ORCAM | ALTERNATIVE PERSPECTIVES

Macro Strategy & Research

July 7, 2012

Q3 Outlook—10 Questions & Answers

Cullen O. Roche
Founder
Orcam Financial Group, LLC
cullenroche@orcamgroup.com

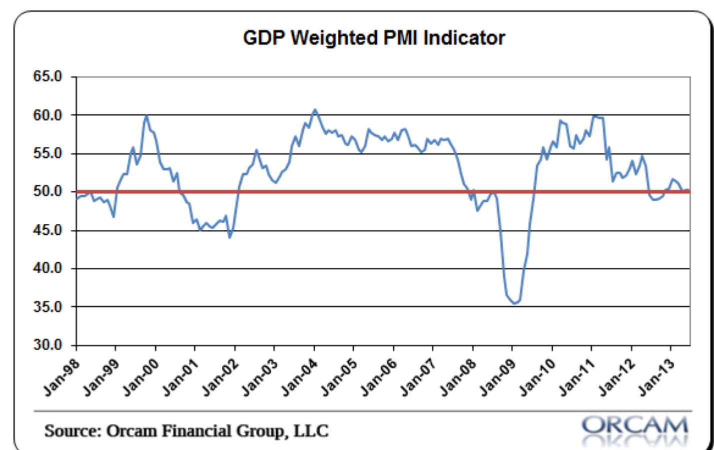
2013 is half way over already. So let's regroup and take a look at what the second half of the year might look like. Here, I answer 10 important questions for the upcoming quarter.

1. Where is the Global Economy Headed?

The three legs of the global economy (China, Europe and the USA) are telling very different stories at present that all sum up to a rather boring overall picture. The GDP weighted PMI has essentially stagnated for 12 months straight. That's due in large part to weakness in Europe, a meager expansion in the USA and renewed weakness in China.

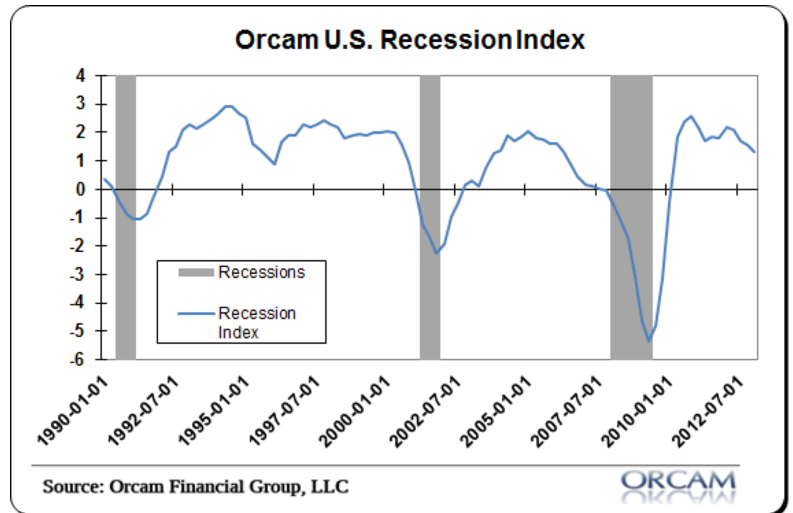
China, in particular has become a red flag, as they're beginning to experience signs of a minor credit crisis. But their government tends to be particularly proactive regarding private sector problems so that could alleviate near-term problems even if it creates more long-term problems. The situation in Europe appears to be steadying to some degree at a below sufficient rate of economic output. The latest reading from the EuroCoin index showed continued declines in Europe and the PMI reports show a very mixed story. The USA has continued to muddle through as government spending slows and the private sector slowly runs with the baton. The sum of the parts is a pretty stagnant overall picture that I would expect to continue as Europe flounders and the USA heals slowly after the balance sheet recession.

> "Failure to prepare is preparing to fail."
> -Coach John Wooden



(Figure 1—GDP Weighted PMI)

2. Will Recession Arrive in the USA?

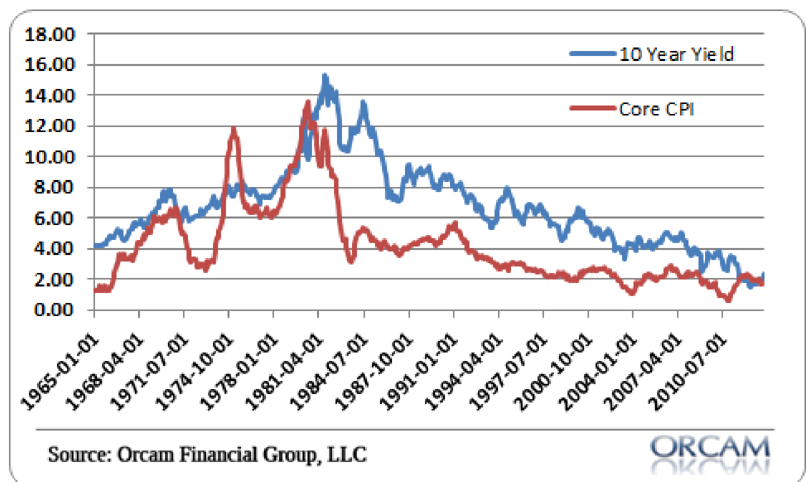


(Figure 2—US Recession Index)

The US economy has continued to grow in recent quarters despite its sluggishness. That's important. Growth is growth even if it's low growth. The key to this story remains the private sector's recovery in the face of a de-leveraging cycle. As the credit bust unfolded the private sector was left flat on its back. Spenders turned into savers and the economy slowed. The government stepped in to turn on the spending faucet and helped the economy grow during this unusual de-leveraging period. Since then, private balance sheets have improved and the government has been able to ease off the gas. The sum has been a moderate expansion that continues into the foreseeable future.

The Orcam Recession Index, which has proven quite prescient in recent years, continues to point to an environment that is consistent with low growth. I do not presently foresee high recession risk heading into the 3rd quarter.

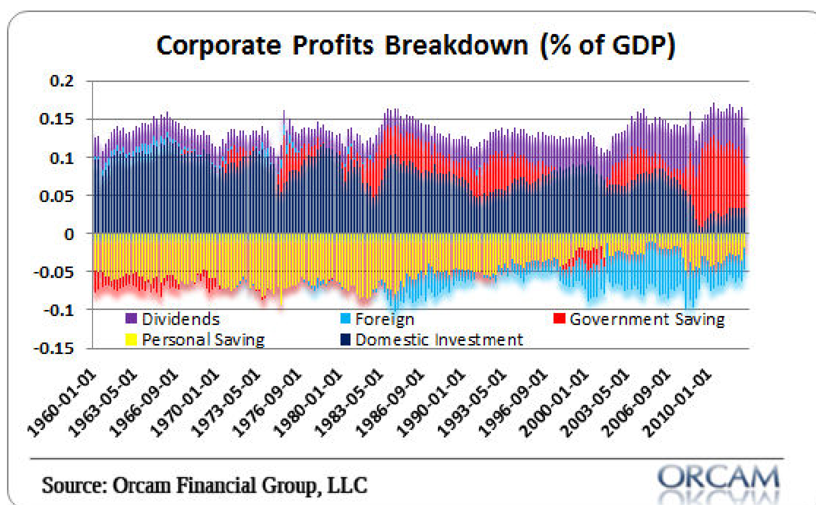
3. Interest Rates—Higher or Lower From Here?



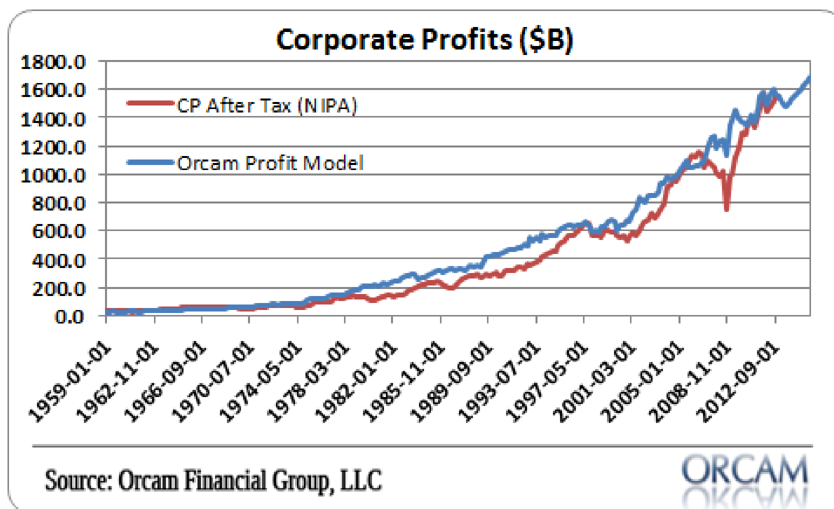
Interest rates have been volatile in recent weeks as increased talk of "tapering" has surfaced. I think the bond market is getting this wrong. First, the interest rate is a function of the economy. So, if we expect the economy to remain relatively weak then we should expect interest rates to remain relatively low as bond markets will not demand more from a real rate perspective. Unless we believe that inflation is going to rise substantially from here, then we should continue to believe that interest rates will remain low. As you can see in the image to the right, the bond market tends to demand a premium above the rate of core inflation. That makes intuitive sense since the principal risk in a 10 year t-bond should be rewarded by a real

return. Otherwise, there would be no incentive to hold t-bonds over cash. So the question then becomes all about inflation and where it's headed. In my opinion, the Recession Index puts us in a scenario where growth is actually decelerating some and we're likely closer to the next TIGHTENING period than Fed LOOSENING period. In other words, we're at an unusual place in the business cycle where monetary policy is actually very loose and more likely to get *looser* given that the risk at this point in the cycle is on the down side. That means rates are likely capped and that Treasury bonds now represent a good value relative to potential inflation scenarios.

4. Where are Corporate Profits Headed?



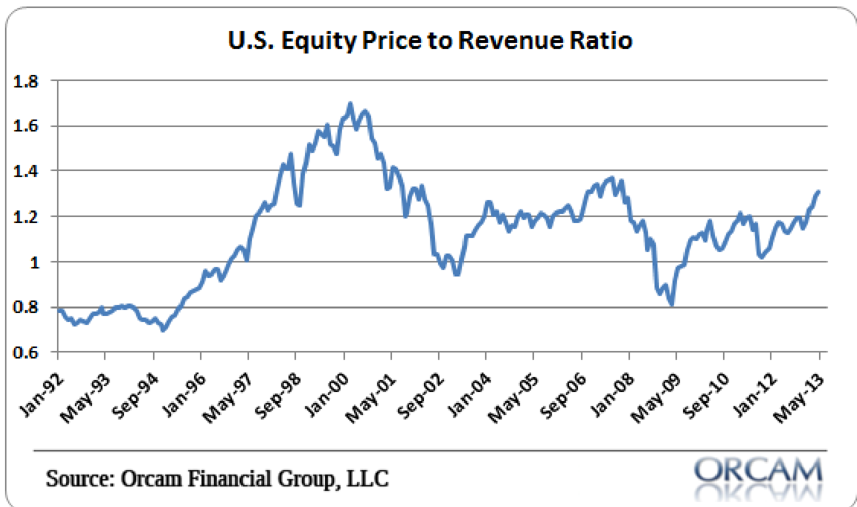
I think that few charts have been more instructive than the one at the right showing the composition of corporate profits as a percentage of GDP. What this chart shows us is that corporate profits have usually been driven by domestic investment and dividends. But this most recent cycle has been a case of "it's different this time". When the credit bubble burst aggregate demand collapsed leaving corporate America with smaller than expected revenues and cost cuts as the only response to the economic weakness. The government stimulus that was enacted in 2008 (the red bars) helped to bolster corporate revenues as the private sector remained too weak to spend. This deficit spending contributed directly to corporate profits and continues to bolster the state of corporate America.



If we assume moderate declines in the deficit and continued moderate capital expenditures then corporate profits can continue to growth modestly from here. The big risk is a substantial decline in the budget deficit and it's leading to a direct slowdown in profit growth to the low single digits. Therefore, equity markets will rely more on multiple expansion and less on fundamental improvements.

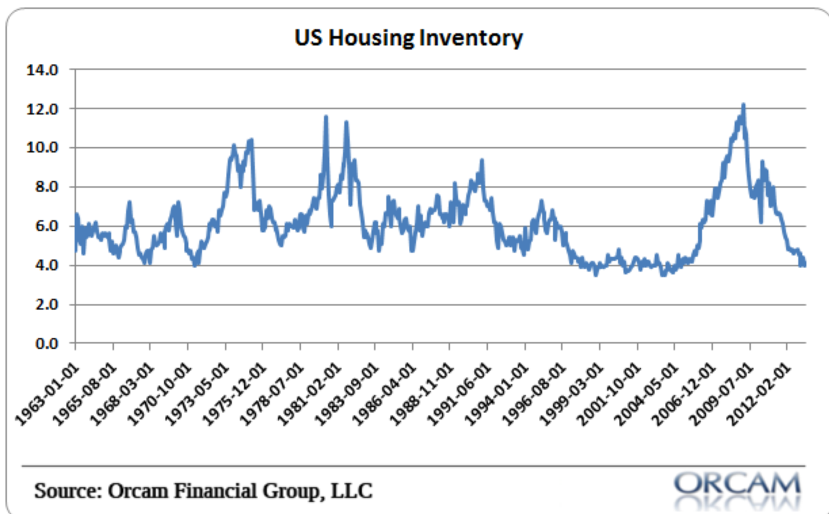
5. Is the U.S. Equity Market Expensive?

Speaking of multiple expansion – I don't much like using P/E ratios or most of the traditional valuation metrics that Wall Street relies on because I view them as flawed on both sides of the equation. That is, the P/E ratio is generally a guess about price (the current market price set by irrational market participants) divided by the expected earnings (which are guesses by biased analysts). In other words, you end up with a metric that is essentially a guess divided by a guess. I prefer to use a metric such as price to sales since sales can't be faked or fudged. The most recent reading shows a market that is slightly overvalued and approaching the higher end of its historical range. I would conclude that the equity market is becoming increasingly risky and warrants some level of hedging via other asset classes at this juncture. But importantly, we are not at nosebleed type levels that would warrant a total aversion to the equity markets.



6. Where is the U.S. Housing Market Headed?

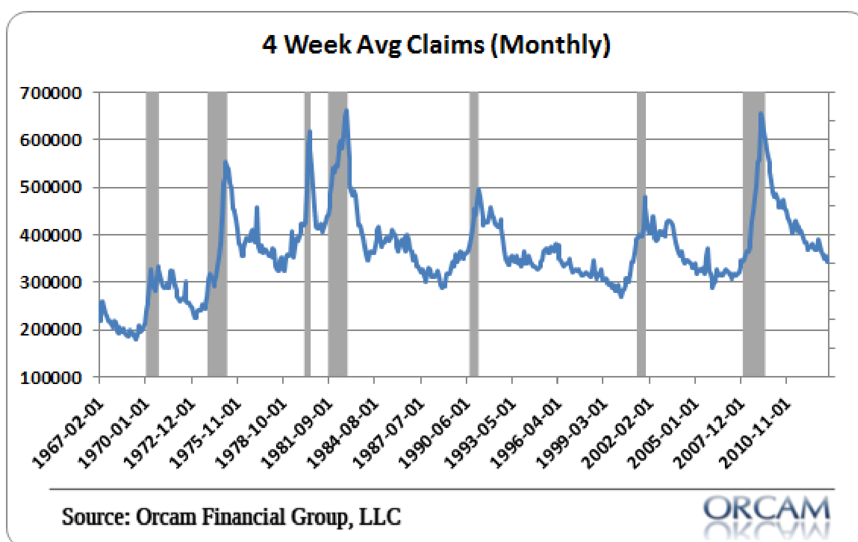
The US housing market has shown strong signs of recovery that I think are likely to moderate in the back half of the year, but remain positive. The primary trend driving the housing market is the lack of inventory and the strong seasonal demand. The Spring and Summer months tend to be strong periods for U.S. housing and this year has been no exception. I would expect that to moderate some, however, the lack of inventory creates an environment that is likely to remain positive for prices. Inventories are at a 8 year low and consistent with past periods of price appreciation. Higher interest rates and seasonal weakness should ease the hot markets we've seen in recent months, but shouldn't stomp out the bull trend.



ORCAM

7. Is the Cyclical Bull Market Still Alive?

Few indicators have correlated with the cyclical bull market better than the Orcam Recession Index and the jobless claims data. As I've noted earlier, the ORI remains solidly positive and at present, is not consistent with a market environment that is susceptible to substantial downside. The jobless claims data has also been a superb indicator of broader economic strength and has correlated with the S&P 500 extremely well over the last few years.



Historically, claims have tended to lead the business cycle on the downside. In each of the last 7 recessions the 4 week average for jobless claims has started to rise prior to a recession. It's also interesting to note that claims have tended to trough in the sub-300K range before the economy peaks. That's intuitively interesting since we should near an environment of high employment before reaching full capacity and then experiencing a negative portion of the business cycle. The current reading around 350K has neither turned up nor reached a level that might be consistent with a full capacity environment. Therefore, I think claims remain a positive sign for the overall economy and the stock market in general.

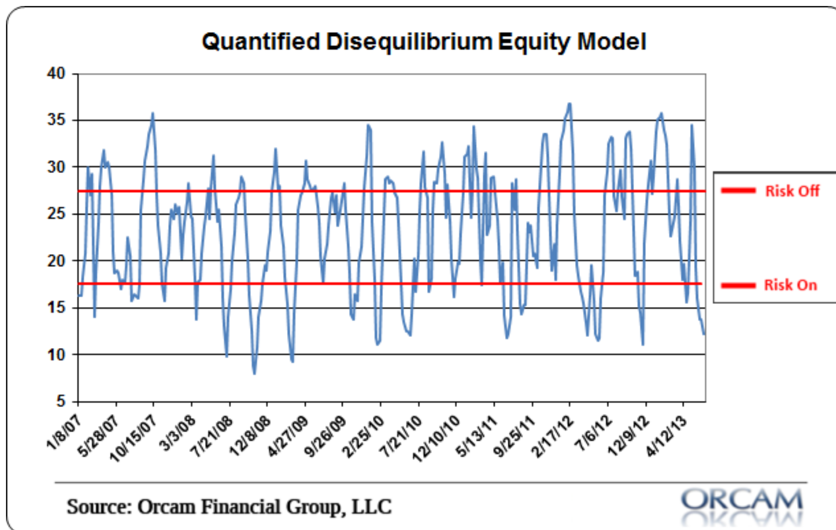
In my opinion, a core bullish strategic position should remain the center of any portfolio at present. Given the limited downside risks from the cyclical view I think the risk/reward at present favors continued long equity exposure.

8. What About the Tactical Market View?

The tactical view is less certain. We've seen a bit of a June swoon in the last few weeks with the S&P 500 now off about –3.3% from its May peak. I think the equity market remains vulnerable to further downside in the near-term so some hedging of the core strategic piece remains a prudent approach. That said, my QD indicator has turned much more constructive so we will be looking to be buyers of equities into any further downturn (see chart on the following page for details).

ORCAM

The QD model is at its most constructive levels since November of last year.



9. What are the Big Risks to This Moderately Positive Forecast?

I often stress that successful portfolio construction isn't only about knowing *where* to allocate capital, but also knowing where *NOT* to allocate capital. You can eliminate some of the biggest risks in a portfolio merely by eliminating those options that are unusually risky.

First, what are the major risks to my modestly positive economic view? In no particular order I would cite: 1) higher energy prices; 2) increased government fiscal constraint; 3) slowing housing market 4) China hard landing; 5) European relapse.

That said, the markets I would be most wary of at present are Chinese equities, European equities, and peripheral European government bonds. These are all risky houses in bad neighborhoods. With a global pool of assets to choose from I see no need to wade into these waters.

10. When Will the Fed Taper & Does it Matter?

There are few questions on the minds of investors that matter more than the Fed's decision to taper QE. But I don't think tapering worries get it all right. QE is merely an asset swap and while many believe it's had a vast impact on the economy, I think this has been largely an illusion since there is no real transmission mechanism through which QE works. QE, in essence, is swapping a private sector savings account (a t-bond) for a checking account (a reserve deposit). Private sector net financial assets remain completely unchanged. So, aside from the psychological "wealth effect" and the less discernible interest rate effect, QE's powers appear to be more mythical than anything else.

The more important factor is probably the fiscal side of the government's balance sheet and less QE will likely coincide with reduced government spending since the Fed will view QE as unnecessary in an environment where they don't need to monetize as much debt. But weakness due to less government spending implies no offsetting private sector strength. While I don't see a robust private sector recovery there are clear signs that the private sector is running with the baton more than it has been.

So, the more important question is not whether the Fed will taper, but whether we will start to see material weakness in the private sector side of the economy. While the recovery certainly hasn't been strong, I don't see the data supporting the view that there will be no fundamental support beneath any tapering. And that means that any negative market reaction to tapering will likely be a case of shoot first and ask questions later. But we want to ask the important questions now and shoot later if we must. And the important question is not whether or not the Fed will taper, but whether tapering will result in fundamental weakness in the US private sector. I don't see it so far, but I will obviously be keeping my ear to the ground as the year progresses.

I hope this outlook finds you all well. If you have any questions please don't hesitate to reach out.

Orcam Financial Group, LLC

Orcam Financial Group, LLC is a fee only financial services firm offering macro research, personal advisory, institutional consulting and educational services.

Important Disclaimer

Nothing contained herein should be construed as an offer to buy any security or a recommendation as to the advisability of investing in, purchasing or selling any security. Some of the statements contained herein are statements of future expectations and other forward-looking statements. These expectations are based on Orcam's current views and assumptions and involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those in such statements due to, among other things, general economic conditions, performance of financial markets, Orcam Financial Group, LLC assumes no obligation to update any forward-looking information contained in this document.

ORCAM