of their economic output (GDP). The sanctions could be over-ridden by a 2/3 vote of the members but these votes are weighted, presumably toward the larger countries.

While penalties for misbehavior are a good idea, the idea was enshrined years ago when the European Union was founded. That was ignored during 2008-10 because all the countries exceeded the maximum.

Automatic sanctions are a good step and it remains to be seen how tough they are and if they are defined at this meeting. It is also unclear as to whether they would apply to the 27 EU nations or just the 17 Eurozone nations (see my Sept. newsletter for the distinction).

It is very important to note that the disbanding of the Eurozone and its common currency would be devastating for banks and would bring great harm across the Eurozone. No one, not even the Greeks want the Euro to fail.



Here's why. Banks are required to hold a certain amount of assets in "risk-free" investments. The sovereign debt of developed countries has for many years been seen as in that category. In fact, the new bank standards set by the Basel III meeting require banks to carry a greater amount in risk-free assets and so they were required to buy more sovereign debt, much of which was of course European countries. But, such debts are far from risk-free these days. The banks after all just had to write down the value of their Greek government bonds by 50%.

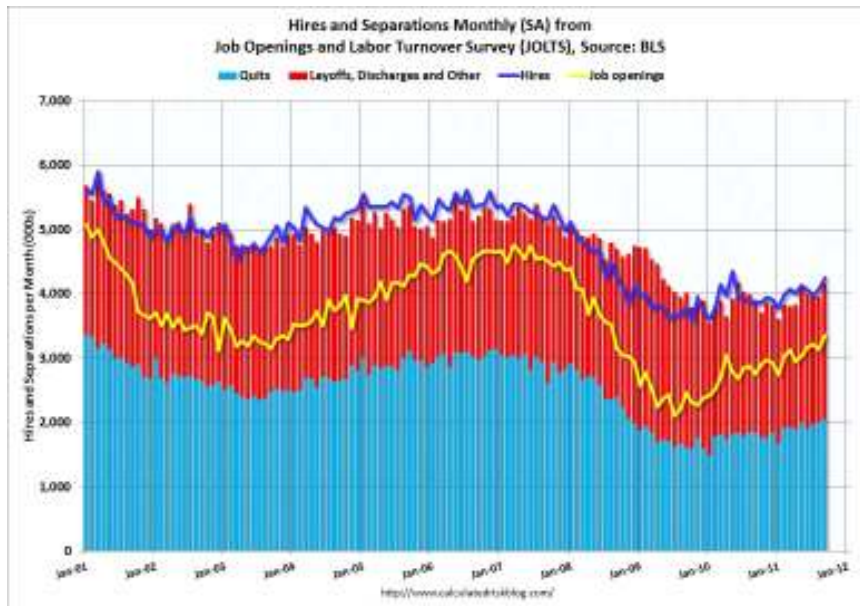
Thus, European banks among others have been selling European government bonds lately, dropping the prices on these bonds and raising the effective interest rates. In Italy's case the yields were over 7% last week.

Enter some strong-arming by European regulators to get their banks to stop selling these bonds followed by the announcement by several central banks including our own Federal Reserve that they would be happy to make as many dollars available to these banks as they like, all for a rate of 0.5%. Problem solved, apparently. Selling stopped and yields came down sharply.

European stocks have thus rebounded sharply the last week, as have bank stocks and many others.

## US Employment

Let's talk closer to home where economic conditions have been improving somewhat. Of course one major news story is the drop in the unemployment rate from 9% to 8.6% last month. However, as I wrote on the blog, the drop was mostly due to many unemployed dropping out of the group of people looking for a job. When they do that, they are no longer counted as unemployed and the unemployment rate drops.



The JOLTS report at left gives a more accurate picture of the job market. Look first at the yellow line in the 10-year chart above. Yellow is for *job openings* and you can see that is well on its way to better levels. It is at 3,400 and we want to see it at 4,000–5,000. Not there yet, but better.

*Hiring* is the blue line and that is also trending up. Good. We want to see it above 5,000 rather than the current 4,200. The fact that

openings are rising faster than hires has a lot to do with trouble finding qualified workers, engineers and oil workers, for example.

Last, notice that the trend in layoffs (red) is up and so is the trend in those quitting jobs (blue). Layoffs need to drop again. Overall, the employment picture is moving in the right direction.

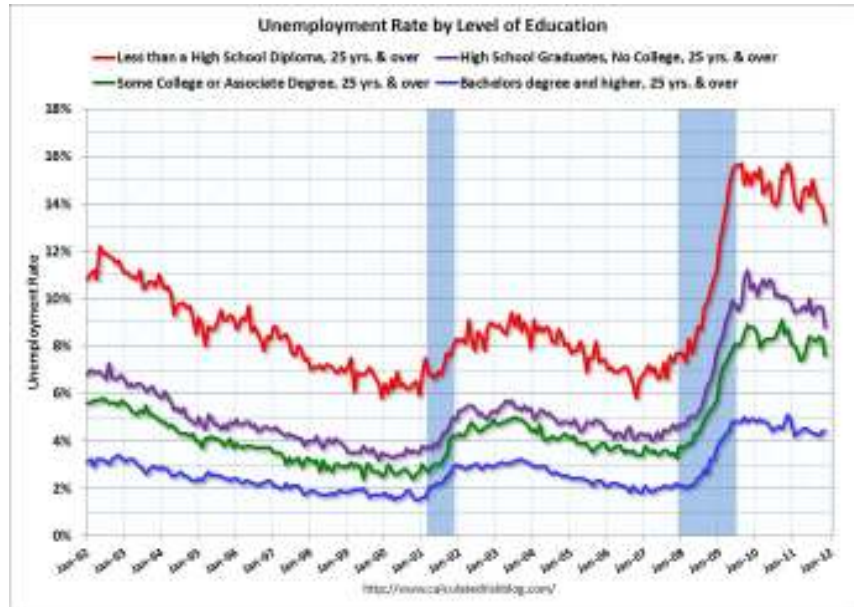
## College and Jobs



I want to show you two charts here. The first one at left shows how the cost of college is still rising but the earnings for graduates are flat to down since 2000. You can understand why graduates complain about the cost of paying off student loans. The average student loan balance upon graduation is \$22,000 – about the cost of a new car. My take is that many have learned excessive borrowing habits from their parents and don't properly count the cost before they take out the loans. Many should do what me and my kids did and that is to work one's way through school or go into the military and have it pay for college.

Source: BusinessWeek, [www.mybudget.com](http://www.mybudget.com)

The second chart is this one at right showing a good reason to graduate high school and complete college. College graduates have a rate of unemployment of 4.5% now, half that of the general population. The rate goes up for those with only some college, graduated high school and didn't complete high school. Source: *Check out —What's Your Kid Getting from College?* - WSJ November 11, 2011



### Consumer Spending and Wage Income Gap



Look at the chart at left. It shows consumer spending versus income from wages over the last 60 years. Notice anything? How about a huge and growing gap between wages and spending over the last 40 years?

How is it possible to spend more than one earns at work? Let me count the ways. There is always a gap because people:

1. Draw down savings
2. Inherit money
3. Make profits on investments including homes or stocks
4. Borrow more (credit cards, consumer loans, home equity loans, bigger mortgage)
5. Get more money from the government

All of the above explain the gap but the biggest contributors have been increasing debt and increasing money from Uncle Sam. Personal debt charts I have shown here many times.

Payments from the federal government now account for 12% of all personal income in the US. That has more than doubled in the last four years, up from 5%.

Closing this spending / wage gap must come from either:

1. Lower consumer spending
2. Higher wages

Otherwise, the only ways this gap can keep going are more money from Uncle Sam, more inheritance, more borrowing or more profits, the same things that opened up the gap. More people going to work and more training for jobs in demand is the best way to make this up.

## Stock Market

Stocks are historically underpriced right now based on a number of factors. One is profits. Below is the correlation between operating earnings (blue) and stock prices (red). The gray bars are recessions. There is almost a 90% historical correlation between profits and stock prices.

### **S&P 500 Operating Earnings per Share Compared to S&P 500 Index, 1986 -2011**



Source: Ned Davis Research

You can see that the main exception was in the late 1990s when the stock market (red line) got, shall we say, a little ahead of profits. However, the high correlation between the two was rather quickly re-established by the market decline of 2000-2002.

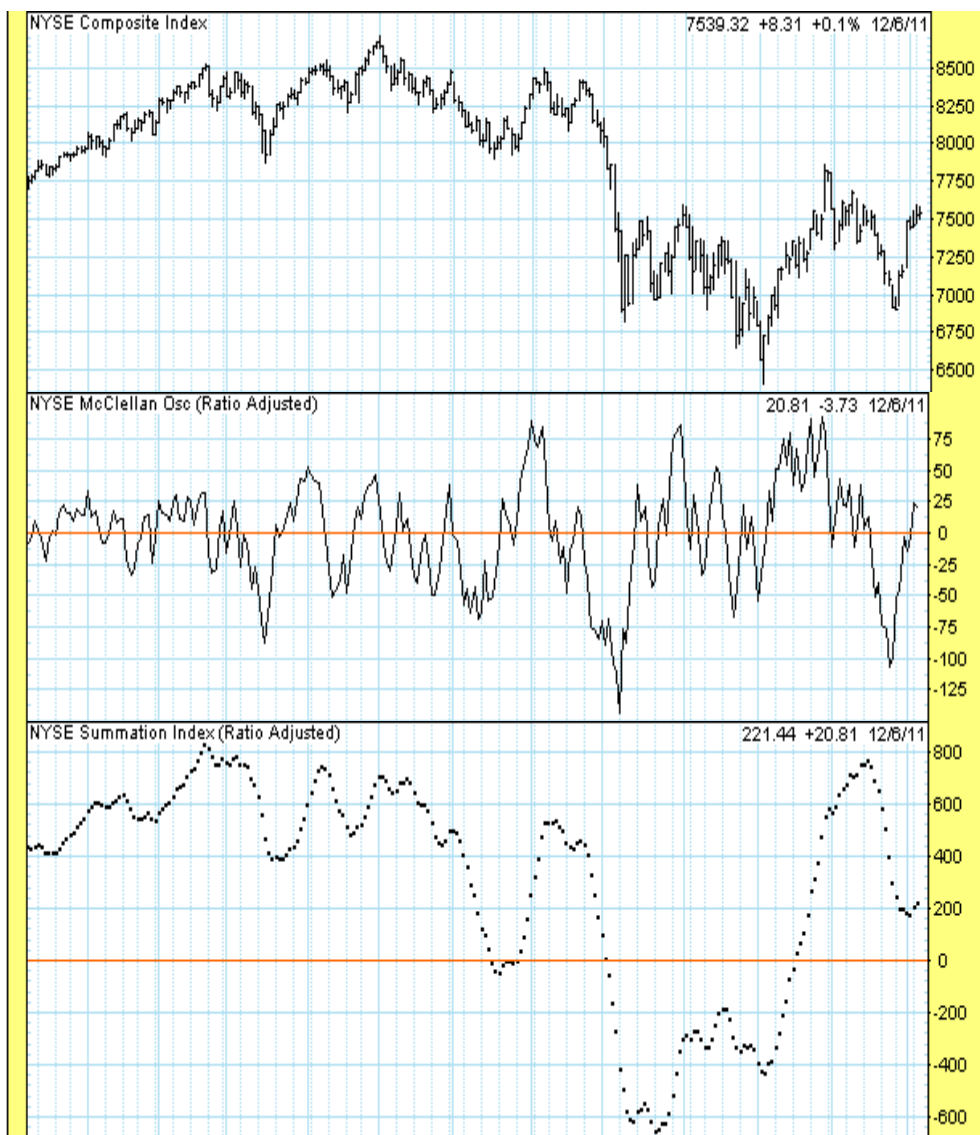
Now, however, there is again a significant gap, only this time profits are well ahead of stock prices. This shows up as the low price/earnings multiple (P/E) the market has now. So profits are coming down or stock prices should go up., probably both – recession in Europe and a slowdown in China, both underway, may reduce profits of multinational companies and stocks should go up.

## Stock Market Chart Lesson

Below I have shown three panels. The top represents stock prices, the middle is a measure of momentum and the bottom is a trending indicator.

The McClellan Oscillator in the middle, a big, scary sounding term shows whether the market is “oversold” or “overbought” or in-between. It moves at the same time as stocks so it doesn’t predict direction but it does tell you how extreme a market move has become. Extremes are usually worth acting on for long term investors.

The NYSE Summation Index at bottom has been uncanny in telling when to buy or sell the last few years. You look for turns. You’ll never hit the exact top or bottom with this indicator but it will get you in or out a couple weeks afterward so again, it is for longer term investors, not speculators. Right now it is on a fairly recent buy signal.



Source: Stockcharts.com

Keep checking the blog at [www.CornerstoneInvestment.com](http://www.CornerstoneInvestment.com) . Some of what is written here first appeared there and I comment almost every day on the market or economy and sometimes politics. Every post is designed to put something in perspective for you.

There are lots of news sites, including the scrolling Wall St. Journal headline links at the bottom of my home page but not too many sites boil things down to give you an objective perspective on these topics, especially investing.

I hope this was helpful. If so, pass it on or the name and number of someone you think would benefit from working with me. Even after 27 years of doing this, I am still gladly accepting new business and it is much appreciated.

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