ALTMAN INVESTMENT MANAGEMENT

MARKET PERSPECTIVE

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A Brief Outlook on the Economy

The latest round of gloomy headlines have raised worries about a Spain bailout and another wave of contagion, sending sovereign yields to new highs and scaring investors into the safety of U.S. Treasuries and other havens. The worries have rattled equities in the second quarter, with Spanish and Italian markets testing their lows for the year, and have reinforced a pessimistic market sentiment.

- **Last year the economy grew at a 1.7% rate with the median forecast by 93 economists surveyed by Bloomberg at 2.2% for 2012.** This sub-par economic recovery in the third year of recovery from recession compares with a 3.9% average expansion after the recessions of 1982, 1994 and 2001. The primary reason given for the extremely modest recovery is the high level of debt outstanding and the process of deleveraging in the private sector as attempts are made to restore debt to more normal levels. One can add that similar forces were at work in Europe as large debts accumulated there, much of it related to real estate, and they have now entered another period of recession. Another engine of global growth, China, is experiencing slower economic growth in 2012 but is not expected to enter a recession. These two external forces will act as headwinds for the U. S. economy largely via exports and direct investment in those regions.

- **The outlook for the current quarter of GDP growth is similar to the first quarter since many statistics have weakened during the second quarter.** These include employment, manufacturing and service surveys which include the ISM data, industrial production, the leading indicators, and retail sales. Commodity prices have been hit particularly hard largely because of the recession in Europe and the slowdown in China due to its huge investment in infrastructure. A beneficial aspect of this phenomenon is a significant decline in inflation. For example, the producer price index (PPI) rose only slightly in June with the twelve-month rate of growth at 0.7%. Intermediate prices fell 0.8% and crude goods 3.2% in May. Energy prices fell 2.6% in June, with gasoline prices reversing their direction in June rising only modestly 1.9% after declining 8.9% in May. Crude prices in general have fallen at an annual rate of 9.7% over the past three months. A similar pattern exists at the consumer price level (CPI) which was flat on a month to month basis in June, with the core CPI declining 4.3% year over year. At the CPI level, energy prices have fallen 3.9% over the past year. Peak CPI numbers were in September 2011 at 3.9%. Ironically, core CPI prices (ex. food and energy) are now above the general CPI level at 2.3%.

- **The Department of Commerce in June revised downward the growth in real GDP for the first quarter from 2.2% to 1.9%.** Based on the revisions, consumption contributed 1.9% of the growth with gross private domestic investment accounting for 0.8%. Net exports of goods and services balanced out imports as the government sector subtracted 0.8% from growth. Consumption grew at a rate of 2.7% led by spending on durables (mainly autos) which increased 14.3%. While residential spending increased 19.4%, keep in mind that the base is much smaller after five years of decline. The government sector has subtracted from economic growth for six quarters largely because of declines in defense spending and because of significant declines in state and local expenditures as budgets are balanced.

- **Core goods prices are likely to remain relatively volatile and may soften from the pace of recent gains, given signs of softer consumer demand and weaker energy prices.** However, we continue to expect core inflation to rise gradually on a y/y basis in the second half of 2012 and 2013, driven by persistent gains in the less volatile core services component. This is consistent with our view that the degree of spare capacity in the economy is fairly limited and will not translate into renewed disinflationary pressure, despite the softer backdrop for growth. Inflation rates could fall a bit further because the money supply (M-2) is now growing at an annual 3-month average of 3%, much lower than earlier months. A big unknown, however, is whether or not there will be more quantitative easing by the Federal Reserve.

- **Another positive is that total debt in the U.S. as a percent of the economy has fallen for twelve quarters in a row.** The rapid deleveraging by consumers, banks, non-financial businesses and state and local governments has brought the ratio of total debt to GDP to 3.36 from 3.73 at the height of the debt boom in 2007. While public debt has risen to 89% of GDP at present from 56% in 2007, household debt has fallen to 84% from 98%, nonfinancial corporate debt has fallen to 77% from 83% and financial sector debt has collapsed from 123% of GDP to 89%. The media, along with the political process, has highlighted the perils of government debt while not emphasizing the constant private process of deleveraging, which has taken place since the Great Recession.

- **We believe that the U.S. will continue on a path of historically slow economic growth because of further deleveraging against the background of a European recession**, with worries of sovereign debt problems and the viability of the euro, as well as a Chinese slowdown with growth rates that the West will envy. At present, we are maintaining our forecast of 2.5% real GDP, with corporate profits advancing by 7.0%. We have further reduced our CPI forecast to 2.3 % from 2.5% to reflect the falling commodity prices.

A Closer Look at the Financial Markets:

- **The defining feature of the financial markets has been the continued decline in interest rates and the extreme weakness in commodity prices.** Equity prices in the U.S. have been remarkably stable given the slowing pattern in many economic statistics and the return of Europe to recession, while many emerging markets, including China, are experiencing slowdowns. The 10-year Treasury bond sells at a yield of 1.47% versus 1.73% a month ago and 2.98% a year ago. Corporate bonds, mortgages, and municipal bonds display a similar pattern. Many of the government yields are hard to believe but must be taken in the context of the Federal Reserve's zero interest rate monetary policy and the programs of quantitative easing which do not reflect free markets. Ben Bernanke, Chairman of the Federal Reserve, believes that the U.S. economy could be on the cusp of a repeat of the Great Depression and the U.S. monetary policy largely reflects that view, particularly now that Europe appears to be experiencing a double-dip recession and many of the emerging markets are in slowdowns.

- **Commodity prices have suffered the worst over the past year with significant weakness over the past three months.** The CRB index of commodities has fallen 13% over the past year while oil ($89 per barrel) is down 14% and copper ($3.41 per lb.) is down 24%. The Baltic Dry Index, a measure of shipping costs for raw materials, at 921 is down 27% from a year ago. These statistics along with the extraordinary low interest rates reflect the global fears of a double dip recession. In contrast, the U.S. dollar index (82.8) has appreciated 9.3% over the past year as investors have embraced what they believe to be a safe currency in a turbulent market. Gold ($1619) while down from its high of $1900 last September has been relatively stable as a commodity, particularly since many commodities have been reflecting deflationary fears. Gold should be viewed as a store of value offering protection primarily against the tendency of governments to debase their currencies. The S&P 500 Stock Index (1384) is up 4.3% over the past month and up 8.9% over the past year.

- **The Morgan Stanley EAFE Index (1426), a measure of foreign stock markets, is down 12% from year-ago levels.** Foreign stocks, particularly those of emerging markets, have been periodically viewed as growth stocks because of the higher economic growth rates of their economies. As a result, until recently, they sold at much higher price to earnings ratios. At recent levels however, many of them now sell below the 13 price to earnings ratio of U.S. stocks. P/E ratios often are based on estimates of earnings and are therefore subject to high levels of risk. Our own view is that U.S. earnings can still advance 7% in 2012, despite all the concerns, bringing earnings on the S&P to $105. At this price the P/E ratio for 2012 is 13.2. Equity valuation has become somewhat more difficult at present because interest rate levels are at artificially low levels because of Federal Reserve monetary policy, which is heavily biased towards easing.

- **Nevertheless, when all types of investments are evaluated on a risk/reward basis, equities would appear to stand out, particularly on a longer time frame.** The so-called fiscal cliff (tax increases and government spending cuts to take place at the beginning of 2013) amounting to about 4% of GDP and the results of the election will be significant factors to consider in evaluating the direction of the economy and the financial market outlook. At the same time, when stepping back from the headlines, and assessing the facts, a different message emerges—one of improvement. The problems in southern Europe notwithstanding, global markets are climbing the "wall of worry" that normally looms in the early stages of a market recovery. This typically represents upside potential. In the midst of the choppiness and the lack of investor conviction, an uptrend has taken hold. This suggests that the global economic outlook is better than markets have been expecting, with increasing global monetary accommodation likely to lift the economic momentum in the months ahead.