

Overview:



Why have stocks and commodities been in correction mode since late April? Well, I believe we are at a fork in the road, and potentially a big one at that. Not only has the U.S. economy hit a soft patch, but at the same time the PIIGS (Portugal, Ireland, Italy, Greece, Spain) crisis is threatening to infect our financial system in the

same way sub-prime did in 2007.

There are two issues here. One is the systemic flue caused by impaired European balance sheets and fiscal sickness spilling over to the U.S. and the rest of the world. This has already happened to some degree, which is why the dollar has been strong against the Euro, and liquidity measures have weakened. In my view, a strong dollar is a bad sign at this time, for it is symptomatic of tightening financial conditions.

The more serious issue is whether we could become the next Greece. This is what Harvard professors Niall Ferguson and Ken Rogoff have been writing about. The issue is that the U.S. government has compensated for the deleveraging in the household sector by re-leveraging the public balance sheet through classic Keynesian deficit spending. If they had not done so, many believe it could have been the Great Depression all over again. Instead, we only got a Great Recession.

I think these deficits are no longer just cyclical (as Keynes had intended), but structural. Why? I think it's because we are an aging society with entitlement programs that have not been fully paid for, at least not yet. The debt to gross domestic product (GDP) ratio in the U.S. already is at a post World War II high of 83%,

and according to the Treasury's own estimates it could rise to 119% in the next few years. That would be higher than the World War II extreme of 116. Also, if you add Fannie Mae and Freddie Mac to the mix (which essentially are now guaranteed by the U.S. taxpayer), the current debt-to-GDP ratio may rise from 83% to 129%. (*Data from Fidelity Viewpoints July 2010*).

Right now the sovereign debt storm is raging in peripheral Europe. Perhaps someday it will rage here too.

There are two players right now with the power to reverse the slide: the Fed and the European Central Bank (ECB).

Let's start with the ECB. The ECB stepped up to the plate last month when it announced a big and bold plan to buy the sovereign debt of the PIIGS countries, but since then their activity has slowed. The ECB has bought some debt, but every week it has been buying less and less, even though spreads have been widening. And, in my opinion, the surest symptom of fiscal illness is widening sovereign debt spreads. I think the ECB needs to take a page from the Fed and do quantitative easing (QE) the right way: through a massive repurchase of troubled sovereign debt. Between all the talk of fiscal illness across Europe and the ECB's lack of decisive action, I am not surprised the stock market is under renewed pressure. If and when the ECB starts engaging in Federal Reserve-type QE, I think the bleeding could stop instantly among the PIIGS and therefore the equity markets.

This brings us to the Fed. In the U.S., the Fed ended QE in March 2010, and this appears to be weighing on the markets. Think about it: The Fed started QE in March 2009 by purchasing assets and expanding its balance sheet without offsetting its stimulative effects. That's when stocks bottomed. One year later, in March 2010, the Fed ended QE. A month after that, the bull market started to sputter, and now the S&P 500® Index



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has corrected 17.1% (as of July 1). (*Data from Yahoo Finance Historical Prices*)

I think that the markets appear to need QE to be able to rally, at least for now. I don't think zero rates are enough. Short rates should really be -5% or so, according to the Fed's Taylor Rule (one of the mathematical formulas used by the Fed to help determine at what level it should set its target interest rate). I believe that means the Fed has to continuously engage in QE to keep things moving forward, until the financial system is healthy enough to thrive on its own. In my view, by not doing QE anymore, the Fed is in effect tightening. Until the system is healed, I believe the Fed needs to keep things going.

Just last week Charlie Rose interviewed Timothy Geithner. Mr. Geithner indicated that the Fed must continue to work to help the economy stand on its on two legs. Mr. Geithner stated the next big challenge is Fannie and Freddie and that his biggest fear is that polarized politics prevent the Fed, the Treasury, and Congress from making good decisions versus political decisions.

Back in November I wrote about an impending implosion in the commercial real estate sector. I outlined that since the implosion of 2008 Wall Street no longer has the ability to create Collateralized Mortgage Backed Securities and pointed out that there is an impending spike in maturities and subsequent need for restructure coming. My view has not changed. Add to that the fact Banks are being forced to reduce their exposure to real estate by as much as 50% and there simply aren't enough lending mechanisms to solve the problem.

Additionally the nation's unemployment crisis will weigh heavily on the real estate industry. Companies

are cutting back on employees and consequently cutting back on required space. Landlords are experiencing shrinking income statements while they stare a required refinance dead in the teeth. In Bonne CRS's June Newsletter the author points out that the office vacancy rate nationally is about 17.4%. This is the largest number of empty square feet since 1993. I can testify personally that tenants benefit from this conundrum. Landlords are willing to negotiate more favorable rental rates, provide incentives such as free rent, and some even throw in free furniture. The list of incentives gets more creative every day. The problem is that this is symptomatic of the larger problem. Landlords are experiencing more empty space, less rental income, and are willing to deal in order to keep tenants. For these reasons I firmly believe that those with sufficient cash will be able to purchase buildings, strip malls, apartment complexes, etc. for very favorable prices.

My view of the economy for the 2nd half of the year is that GDP is somewhere in the 1.5% - 2% range. While I do not anticipate a double dip recession I believe we are on very fragile ground. I believe that the actions of the ECB will have a huge effect here in the U.S. I do expect that companies will experience better margins, and thus spend more. I expect the corporate spending to be focused on projects more than employees. Simply put, projects can be put on hold, employees cannot be let go without cost. We can only hope companies begin to invest in labor more than inventory and Capex projects. So in short, look for sluggish growth but growth none the less. Look for a choppy market for the duration of the summer and an upward trending market in the fall. I continue to find value in the fixed income (bond) market with 1/3 of the volatility of the equity markets.

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