

MARKET INSIGHT REPORT

Micro Booms, but Macro Slump

July 15, 2010

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This week, the US equity market is starting its quarterly earnings ritual and the odds favor a strong performance for the closely followed investor favorites. Although the game is rigged as almost 50% of the corporate managements have adjusted their guidance in the past month trying to lower analysts' projections down to levels that the companies know they can beat. Despite the *opera buffa* quality of the process, the S&P 500 companies will still produce a dramatic increase in earnings over the second quarter of 2009. The same can be said of the major European corporations. The increase in corporate earnings and the projection of further increases seems to be universal, and many argue that the positive outlook for thousands of individual companies must sum to an impressive economic recovery. Despite these positive micro stories, they do not add up to a happy macro outcome. There are several reasons why this is the case, but the result is that the vast majority of the analysts that examine individual companies are bullish and almost all of the macro analysts are bearish, many like us, and dramatically so.

There is a very large segment of the US, Canadian, and European economies that is not part of the global equity system and this major fraction of the economies is not doing at all well. Even if the optimists will retort that moaning about the depressed readings in the National Federation of Independent Businesses (NFIB) reports, the collapse in bank credit, and the sharp decline in the ECRI leading indicators are nothing but anecdotal examples, they should carry at least as much weight as the positive earnings numbers. These smaller businesses represent the lion's share of the internal and retail economies, while the giants represent almost all of the export and global part of the economies. The slowdown in the non-S&P sector of the economy is actually reflected in the sluggish increase in the major companies' top-line revenue, but the tight cost controls that have allowed their reported earnings to keep climbing has exaggerated the decline hitting the independent businesses. The shrinking cost of goods at every Fortune 100 company represents the top line sales of many smaller companies and the take-home pay of thousands of employees. Because nominal GDP is growing more slowly than the outstanding national debt is compounding, it is becoming a more oppressive weight on the "non-S&P" economy, tightening the financial position of small businesses and the consumer.

The macro pessimists actually have academic research firmly on their side. Just two points must suffice here. Keynes famously noted that there was a savings paradox. As I would paraphrase it, if one family saves, it is good for the family, but if all families save, the economy will be ruined. This is happening everywhere. The S&P 500 companies are all saving, by cutting costs – and building giant worthless cash mountains (like they did in the 1930's) – but this is shrinking nominal GDP as their saved costs are others' lost earnings. The global economies are all trying to grow by increasing exports, which is the same as saving. If there are no countries stimulating consumption, the world economy will shrink. If all countries try to balance their fiscal books, they are clearly saving. The Eurozone, the UK, and the American states are dramatic examples of this. And if consumers build up their savings, we know what happens to retail sales and the GDP. On top of this the money multiplier comes into play. With the global banking system suffering under an extremely high load of worthless assets – whether recognized or not – and being forced to improve their capital allocation for risk by the Basel II and Basel III rules, banks must cut back the amount of credit that they make available to the economy. The multiplier will force global economies to shrink in the years ahead. Cash is now king, worthless or not, so buy dollars.



CURRENCY – Commodity Currencies Long-Term View

The Wonder from Down Under

By Jonathan Clark

For its performance during the financial crisis Australia has been nicknamed “The Wonder from Down Under”. The Australian dollar has been trending higher for the past five weeks and has regained nearly 60% of its losses from the peak in April to the low in May, but **from a quantitative perspective the AUD should be much lower.** The recent success of the Australian economy is largely dependent on the growth of the Chinese economy. The largest Australian exports to China are iron ore and coal.

The mining investment boom in Australia has boosted employment and during the second quarter jobs surged by the most in four years. However, iron ore prices have been trending lower and are at the lowest level of the year in China, while coal prices are 29% below their high in January. China’s State Council introduced a series of tightening measures in April to cool the overheated housing market and curb speculation, including tightened scrutiny of developer financing, higher down-payment requirements for second home purchases and suspension of loans for third home purchases. A slowdown of the Chinese building industry will lessen the demand for commodities and this is reflected in shipping rates. The Baltic Dry Index tracks worldwide international shipping prices of various dry bulk cargoes (mostly iron ore and coal) and has declined for 34 consecutive days. Commodity prices as measured by the CRB index have been trending lower since January. A combination of falling commodity prices and declining shipping volumes will have a very negative impact on the Australian economy, and earlier this week the Australian government reduced its GDP forecast for the current fiscal year. By our reckoning, this is all very negative for AUD/USD.



The Australian dollar is approaching our recovery target of the .8950 to .8980 area and the middle of next week is the most likely time for a peak. **We recommend using this expected strength to sell as following this peak the Aussie should turn lower and begin a sustained downtrend.** The support at .8650 must give way to confirm it is headed lower into September and the Aussie should fall to the .8075 area. The longer-term cycles call for this overall weakness to last into early next year and our further objective is the .7250 area.