

From: US GIO <[REDACTED]>

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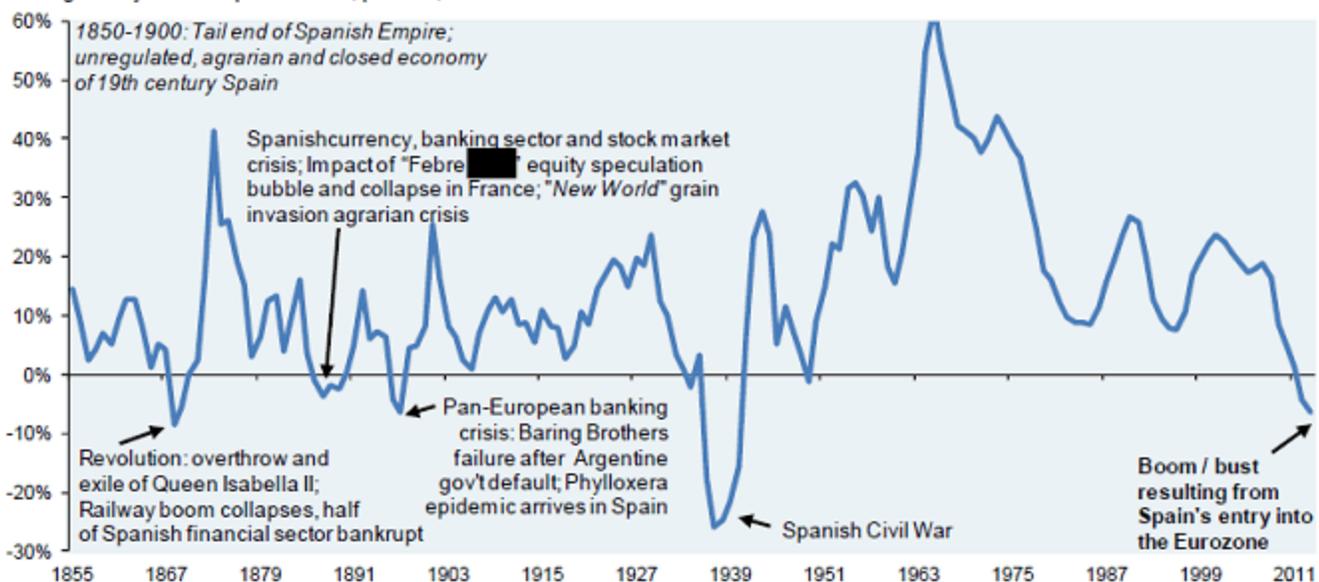
Eye on the Market, October 1, 2012

Topics: Spain, France, the US and other places where Central Banks have propelled equities ahead of the facts on the ground

Confidence Men. There are charts at the back showing the collapse in retail sales in Spain, along with surging unemployment, bankruptcies and non-performing bank loans. But to do justice to the situation, you've got to put it in context of the last 150 years. **Spain's adventure in the Eurozone has sent it into an economic tailspin the likes of which have not been seen, with the exception of the Spanish Civil War, since the 19th century.** At that time, the Spanish empire was at the tail end of its colonial decline [a], and was an under-regulated, agrarian, closed economy subject to frequent crises. The chart shows the details, highlighting the economic declines during revolutions, depressions and agricultural epidemics. Spain's recent decline has now matched them.

Taking stock of the Euro on the Iberian Peninsula: Spain's economic decline in the context of the last 150 years

Change in 5-year real Spanish GDP, percent, since 1850



Sources: "Statistics on World Population, GDP and Per Capita GDP", University of Groningen; Standard & Poor's; Conference Board; Universidad Carlos III de Madrid, Departamento de Historia Económica e Instituciones

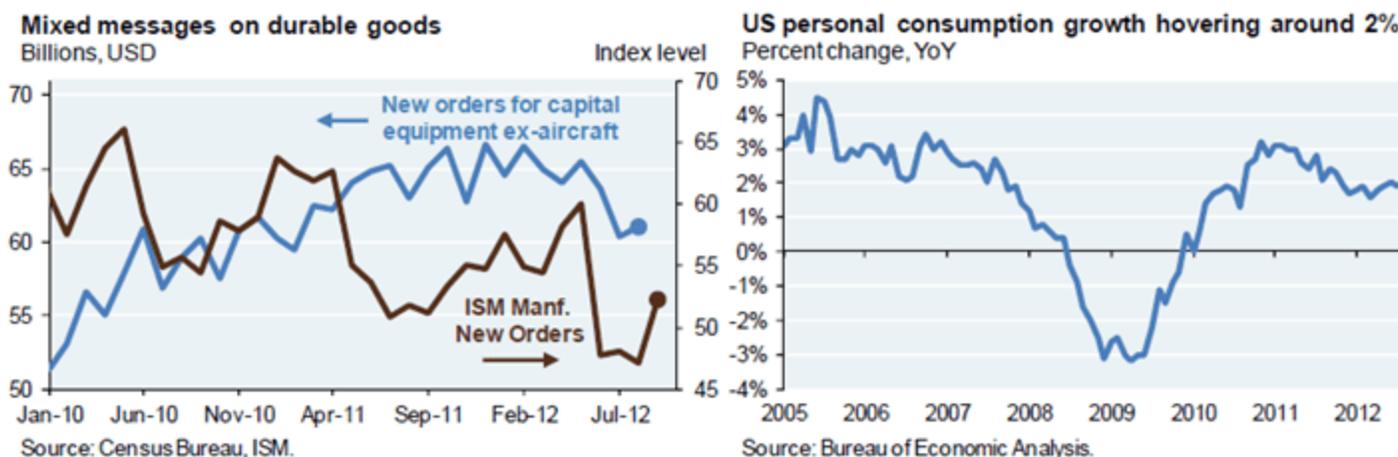
From a markets perspective, the direness of Spain's situation is no secret, and forced the ECB to announce measures in July to restore confidence and prevent default. Unlike Argentina (cited recently by the IMF for the creativity in its published economic data), the situation in Spain is visible through public and private sources. After ECB sovereign bond purchase and bank recapitalization measures were announced, markets rallied and now view Spain more optimistically. After being down 30% earlier this year, the IBEX 35 index is only down 7%. Spain's P/E multiple on current earnings is around 14x, but falls to 10x using consensus earnings estimates for 2013, the implication being that Spanish earnings will grow by 41%. On a price/book basis, banks like BBVA and Santander now trade closer to book value (0.8x). The bottom line: while the situation is terrible, **markets are pricing in hopes that the ECB's Confidence Men will bail everyone out until Spain recovers.**

How realistic is that? Eventually, epidemics and panics come to an end, usually through some combination of currency devaluation, default, inflation, and declines in domestic wages and prices. If Spain is going to try to achieve economic

balance primarily through the latter, the situation still looks pretty bleak. What about sovereign debt? Our analysis suggests that Spain may have to issue another 80-90 billion Euros in sovereign debt this year. Let's assume that Spain formally asks the ECB to buy some of it through a rescue program. Piggy-backing on the ECB and buying short-term Spanish debt makes sense if you believe that the ECB will honor its pledge to treat itself on a pari-passu basis with the private sector, which the ECB did *not* do in Greece **. An investment in Spanish government bonds is effectively a view on the credibility of the ECB, the durability of the European political status quo and growth prospects in Spain under austerity. Buena suerte.

[** Private holders of Greek debt took losses while the ECB did not. ■ Morgan Securities argues that since so many bonds are now owned domestically in Spain after massive capital flight, the incentive for the ECB to impose losses on private sector debt holders who are mostly Spanish is diminished. **Isn't it great to know how central bankers, politicians and the IMF really feel about your bond contract?]**

The US is another region where Central Banks have rebuilt market confidence at a time of weak economic data. In the US, the negative surprise of last week was durable goods for July/August, a report which tracks business spending on capital equipment and other long-lived assets. It's a *very* volatile series (even ex-aircraft), but the summer decline was sharp. The good news: today's ISM survey for September reverses some of the concern about the drop in durable goods orders. The messages are mixed; we'll have to wait and see how the election and fiscal cliff issues affect business confidence and spending in the months ahead. Business spending has been a large contributor to growth since 2009, but negative earnings revisions on capital equipment companies and weak surveys from the NFIB and The Business Roundtable suggest it may be fading. Housing is staging a modest recovery, and if Fed stimulus manages to jumpstart consumer spending, that would more than offset the weakness in business capital spending. However, that would take a turnaround not yet visible in the data: personal consumption grew by less than 2% in Q2 2012, and the impact of the fiscal cliff, however it's handled, hasn't hit yet.



That US growth is weak is not a surprise; the Fed would not have rushed its QE-forever policy into place just three months after "Operation Twist" if US growth were in good shape. What's notable is that the Fed convinced US equity markets that it's going to work: the S&P is now up 17% for the year, with the NASDAQ up 21%. As we showed last week and as summarized in the table below, weak-economy equity rallies have had a good track record in predicting a subsequent recovery. **If the latest one is right as well, it will be the triumph of the Confidence Men:** the ability to get the markets to act as a discounting mechanism, ignoring the way things are and focusing instead on how they might change.

Subsequent 2-year equity return and PMI change following periods of rising equities and low/falling PMIs

Subsequent 2-year			Subsequent 2-year		
Date	Equity Return	PMI Change	Date	Equity Return	PMI Change
Jan-61	2.1%	13.3	Jun-89	22.6%	-2.8
Mar-67	8.8%	11.7	Jan-91	26.7%	15.0
Sep-70	31.9%	17.6	May-95	50.2%	7.0
Jan-75	39.6%	25.9	Feb-96	50.1%	8.1
Jul-80	-9.9%	3.3	Dec-98	4.6%	4.5
Mar-85	57.3%	4.8	Sep-12	???	???

Sources: S&P 500 and US PMI index until December 1997; MSCI World Equity Index and Global PMI thereafter. Morgan Securities LLC. A PMI above/below 50 denotes an expansion/contraction.

Manufacturing in China and Japan: weak
Percent change, YoY



Source: China National Bureau of Statistics, ISI Group, Ministry of Economy, Trade & Industry.

More or less the same story in China, where equity markets rose last week despite continued declines in industrial profits. Markets appear optimistic about government stimulus plans over the next 4 years, mostly on infrastructure. When Chinese fiscal deficit projections are combined with announced stimulus plans, the total is around 3.5-4% of GDP. That's around 30%-40% of the stimulus which took place in 2009 and 2010. In other words, **the amounts are material if they are actually spent**. In Japan, where exports, production and growth are weak, the Bank of Japan may be moving towards an explicit inflation target of 2%, although there have been rumors about this kind of thing since 1990-something. Japan has already tried, in 1999 and in 2009, to jumpstart consumer spending through the distribution of shopping vouchers with 6-month expiration dates.

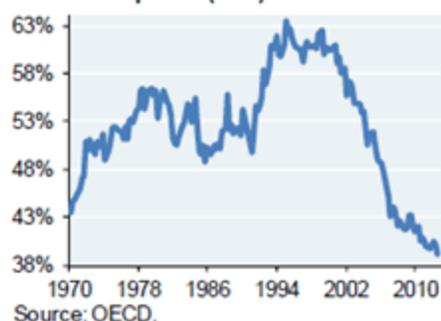
Overall, the world's Central Bank Confidence Men have their work cut out for them. Global equities have risen sharply this year, but continued improvement in growth and employment conditions will be needed over the next few months to justify the rally that has already taken place. The good news is that there is plenty of "ammunition" in the form of idle cash balances held by corporations, households and sovereign wealth funds to propel a stronger global economy. As we noted a few months ago, if corporate cash and leverage were to return to their 1996-2009 averages, S&P non-financial firms would have \$1.4 trillion dollars available for [redacted] and shareholder distributions.

One last thing: as shown below, the situation in France is deteriorating markedly, which bears watching. While French equity markets are up 12% this year, it does not seem to be a function of French manufacturing, exports or employment conditions, which look bad and are getting worse. One thing's for sure: France will be an interesting litmus test for the success of redistributionist tax policies to solve deficit concerns at a time of low growth. Hollande's latest budget calls for a whopping, retroactive 62% long term capital gains tax rate (all-in, including Sarkozy and other social taxes), one which applies to capital gains above 150,000 Euros. Robin Hood used to target the ultra-rich, but in France, he has apparently lowered his sights. If Spain is any guide, these policies may simply lead to lower growth and little net improvement in France's budget deficit.

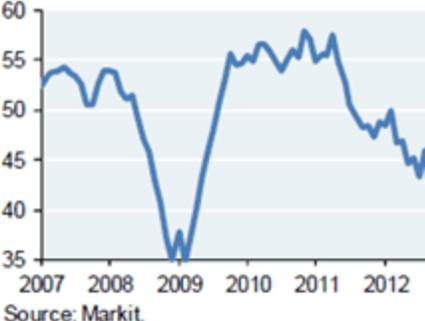
Michael Cembalest
Morgan Asset Management

That obscure object of desire: stronger growth in France

French exports as a percent of German exports (real)



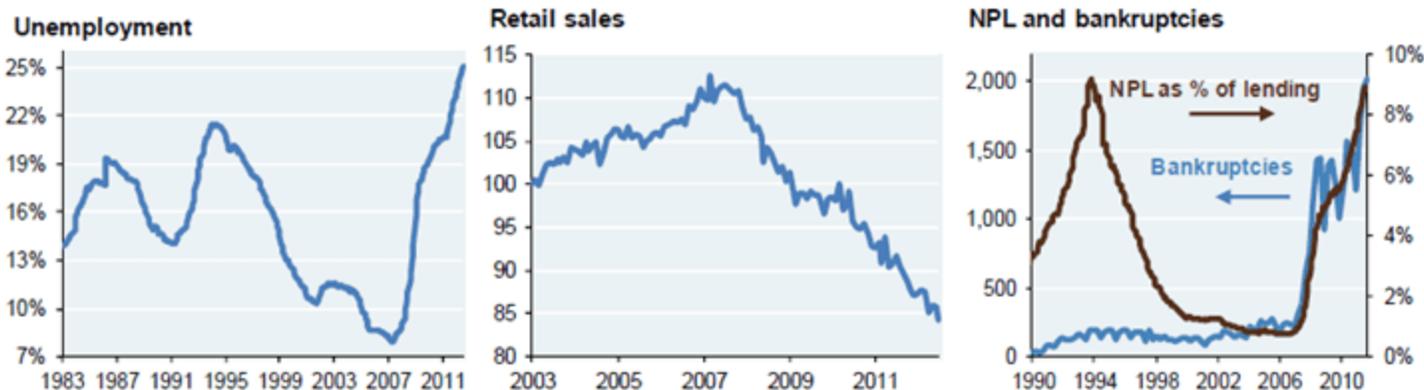
France Manufacturing PMI Index, sa



Unemployment rates
Percent



Appendix: Spain



Sources: Statistical Office of the European Communities, INE, Bank of Spain, Morgan Asset Management.

Notes

[a] At its height, Spain controlled parts of what is now the US, Central America, South America, the Caribbean, Italy and the Philippines. While the rest of Europe benefitted from urbanization and the industrial revolution, Spain stagnated, with per capita GDP in 1850 not much higher than it was in 1350. By the end of the 19th century Spain's empire was gone, other than its presence in the Spanish Sahara.

Sources include

"Financial Crises and Financial Reforms in Spain: What have we learned", Pablo Martín-Aceña, Ángeles Pons and Concepción Betrán, Universidad Carlos III de Madrid, January 2010

"The rise and fall of Spain, 1270-1850", Carlos Alvarez-Nogal and Leandro Prados de la Escosura, Universidad Carlos III de Madrid, 2012

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