

Market Outlook

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The Sick Men of Europe

The Ottoman Empire was commonly known in 1914 as 'the sick man of Europe', a sign that the once-great power was crumbling. The Turks ("Ottomans") had dominated the Eastern Mediterranean for over 500 years, controlling vast stretches of Central Europe, Arab lands as far south as Egypt, and at one stage had advanced as far as the gates of Vienna and Venice. On the eve of WWI, all that remained in Ottoman hands outside Turkey was Syria, Mesopotamia, Palestine and parts of Arabia.

Throughout the 1970s, the United Kingdom was often called the "sick man of Europe" because of industrial strife, labor rigidity, and poor economic performance compared to other European countries. This culminated in the "Winter of Discontent" of 1978-1979, during which widespread strikes by trade unions brought trash collection, hospital services, and even grave digging to a standstill. While the strikes were largely over by February 1979, the government's inability to control them led directly to Margaret Thatcher's Conservative victory in the 1979 general election.

The sick men of Europe today are Portugal, Ireland, Greece and Spain (known by the unflattering acronym of "PIGS"). It is not imperial overreach that caused their dilemma, but overdependence on debt to fuel growth over the past 15 years.

Like the reckless lenders and borrowers that brought global banks such as Citigroup, Royal Bank of Scotland, and UBS (Switzerland) to their knees, it is now being revealed how the debt culture of past decades has ensnared entire countries. The most vulnerable countries in 2010 are shown in PIMCO's chart "The Ring of Fire." These red zone countries are ones with the potential for public debt to exceed 90% of GDP within a few years' time, which would slow GDP by 1% or more. The yellow and green areas are considered to be the most conservative and potentially most solvent, with the potential for higher growth.

While Greece has long been known as a profligate spender, recent revelations have indicated the country used financial engineering techniques to hide debt from the European monetary

authorities, raising its budget deficit from 6.5% to 13% of GDP overnight. This led to a collapse of its bond market, and similar follow-on effects in the other PIGS markets. Moreover, the future of the single-currency European Monetary Union (EMU) has been shaken by the potential default of one of their members. Remember, we are talking about an entire country defaulting, an outcome supposedly impossible under the EMU's stringent rules.

Currently, Greece is working feverishly with the EMU on a rescue program to "backstop" or guarantee Greek debt in order to prevent the domino effect of Greek problems infecting other financially weak economies (all eyes are on Spain in that regard). However, unlike the panic bailouts of late 2008, the EMU demanded that Greece get its financial house in order before any aid is received. Knowing there is no alternative, prime minister George Papandreou announced a pay freeze for civil servants and 10% cuts in operating budgets and tax rises on wealthy Greeks. This was met by nationwide strikes, ironically including the

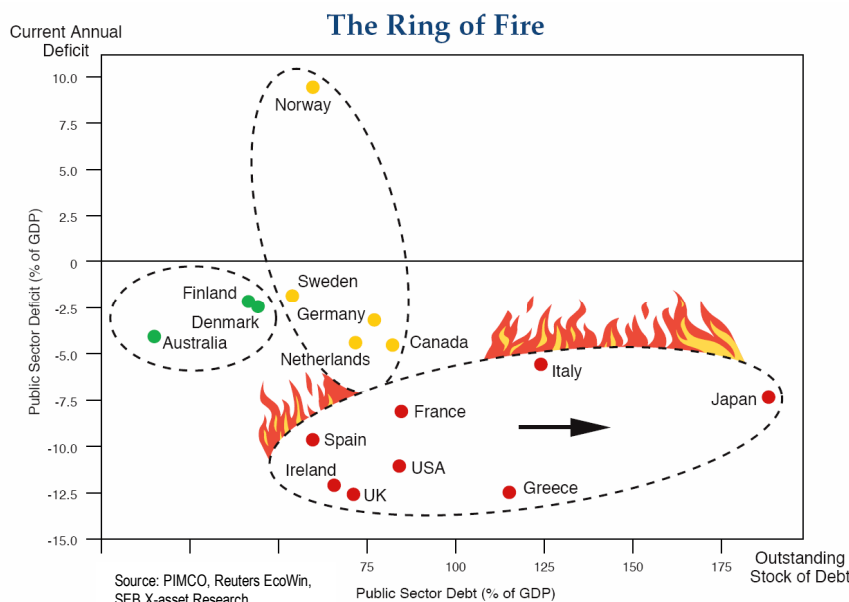
government's finance ministry. The country remains in a state of semi-paralysis today as strikes continue.

Reaching the End Game?

In better times, the Greek government would have quickly caved in to the demands of strikers, but the prime minister appears to have developed a resolve to maintain proposed austerity measures. It is too soon to know whether this is due to a newfound moral backbone or the

outright fear of default, but he is holding firm. This is an indication, in our opinion, of a shift in the unfolding debt crisis.

That shift is to the recognition that the debt merry-go-round has stopped, and reckless debt-financed spending is no longer possible. Debt expansion has potentially reached its end. Not that countries wouldn't like to continue to rack up debt, but they can't. The spell of the siren song of debt has been broken. The long-complacent bond markets have woken up to the danger of feeding debt-addicts without limit. Ironically, this newfound attitude would have seemed ordinary a mere generation ago, when favorable financing terms went to the prudent, and the least credit-worthy had to pay in terms of higher rates and greater scrutiny.



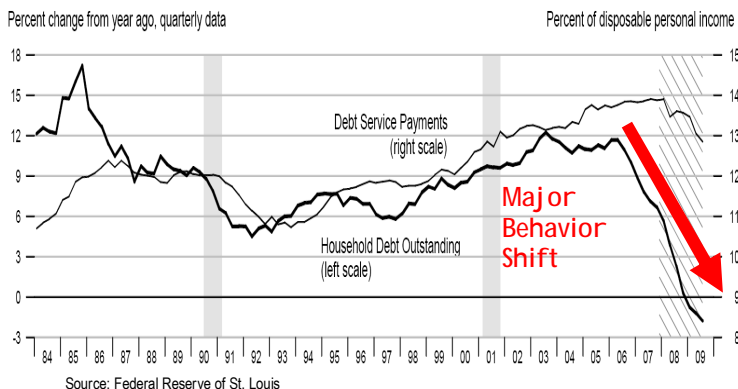
Source: PIMCO, Reuters EcoWin, SEB X-asset Research

Evidence of this “new normal” change is growing. The annual rate of change in US household debt has fallen for the first time since the 1950s, a major shift in behavior. Ireland’s government introduced the harshest budget in the country’s history, cutting pay for public servants, as well as unemployment and welfare benefits. Despite howls of protest, they are holding firm. Portugal has done the same, after failing in an initial attempt to pass an austere budget. Finally, Icelandic voters solidly rejected a referendum to back a plan repaying \$5.3 billion to Britain and the Netherlands as compensation to deposit-holders of the collapsed Icesave internet bank.

All of these actions reflect that the merry-go-round has stopped, as the collective wisdom swings toward the view that there is such a thing as over-leverage, and we are there. Collectively, these actions are saying “enough is enough” and that debt will be dealt with through the time-honored methods of repayment (repayment of TARP funds), refinancing (low interest rates are helping engineer this), and repudiation (defaults too numerous to name and...Iceland). While there is an enormous debt problem everyone from households to entire countries must contend with, the mindset is slowly shifting toward less debt, not more.

Can the United States go the way of the PIGS? It is hard to imagine, given the enormous differences in the size and composition of their economies, and the dollar’s role as world’s reserve currency. Nonetheless, the debt fallout in the US is pervasive. From home foreclosures to the Kansas City school system, stopping the debt merry-go-round is taking its toll on

Debt Service Payments and Household Debt Outstanding



towns across the US. In a generation, we have gone from being a net creditor to the world (1984, just as the deficits began to balloon under Reagan’s first term) to a major net debtor to Asia (today).

In a sense we have reached the end game, too, with the realization that debt cannot be infinitely expanded. The capacity of China and, especially, Japan to finance the US is finite, and trade friction will only make this more so. Even Moody’s, a credit rating agency, declared that America’s previously unquestioned AAA bond rating was in danger of downgrading if things continue on their present course. Despite the raucous

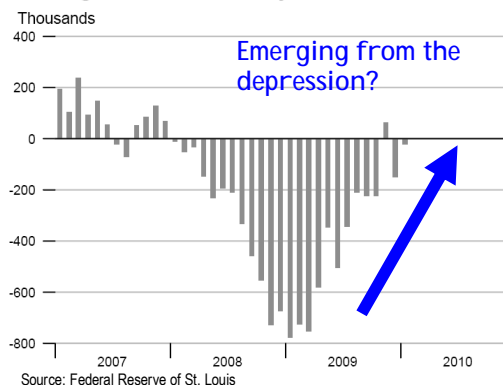
political wrangling in Washington, even the most myopic Congressmen of either party are beginning to recognize that Treasury debt issuance cannot be infinite.

Most importantly, people’s behavior is changing to adapt to the now-obvious dangers of debt. The ingrained psychology of borrowing is enormously difficult to change, but the currently evolving behaviors and attitudes toward debt are one more step in the move back from the brink of a truly Greek tragedy.

The Message of the Markets

For an economy that has gotten hooked on easy credit to finance conspicuous consumption, the worry has been how we get along in the “new normal.” The answer seems to be as expected—we are muddling through with gradual, but not spectacular, improvements. Unemployment has been stubbornly high, but new claims for unemployment have been dropping. There is plenty of overcapacity, but the ISM Industrial Index has been recovering. Many other small gains can be cited, and equally as many problems, but the green shoots of recovery are becoming more widespread.

Change in Nonfarm Payrolls



The stock market is certainly behaving as if a recovery is underway. Traditional measures such as market breadth, new highs vs. new

lows, and the number of stocks on point-and-figure buy signals all paint a positive picture for the economy, on balance. The stock market trend is one of the more reliable measures among the Leading Economic Indicators published by the Conference Board. On a micro level, more individual companies have regained their footing after a horrible 2008-09, and are reporting better performance (albeit after sometimes significant labor cuts) and slowly improving demand from customers. In the new normal world of 2010, the lack of easy financing has certainly hobbled growth, but households and businesses are slowing adjusting to this new world.

The Federal Reserve has begun telegraphing its intentions to the bond and money markets, as the need for the extraordinary liquidity infusions are diminishing. In a far cry from Greenspan’s cryptic code, the Bernanke Fed is communicating its intentions clearly so that the fixed-income markets are not taken by surprise by their inevitable change of policy. Given that interest rates are at rock-bottom, there is only one direction for them to go, so investors must prepare for gradually rising interest rates. Unlike the Greenspan era, this may be welcomed as a sign of economic recovery within a long period of rehabilitation.