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Economic & Market Outlook
July 1, 2013

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Economic & Market Outlook for 2013

The US economy bumped along at a slow pace of growth in the first quarter of 2013 (1.8% GDP growth), and it is likely that the second quarter will show similar growth. With Europe in recession and China's economy slowing, along with countries whose economies depend on China's (Australia, Brazil, etc.), it will be difficult for growth in the U.S. to pick up in the second half of 2013. While the recovery in housing (although not as organic as we would like), the mini energy boom in the US, and signs of some in-sourcing of manufacturing back to the US should help slow growth continue in the second half of 2013, we are somewhat concerned about the headwinds from spiking interest rates and increasing energy prices. Though the US economy will continue to bump along, growth rates will probably not be high enough to justify current stock market prices. Whether the US stock market can stay elevated near all-time highs will depend on the continuation of Bernanke's money printing at the Federal Reserve.

We mentioned last quarter that it was our opinion that the Federal Reserve's massive money printing strategy (quantitative easing or QE) had pushed the US stock markets to pricey levels, leaving the market vulnerable to sharp falls should one of many catalysts pop up. We were surprised to see that the catalyst ended up being the Fed signaling their intention to "taper" their money printing program. It was clear that market participants were surprised as well from the sharp rise in interest rates and drop in the stock market over the last two months. While the stock market's drop was very mild compared to the selloff in bonds (rise in interest rates) and has since recovered, in our opinion there may be more to come over the next few months. Slowing growth around the world is not supportive of higher interest rates (from where we are now) and we believe the bond market correction is close to over. The problem is that with the Fed distorting interest rates so much over the last few years, it is difficult to tell if they will continue rising should the Fed wind down their QE program over the next year.

The Fed as the catalyst was a surprise because we are not that close to the Fed's initial 6.5% unemployment rate target, and yet they are signaling they will slow their money printing soon ("taper QE" is the terminology). It appears that the Fed has become concerned about the bubbles they have been blowing in the financial markets. This has always been a concern of ours and others - the Fed has boxed themselves in. If they continue printing money (QE), expanding their balance sheet (where they own trillions of dollars of US government bonds and mortgage backed bonds), it gets more difficult to exit the strategy. This is especially true if the economy is not growing faster than the crawl speed we've been at, and when most of the impact from QE continues to be inflated stock prices and bubbles in credit products.

We are not alone in this thinking, as Paul Singer, Stanley Druckenmiller, Seth Klarmen, and others have all indicated that the Federal Reserve has distorted financial markets so much that there are no price signals left, only central bank footprints.[1]

In our opinion, the Fed realizes that they are blowing bubbles in credit and the stock market. This is why they are discussing tapering of their Quantitative Easing (QE) program, not because they will soon hit their economic targets but because they are trying to let some air out of the bubbles they are blowing (though the MSM will not report it this way). Even Alan Greenspan stated on Bloomberg news recently that the Fed should begin winding down their QE program before the market forces them to do it. Martin Feldstein recommended in an Op-Ed in the Wall Street Journal that the Fed should immediately start to wind down its QE program as he sees the risks outweighing any benefits of continuing the program.[2] To quote Mr. Feldstein's last paragraph from his Op-Ed,

"The danger of mispricing risk is that there is no way out without investors taking losses. And the longer the process continues, the bigger those losses could be. That's why the Fed should start tapering this summer before financial market distortions become even more damaging."

This is an important point that is not often discussed - the further along the Fed is in this "experiment" (QE), the more unstable the financial system becomes, especially when the Fed's balance sheet continues to expand, along with debt/gdp ratios, even as the economy stalls. If they keep printing, credit bubbles will continue to blow up larger (and stock bubbles), and the ensuing pop will be larger when the bubble at some point bursts. If the Fed begins to "taper" their QE now, credit (bonds) and equity markets will most likely continue to cause volatility.[3] The following Chart shows the relationship between the Fed's balance sheet and the S&P 500 over the last several years.[4]

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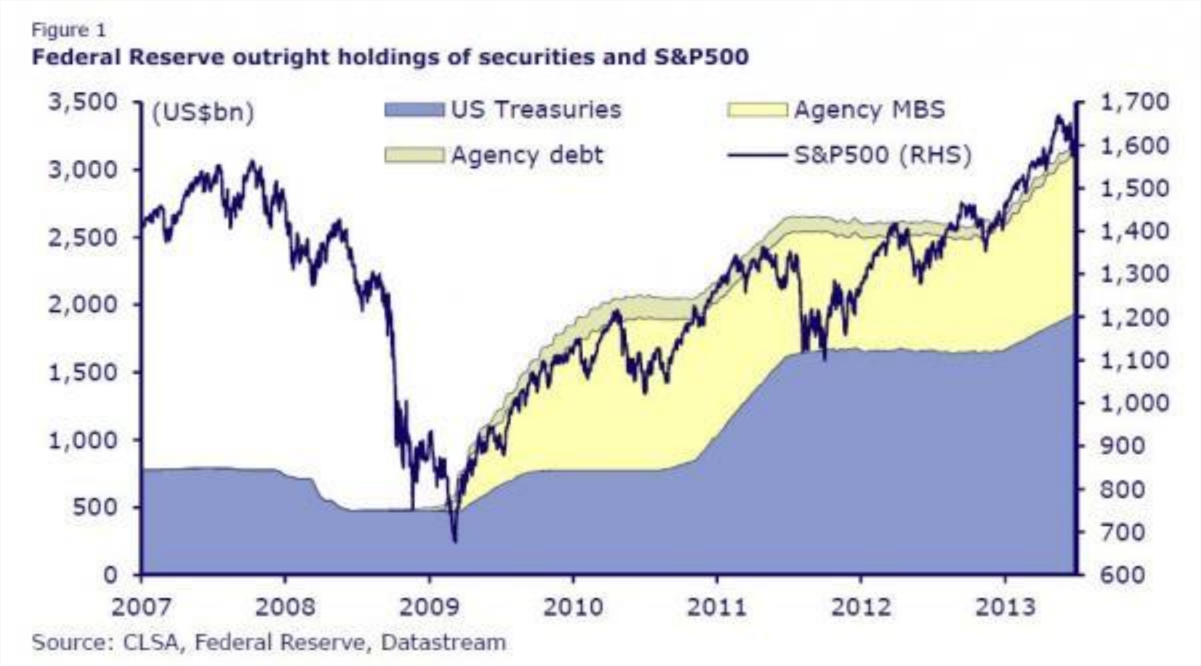
[1] Hedge Funds: Fighting the Fed, Financial Times, June 2, 2013, found here, http://www.ft.com/intl/cms/s/0/801b8358-c9da-11e2-af47-00144feab7de.html#axzz2Z9I1Asxl

[2] Alan Greenspan on CNBC, June 7, 2013, found here http://www.bloomberg.com/news/2013-06-07/greenspan-calls-for-tapering-of-federal-reserve-asset-purchases.html

[3] Martin Feldstein: The Fed Should Start to 'Taper' Now, The Wall Street Journal, July 1, 2013 found here http://online.wsj.com/article/SB10001424127887324436104578579182412751550.html

[4] Zero Hedge, July 4, 2013, found here http://www.zerohedge.com/news/2013-07-04/guess-what-fair-value-sp. The S&P 500 Index is an unmanaged, market-capitalization-weighted index representing 500 major, blue chip stocks representing diverse industry groups. You cannot directly invest in the index.



Here are a couple of areas that could cause the market to move ahead of the Fed:

- Europe: Banks are weak, Eurozone in recession, possible bank trouble in several countries
- China: Banking volatility (interbank rates) recently is red flag, new regime, reduced lending (reign in shadow banking sector), danger of property bubble, credit bubble…
- Japan: Abenomics, more debt with QE times infinity, Gov.t interest payments/tax revenues way too high, dangerous if rates rise at all. Slowing China will affect Japan strongly.
- Middle East: Syria, Egypt, Iran.
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As Kyle Bass states in his latest investor newsletter:

"*The largest Divergence Ever Seen*

Global equities are exhibiting one of the largest divergences between true economic growth and prices. In fact, it feels similar to July 2007. Equities march higher and higher as P/E multiples expand while industrial production numbers tank globally. We are concerned about the possibility for substantial further correction in some overstretched equity markets."[5]

[5] Kyle Bass, Hayman Capital Management LP Investor letter dated June 5, 2013, found here http://www.scribd.com/doc/151738436/Hayman-June-2013

The US stock market (S&P 500) is as overstretched as any of the world markets in our opinion. Can the Fed induce further stretching – of course they can. Bernanke recently made an about face from recent signals in a speech (really the Q&A session afterword's) and insinuated that their QE forever program instituted at the start of this year (printing $85 billion a month) will not end any time soon, the stock market celebrated and jumped higher. However, many still think the Fed does begin to "taper" (slow down their money printing) in the next few months and we tend to agree. Even if they don't begin to "taper", it is likely that at some point some external force, be it Europe, China, the middle east, etc. will be a catalyst for volatility in stock market.

We may just have seen a glimpse of this over the last two months as interest rates spiked precipitously, supposedly caused by the Fed's jawboning about "tapering" their QE program. In our opinion that was only part of the cause, while the seizing up in China's interbank lending rates (Shibor) were a significant factor in the Treasury bond sell -off as well. This volatility out of the Chinese banking system could well just be beginning, as the new leadership tries to rein in their shadow banking system.[6]

Both stocks and bonds could be vulnerable. We did not think that interest rates would spike higher to the extent that they have over the last two months. As we have said, the economy is weak and it is hard to justify current rates or higher in a deleveraging, almost zero growth economy. However, the US still sports a massive federal deficit, and should the Fed step away from monetizing that deficit no one knows what rates the market will demand for US government bonds. However, as even Alan Greenspan has said recently if the Fed doesn't end their QE program soon and continues to expand their bloated balance sheet, the market may dictate the end of it for them, with dangerous results. In our opinion bond markets are probably closer to the end of their correction than the US stock market over the short term (next 1-3 months).

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[6] See Harry Wilson, The Telegraph "Chinese Banking: A wild West in the Far East?", July 6, 2013, found here http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10164580/Chinese-banking-a-Wild-West-in-the-Far-East.html