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Subject: A New Year Ray of Hope?

A New Year Ray of Hope?

Sticking with my theme of trying to be pragmatic, the first week of 2012 closed with, on the one hand, a few highly interesting developments, and on the other hand, a sense of 2011 déjà vu, especially as it relates to Europe.

Following the tone of my Jan 3rd Viewpoint, I shall be watching the Monday evening close of the S&P very closely to firm up or reject my current biases. More on this below.

The US. Virtuous Improvements Starting or Another False Dawn?

Following an encouraging December manufacturing ISM index, December payrolls contained many positive signs as well as the complementary household survey reporting another drop in unemployment. For many obvious reasons, an improving job market in the US is vital to a number of related topics. This would include the political strength of President Obama and the mood of policymakers. However, most importantly, an improving job market would create the conditions for some continued strength in consumption without requiring a further unsustainable decline in the personal savings rate.

Having been on the positive side of the cyclical arguments about the US since early last year, and then a bit baffled as to why so much momentum suddenly disappeared last Summer, this improving mood is not a surprise to me. A lot of ingredients are present for a more vigorous recovery than the consensus is currently forecasting, and indeed, considerably more than our current 2.2 pct GSAM forecast for 2012 GDP. Many reliable coincident and short-term leading indicators are showing promising signs, including the ongoing trend in weekly job claims. Moreover, it seems to me that there are good signs on a couple of major structural issues that have hung over the US also. One is the housing market. And, even without the continued promptings of some US policymakers, such as NY Fed President Dudley last week, a modest turn in the housing market in 2012 could contain a number of virtuous ingredients, including helping the fortunes of major US banks. The second is the changing dynamics of the energy markets, with more signs of deliverable and usable domestic oil and gas supplies, which could also be highly significant for further improving the US balance of payments current account.

Against all of this optimistic thinking, there are many reasons why the recovery could falter once more, including the possibility that some of the reported improvements are due to less inclement weather in late 2012 than usual, the fresh

decline in the savings rate, and the more populist and familiar gloomy issues related to de-levering and the government's fiscal affairs. Of course, there is the widespread belief that, at some point, the European mess is going to have much bigger negative consequences on the US than what is apparent so far. But I am increasingly inclined to think that the 1997 parallel with the Asian crisis might be valid, i.e., due to easier overall financial conditions – for the US – the crisis might indirectly help the US recovery rather than harm it. If, however, the worst path for the Euro Area comes to pass, then it will hurt the US. But at this point, those relying on that factor must perhaps even be hoping that this comes true.

Currently, it seems to me that the consensus is going to have to contemplate a year with close to or above trend growth for the US, and a repeat of December's data pattern in January would probably cause that change.

Asian Signals Unclear.

Against the clearly better marginal signs in the US, the same cannot be concluded from Asia. While the December Chinese manufacturing (and services) PMI positively surprised, as I mentioned on the 3rd, it is conceivable that this might be distorted due to the early Chinese New Year coming up and businesses front-loading activities before the usual shutdown. I am sure that if the Shanghai stock market hadn't opened the year in such a gloomy mood, I might not have given that theory as much credence, but the continuation of the weak December equity market performance suggests something doesn't seem so good. Another explanation is that the much-anticipated decline in Chinese consumer price inflation is not going to happen. A major client raised this possibility with me late last week. I am in the camp that CPI is heading down back towards 3 pct early this year, but if it reversed its late 2011 sharp drop and started rising back to 5 pct and higher, this would be quite an issue.

Data from other parts of Asia is quite mixed, with Japan looking quite disappointing again, and some softness in various internationally-exposed Asian economies. But against that, the most up-to-date and highly pertinent Asian trade data, that from Korea, strongly surpassed expectations. Korean exports rose by around 12.5 pct year-on-year last month, nearly twice expectations. As I am fond of saying, unless they are trading with Jupiter, someone around the world is doing ok. The details that are available at this early stage, suggest that while their exports to Europe are weak, this is strongly offset by strength elsewhere, especially to other parts of Asia.

More Signs of Currency Reform in China.

In addition to a second speech from PBOC Governor Zhou about further capital account opening, over the weekend, Premier Wen has indicated that China will undertake more reforms including enhanced flexibility of the Yuan. This is both cyclically and structurally a key issue for all of us, and consistent with my ongoing assumption since last Summer that full convertibility – at least Chinese style – could be upon us by 2015.

And As For Europe?

Most of last week's disappointments came from Europe predictably, although in terms of data, it has not all been one way. Indeed, quite a lot of the German data continues to positively surprise. While their highly volatile factory orders fell sharply in November, the December data to date has been better, including both auto sales and unemployment and, in-line with the earlier reported better-than-expected December IFO, the latest German PMI positively surprised.

There was also a somewhat pleasant surprise with the release of the much better-than-expected December services PMI in the UK and combined with slightly better-than-expected manufacturing and construction PMIs, this raises the possibility that the UK is not as weak as the very grim mood. There is also more and more positive evidence emerging about auto construction in the UK, much of which is earmarked for export. Perhaps the UK is creeping down the path of underlying adjustment more than many realize?

A number of the obvious weak spots of Europe were disappointing PMIs but, to support my oft stated judgment that people shouldn't exaggerate the global aspects of the deep crisis many are facing, as I had already mentioned on the 3rd, December's global PMI rose to 50.8 from 49.7.

The real disappointment relates to the ongoing performance of many Euro Area financial markets, and certainly in recent days, the fresh weakness of European banks equity value. Following the late 2011 generous ECB 3-year money market activities, this suggests that investors don't believe the funding support is going to help the earnings capabilities of troubled banks.

In addition, the reported Spanish news that their budget deficit is around 2 pct higher than previously reported, together with plans to tighten fiscal policy, further highlights the questionable core cyclical tactic of many struggling Euro Area economies. I have some sympathies with this view. While it is so fashionable to regard the Euro Area crisis as a sovereign budget deficit and debt crisis, until the 2008 collapse and their own housing market reversal, Spain's fiscal position was the strongest of the big 5 Euro Area economies. What Europe needs is more growth, and a European Monetary System that is credible and attractive to private sector investors.

It remains to be seen whether the changing of some key individuals on the ECB board will be relevant in this regard, but I am touch surprised that this is not receiving more commentary. While the replacement of Stark with Rasmussen at the start of 2012 was known, it was not expected that the leadership of the Economics research would shift away from a German head. It has been given to Peter Praet, the Bank of Belgium member, which may or may not be interesting. It certainly seems that President Draghi is going to do things his way.

So What About Markets?

There are two things which are potentially quite interesting about the markets, but we will need more evidence. In addition to the S&P 5-day rule (more below), there is some extremely tentative evidence that this weird risk on/risk off correlation between the Dollar and US economic news could be changing. The prevailing pattern since 2008 where the Dollar drops on better-than-expected US economic news and rises on disappointing news certainly didn't pan out last week. If this is the start of the renewal of the more normal historic trend, this would be a fabulous development in my view, as it should make investment decisions more logical, if not easier.

As far as the 5-day rule I discussed as important for me at least, Monday's close in New York will be the 5th day. After 4 days, the S&P closed up by 1.6 pct year-to-date, but given the fun and games since last Summer, this is easily reversible in a day.

I have found myself quite engrossed in analysis, discussion and debate about this somewhat odd rule in recent days, not least of which because Jose Ursua from the GS Economics, Commodities and Strategy (ECS) department devoted a daily commentary to the topic on Thursday, and subsequently explored it further at my prompting, as have a number of other poor souls including James Wrisdale, and another colleague from GSAM, Rob Hinch.

I first came across this notion from the Stock Market Almanac, and my 2012 edition has been more heavily turned over in the past couple of days than it normally would. It taught be two things many years ago. One, that there is remarkable pattern historically that many major stock markets show very strong performance from November through April, and quite often, quite weak performance from May through October (hence the "sell in May" oft discussed notion). Any investor that stuck to this calendar investing pattern would dramatically boost his returns. And two, when the S&P rises after the first 5 trading days of a new year, the market has a pretty good annual performance. In fact, the Almanac claims the success rate has been just under 87 pct since 1950. Jose studied a broader 5-day rule as well as the "January month" rule in his daily and showed that, for a number of markets, the January factors seemed to be quite powerful, albeit less than I had believed, and not enough to dismiss the superior importance of fundamental analysis.

While I certainly concur with the latter, in fact, the Almanac observation appears to be very strong on additional analysis; it is not useful when the 1st 5 days show a decline. Historically, this appears to offer no concrete signs for the year. In fact, those years are close to 50/50 as to whether the markets are up or down. (There have been 22 of them since 1950.) It is only really powerful when the S&P is up after the first 5 days. As I reported on January 3rd, 2011 was a real oddity, as it became just the 6th year out of 39 years when the rule didn't work. What is especially interesting is that there have been no back-to-back years when the rule hasn't worked. So if for some reason, the S&P is still in positive territory on Monday evening, I shall be most excited.

There is an even more important historical statistic that is exercising me, and millions of others, about a certain Red persuasion this weekend. United have not lost 3 consecutive competitive games since 1997, and those noisy neighbours have a chance to repeat that feat this Sunday afternoon.

Good luck.

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