Stock Markets

Stock markets in most countries had a rough May again this year. I say again because 2010 and 2011 also had rough times in that month. Maybe they should change the old saw to “sell in April and go away” though without the rhyme it’s not nearly as catchy. And 2010 had a big summer rally.

For May, the U.S. S&P 500 stock index lost roughly 8% while Europe was down 12% and China was -14%.

That puts the U.S. market 5% ahead for 2012 (S&P 500) while Europe is down -5% YTD and China -3%. There’s nothing wrong with that pace for the U.S. stock market through 5+ months.

The drop in Europe puts the price/earnings multiple on European stocks to about 9. Single digit PE/Es are cheap but in big crises like we had with sky-high interest rates in 1982, the average multiple can get down to 6. Many European stocks have 4% and 5% dividend yields now, including quite a number of household names.

So, am I buying Europe? Not yet. I’m happy with our U.S. performance. That brings to me to a European update. Since such updates can be outdated within days I will try to focus on the longer term.

Europe

Some people may be tired of hearing about Europe but really Europe is the main thing affecting our stock and bond markets again this year, with our economic slowdown a close second and a big reason for the slowdown is slowing economies around the world, led by Europe. So, either way Europe is the main issue right now.

First, let’s look at European growth figures for last quarter. Here is a good chart from the WSJ showing the growth or contraction in these noteworthy European countries for 1Q/2012. As you can see, all are contracting except for Germany and it is only at 0.5%. The U.S. grew 1.9% during the same time.

Eurozone Crisis

Margaret Thatcher was a figure who dominated European politics in her day that overlapped Ronald Reagan’s two terms. Thatcher was prime minister of the U.K. for 21 years, the longest tenure in the 20th century. Art Cashin reminded viewers of CNBC the other day that P.M. Thatcher once called the Euro currency (not the European Union) “the greatest single folly of the modern era.” Britain still does not use the Euro.

It is instructive to hear why Ms. Thatcher thought the Euro foolish. According to an article that I encourage you to read at http://voices.yahoo.com/margaret-thatcher-predicted-eurozone-8931341.html

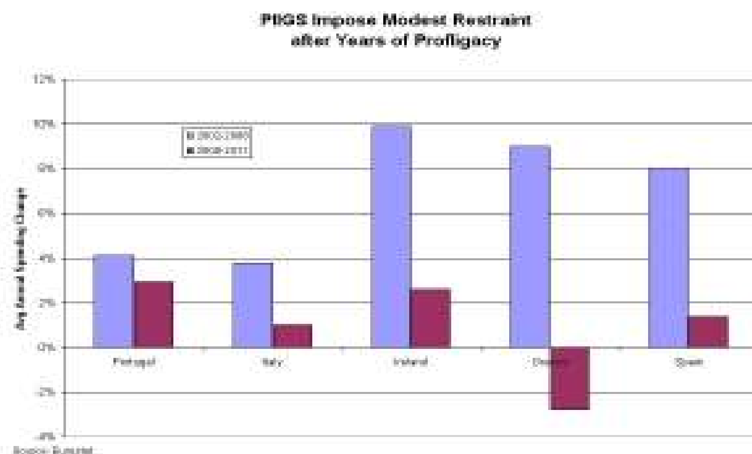
> "Thatcher suggests the Stability Pact, imposed by Germany was '*a condition for allowing economic basket-cases into the euro*.' She explains how European countries giving up their own currencies means they are no longer able to have their own fiscal policies to match the conditions in their own country. She suggests financial policies that are set by the European Union cannot accomodate [sic] differences between different European countries. Thatcher predicts this inflexible policy leads to problems in all countries and economies in, and connected to, Europe . . . '*The power is essentially political, rather than economic. [...] The* real *reason why there can be no functioning pan-European democracy is because there exists no pan-European public opinion.*'"

While "the greatest folly of the modern era" is stretching it, the realization of the challenges the Euro would entail were right on the money. Thatcher was way ahead of her time. While many people envision a United States of Europe the differences in lifestyle, worldview and attitudes toward corruption, spending and especially government spending differ far more greatly between European countries than between U.S. states. Plus, there are very strong national identities that dwarf the differences between the various states in the U.S. While these can withstand operating as a free-trade zone it is questionable whether they can withstand a single currency when stresses become great.

<u>Three Choices for the Eurozone</u>

European leaders are beginning to realize the severity of these difficulties. There are really only three choices for the Eurozone.

Option 1 – The one they have picked so far is the middle choice. It is for Germany, Finland and the Netherlands to keep bailing out the profligate nations. Germany is by far the largest of the stronger nations. The question on this road is whether or not there is a bottom to this money pit. As the Mediterranean countries cut the growth rate of government spending and raise taxes their economies shrink, hurting tax revenue and employment. Except for very minor changes, none have dealt with the crippling red tape, regulations and restrictive labor laws that hamstring businesses trying to be competitive in the world market. Greece is completely uncompetitive except for shipping; Italy could really stand a lot of improvement, as could France and Spain.



Notice, I said "cutting the growth rate of government spending. Despite the characterizations of austerity by politicians and the media parrots, words like *brutal* and *extreme*, <u>only in Greece has the annual growth in government spending during 2008-2011 actually gone negative</u>. Yes, according to the chart here from the highly respected British

magazine, *The Economist*, troubled southern European governments have continued to grow their spending during 2008-2011, just at a slower pace that is a little above the inflation rate.

Nor is loan after loan the right medicine, anyway, just a stalling tactic. It is not an antidote but is more like much a drug that prolongs a poor quality of life and does not cure.

All this borrowing as an attempt to solve a debt problem reminds me of a favorite Will Rogers quote, **"If stupidity got us into this mess, why can't it get us out?"**

Let me rephrase it for today, **"If overspending and escalating debt got us into this mess, why can't they get us out?"**

It's the lure of the rich uncle bailing out the ne'er-do-well. Another example is the person way over his head in credit card debt. The wrong solution is to loan him more money and tell him to be sure to not spend less than last year lest he anger his family. This sorry advice applies even more aptly to the Obama Administration, champions of pushing more spending as the road to fiscal health, but I am not going into that this month. I have written plenty on it the last two years. At least in Europe they are trying to cut down the growth in government spending rather than increasing it ala the U.S. But, even in Europe I think the era of bailouts may be close to ending. Like big government spending projects the cost is far higher than was originally thought. Before long Germany may bail rather than bail out.

Option 2 – tighter fiscal (budget) control over all the Eurozone member counties by a Eurozone leadership in Brussels that is dominated by the Germans. This idea is what people mean by fiscal union. Picture U.S. states needing to have their budgets approved by the federal government. A better picture would be the states going to Canada for budget approvals.

Option 3 – allowing troubled countries to drop the Euro in favor of their own currency, whether the drachma, the pesetta or the lira. Formerly, when countries around the world got into financial trouble they couldn't get out of they defaulted on their debts and devalued their currency, getting them out of debt and returning to being globally competitive via low currency exchange rates that make their good much cheaper for overseas buyers. Argentina is a case in point. In Europe, this would be a partial unraveling of the European Union.

And, the answer is --- a) bailouts of Spanish banks, hoping that Italian debt yields would come down if Spanish yields did and b) letting Greece exit the Eurozone and go back to the drachma.

Greece deserves to go. They got into the Eurozone by falsifying their government financial reports and hiding debt. Then they took advantage of low interest rates for Eurozone countries to pile on more and more debt, completely in violation of the treaty rules, without any major reforms and with rampant tax cheating. Since 2008 they have repeatedly pressed Germany for more money. Cheating on taxes is widespread and true reform has been small compared to the money they have received. Greece probably is a bottomless pit. Germany and the other countries will let Greece go and hope it is an isolated case.

China & Emerging Markets

Chinese growth reports are manipulated but it appears that China has slowed to little or no growth as well. The same goes for India and Brazil. Those three countries are taking steps to get growth moving again. China is mandating more lending while Brazil and India are cutting interest rates in a big way. They have what we would call rather high rates still but consider that they are dealing with inflation while we have relatively low inflation right now. I am keeping a close emerging markets as a possible investment opportunity.

United States

At home, the U.S. is following the pattern of the last two years, which is good economic numbers in the 3Q and 4Q, followed by poor numbers in the 1Q and 2Q. Remember that there is a lag when reporting economic numbers, whether for the prior month or the prior quarter so good growth in the 3Q for example doesn't get reported until the 4th quarter.

Last year business-related effects of the Japanese tsunami had a lot to do with the poor growth here. But, the slowdown was felt throughout the remainder of the year. Growth started to look better in the fall despite the parts shortages. A reacceleration of economic growth in the U.S. is unlikely as long as the rest of the world is in or flirting with a second recession.

The stock market is also looking closely at the election. The vote to keep Scott Walker in office as Wisconsin governor after he went hard after the high costs of unionized government workers may give candidates more confidence in cutting such costs, and they do need cutting in many states. California, a democratic stronghold also passed referenda on cutting the benefits for unionized government employees.

As far as the presidential election goes, things should get hopping again with the summer conventions. Whether President Obama gets reelected depends primarily on the economy over the next five months.

Investment Update

Over the summer we will continue to have a bumpy ride. However, as soon as we get an announcement with respect to a Spanish bank bailout which seems imminent I expect stocks around the world to rally. Accordingly, I have raised stock allocations back to normal.

Emerging markets have a close connection with other world economies but emerging markets is an area I think could be attractive. I also like emerging market bonds for clients that can stomach the volatility. Usually, I use PIMCO's emerging market bond fund which hedges away the currency risk. Loomis Sayles Bond Fund also tends to have emerging market bonds but as part of a diversified portfolio.

Our bond funds have done well this year, generally up anywhere from 3% to 5% for the five months. Those are not annualized numbers. Most stock funds are roughly similar in return YTD with the more aggressive funds returning more than the conservative ones by a good bit. The gap between the two has narrowed on the May decline but aggressive funds are still ahead. How much you have of each group depends on your risk tolerance. The MLP fund is the only negative for the year and that is in sympathy with oil which actually has nothing to do with the profitability of MLP pipelines whose income does not vary with the price of oil. MLPs just get sold with energy stocks which are down on the lower price of oil. MLPs could do very well if oil prices keep from sliding farther. Wells Fargo Advantage Growth has been our best stock fund this year, up nearly 10%.

I have added to our small position in natural gas through UNG. I did that just recently as the price of gas came down. Most accounts have a 5% position and I expect to raise that to 10% opportunistically. I have also added the T. Rowe Price Health Care Fund to some portfolios and added to Janus Triton. I have trimmed back Sterling Equity Income in some accounts.

We continue to avoid international markets for the most part with some aggressive clients having positions in emerging market funds. We may add to international holdings shortly, probably Harbor International Fund for emphasis on Europe and Thornburg Developing Countries in emerging markets.

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