A Field Guide To Understanding The New Normal

10 Realities Likely To Shape The Market Outlook Ahead

Hosted By François Trahan
Chief Investment Strategist

September 2011
Investing For Slower Growth In 2011: Markets

Trends In Leading Indicators Alter The Risk-Reward Profile Of Financial Markets

Leading indicators often dictate equity market returns.


Portfolio Strategy | September 2011
Investing For Slower Growth In 2011: Sectors

Economic Momentum Trade: Hyper Cyclicals Typically Lag As LEIs Fall

Source: Wolfe Trahan & Co., Factset
Investing For Slower Growth In 2011: Factors

Aggressive White Box Factors Are Underperforming...

... And Defensive Factors Are Outperforming

Investing For Slower Growth In 2011: Fixed Income

Trends In LEIs Typically Help Explain Movements In Bond Yields

Source: Wolfe Trahan & Co. , Bloomberg
Investing For Slower Growth In 2011

Increasing Portion Of Global Economy In Contraction

Still Expanding | Close To Contraction | In Contraction
--- | --- | ---
Norway | 55.5 | Russia | 49.9
Denmark | 54.4 | China | 49.9
Czech Republic | 53.4 | Poland | 51.8
Germany | 50.9 | South Korea | 49.7
Netherlands | 50.7 | Singapore | 49.3
United States | 50.6 | France | 49.1
Austria | 50.1 | U.K. | 49.0
Hungary | 50.1 | Eurozone | 49.0
Sweden | 48.7 | Turkey | 48.8
Hong Kong | 47.8 | Spain | 46.3
Italy | 47.0 | Taiwan | 46.2
Spain | 45.3 | South Africa | 46.7
Taiwan | 45.2 | Greece | 43.3
South Africa | 46.7 | Australia | 43.3

Most countries outside of the U.S. are already in a double-dip.

Global PMIs mostly fell in the month of August.

Source: Wolfe Trahan & Co. Data Insight
A Field Guide To Understanding The New Normal

10 Realities Likely To Shape The Market Outlook

• 1. The Death Of Traditional Economic Models ... Why They No Longer Work
• 2. Deleveraging And How It Magnifies The Importance Of Employment
• 3. The Breakdown In Conventional Measures Of Fiscal/Monetary Stimulus
• 4. An Inevitable (And Bearish) Road To Government Austerity
• 5. A New Swing Factor In The Economic Growth Equation ... Inflation!
• 6. The Fed's "Goldilocks" Mandate ... And Why It's Unachievable Today
• 7. Rising Core Inflation Probably Delays More Fed Easing (i.e. QE3)
• 8. The Fed's Inflationary Policies Set To Reinforce Deflationary Pressures
• 9. Sub-par Growth Trends Make "Tail Risks" Part Of The New Normal
• 10. Crisis In Developed Economies Set To Weigh On The Secular Emerging Market Story

1. The Death Of Traditional Economic Models… Why They No Longer Work!

Key Economic Data Has Come In Well Outside Of Economists’ Estimates

Economists' GDP Estimates For First Half 2011
(As of January 2011 - WSJ Survey)

For economists, GDP was a wild pitch in the first half @ 0.4%!

1. The Death Of Traditional Economic Models… Why They No Longer Work!

Economists’ GDP Estimates Have Been Off The Mark In 2011 ... What Are They Missing?

Earlier This Year Economists Were Forecasting >3% GDP Growth In 2011:

"Classic" Economic Models Have Failed Because They Assume ...

1. Fed Policy Is Accretive
2. Low Rates Will Boost Housing
3. Corporate Profits Lead To Job Growth
4. Consumers Use Credit
5. Job Growth Is Always Broad-Based

1. The Death Of Traditional Economic Models… Why They No Longer Work!

Models Assume Profits Will Lead To Job Gains In The Economy

The last time that profits and jobs were both correlated is when they both disappeared during the financial crisis.

Labor share at all-time low!

U.S. Labor Compensation Share Of Total Corporate Output

1. The Death Of Traditional Economic Models… Why They No Longer Work!

Models Assume Fed Policy Is Accretive

Post-2000: Opposites!

China is now the marginal consumer of energy commodities.

Source: BP’s 2011 Annual Report

1. The Death Of Traditional Economic Models… Why They No Longer Work!

Models Assume Fed Policy Is Accretive

“A wide range of market indicators support the view that the Fed’s securities purchases have been effective…equity prices have risen significantly.”

- Ben Bernanke

"It’s entirely unfair to attribute excess demand pressures in emerging markets to U.S. monetary policy …"

- Ben Bernanke

1. The Death Of Traditional Economic Models… Why They No Longer Work!

"That Recession Forecast? Yield Curve Says No Way" - Bloomberg

"The yield curve is a valuable forecasting tool. It is simple to use and significantly outperforms other financial and macroeconomic indicators in predicting recessions two to six quarters ahead." - NY FED

"A steep yield curve is a formula for the S&P 500 to hit all-time high" - Institutional Investor

"The most important leading indicator, the yield curve, is saying there will be no recession anytime soon" - The Economist
1. The Death Of Traditional Economic Models... Why They No Longer Work!

Models Assume Lower Rates Lead To A Recovery In Housing

1990s: Lower Interest Rates = Better Housing

Post- 2005: Lower Rates = Worse Housing!?!
1. The Death Of Traditional Economic Models… Why They No Longer Work!

Models Assume Consumers Use Credit

29 percent of poll respondents reported that they do not have a credit card … more than a 10% jump from the number in June 2009.

Source: Scientific poll for CreditCards.com, conducted 2010

37 percent of consumers say they are using their credit cards less.

Source: Javelin Strategy & Research, “Credit Card Issuer Profitability in a Difficult Economy,” July 2008
1. In Summary …

Econometric Models Are Systematically Overestimating Growth

"A PMI in excess of 42.5 percent, over a period of time, generally indicates an expansion of the overall economy."

"The past relationship between the PMI and the overall economy indicates that the average PMI for January through August (56.8 percent) corresponds to a 5 percent increase in real gross domestic product (GDP)"

- Institute For Supply Management, August 2011 Report

1. In Summary …
Econometric Models Are Systematically Overestimating Growth

Rightsizing The Government And Deleveraging Have Changed The Employment Picture

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The 2008 financial crisis brought about a structural regime shift in the relationship between payrolls and the ISM Employment index.

The latest ISM Employment reading of 51.8 coincided with no employment growth in August.

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2. Deleveraging And How It Magnifies The Importance Of Employment

**Student Loans Have Supported Overall Consumer Credit Levels**

Student-Loan Debt Surpasses Credit Cards  
– WSJ 8/9/2010

Since 2006, student loans outstanding have increased 90% whereas credit card debt has declined 4%.  
- FRBNY Consumer Credit Panel/ Equifax

Source: Wolfe Trahan & Co. Data Insight
2. Deleveraging And How It Magnifies The Importance Of Employment

An Economic Recovery Has Never Been This Dependent On Job Growth

Consumption = Income + Credit

Negative credit growth means that employment is the dominant force on equity markets (-50% correlation between claims and stocks!)

3. The Breakdown In Conventional Measures Of Fiscal/Monetary Stimulus

Easy Fed Policy Has Failed To Reaccelerate Money Velocity (i.e. Activity In The Real Economy)

Fed Out Of Policy Options
- Increase money supply
- Improve liquidity
- Lower rates to zero
- Control yields on corporate bonds
- Depreciate the USD
- Buy Foreign Currencies
- TARP
- TALF
- CPFF
- MMIF
- PDCF
- AMLF
- TSLF
- PPFR
- TAF
- QE1
- QE2
- ???

If QE2 didn't lift velocity, why should we do QE3?

Money Velocity (YoY Change, L)  Fed Funds Rate (R)

3. The Breakdown In Conventional Measures Of Fiscal/Monetary Stimulus

Recovery Act Becomes A Drag On GDP Growth

Fiscal Stimulus Contribution To Real GDP Growth (Recovery Act)

The government is essentially kicking the can down the road ...

Source: Recovery.org
4. An Inevitable (And Bearish) Road To Government Austerity

State/Municipalities Already Right-Sizing The Government

Austerity programs at the state-level are set to persist through 2012.

Source: Wolfe Trahan & Co., Center On Budget and Policy Priorities
4. An Inevitable (And Bearish) Road To Government Austerity

State & Local Governments Are Shedding Jobs To Shore Up Their Deficits

Fiscal year 2012 (began July 1st for most states) marks the 4th consecutive year of budget cuts.

- **New York**: Cutting education aid by $1.3b (6.1%)
- **Georgia**: Shortening the school year
- **Arizona**: Eliminating Medicaid for 130,000 people
- **Michigan**: Cutting 124,000 low income kids from a program that helps provide school clothes

670K jobs have been lost at the state and local level since mid-2008 ...

... despite the Federal transfers to “save jobs”

Source: Wolfe Trahan & Co. . Data Insight
4. An Inevitable (And Bearish) Road To Government Austerity

Investors Are Punishing States That Are Being Less Fiscally Responsible

Relative Muni Yields By States Cutting And Not Cutting Jobs

- States that shed jobs are seeing their financing costs drop relative to others.

4. An Inevitable (And Bearish) Road To Government Austerity

Federal Budget Approaching A Tipping Point For Fiscal Stimulus?

The CBO doesn’t expect the budget deficit to return to “normal” levels until 2014!

The CBO Estimate

Assumes no recession

Wolfe Trahan 0% Growth Assumption

Percentage Of GDP

5. A New Swing Factor In The Economic Growth Equation ... Inflation!

Consumers’ Financial Health = Credit + Wealth Effect + Employment

- Consumers’ relationship with credit is impaired.
- The wealth effect is hindered.
- The employment outlook is grim.

5. A New Swing Factor In The Economic Growth Equation ... Inflation!

The Impact Of Inflation On Leading Economic Indicators Is More Important Than Ever

The correlation between CPI (advanced 6 months) and leading indicators now hovers around -75%, the strongest link since the 70s!
6. The Fed's "Goldilocks" Mandate ... And Why It's Unachievable Today

The Fed says it wants to create a Goldilocks economy...

... but she's been missing for over a decade!

"The Federal Reserve remains committed to playing its part to help the U.S. economy return to sustained, noninflationary growth."
- Bernanke, 2010 Jackson Hole Speech

"The Federal Reserve will certainly do all that it can to help restore high rates of growth and employment in a context of price stability."
- Bernanke, 2011 Jackson Hole Speech
7. Rising Core Inflation Probably Delays More Fed Easing (i.e. QE3)

Taylor Rule No Longer Supportive Of Fed Easing

- Fed’s Plosser Says Fed Likely to Need to Tighten Before Mid-2013 - 8/18
- Fed’s Kocherlakota Says Policy Makers Should Raise Rates in ’11 - 5/11

If the Taylor Rule no longer supports additional easing, it will be hard for the Fed to make the case for it...

7. Rising Core Inflation Probably Delays More Fed Easing (i.e. QE3)

Core Measures of Inflation Are Rising … And Likely To Move Higher From Here

Source: Wolfe Trahan & Co. / Bloomberg
8. The Fed’s Inflationary Policies Set To Reinforce Deflationary Pressures

The Path Of Large Declines In The Dollar

<table>
<thead>
<tr>
<th>Period</th>
<th>Export Boom (Starting Point)</th>
<th>Inflation Scare (Tipping Point)</th>
<th>Growth Slowdown (Market Impact)</th>
<th>Rollover In Core CPI (YoY)</th>
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<tbody>
<tr>
<td>1973</td>
<td>Apr-73</td>
<td>Dec-73</td>
<td>Aug-74</td>
<td>Beginning 1975</td>
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<tr>
<td></td>
<td>&quot;U.S. Slashes Trade Deficit As Exports Hit Record High&quot;</td>
<td>&quot;Inflation, Shortages And Recession Seen For 1974&quot;</td>
<td>&quot;Inflation Roars; Stocks Crash&quot;</td>
<td>-6.50%</td>
</tr>
<tr>
<td>1979</td>
<td>Dec-79</td>
<td>Jan-81</td>
<td>Jan-01</td>
<td>Beginning 1980</td>
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<tr>
<td></td>
<td>&quot;Record Exports Boost U.S. To Balance Of Payment Surplus&quot;</td>
<td>&quot;Jobs Scarce As Inflation Soars&quot;</td>
<td>&quot;Inflation News Sends Stock Prices Down&quot;</td>
<td>-9.40%</td>
</tr>
<tr>
<td>1997</td>
<td>Jan-92</td>
<td>Nov-93</td>
<td>Sep-93</td>
<td>Beginning 1998</td>
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<tr>
<td></td>
<td>&quot;Export Sales At All Time High&quot;</td>
<td>&quot;Income Gains Chewed Up By Taxes, Inflation&quot;</td>
<td>&quot;Fear Of Inflation Puts Brakes On The Market&quot;</td>
<td>-2.60%</td>
</tr>
<tr>
<td></td>
<td>&quot;Strong Exports Improve Trade Deficit&quot;</td>
<td>&quot;Increasing Food Prices Eat Into American Wallets&quot;</td>
<td>&quot;Inflation Fears Trip Stocks&quot;</td>
<td>-1.40%</td>
</tr>
<tr>
<td>2010</td>
<td>Mar-10</td>
<td>Mar-11</td>
<td>Aug-11</td>
<td>Beginning 2012</td>
</tr>
<tr>
<td></td>
<td>&quot;U.S. Exports Hit All-Time High In January&quot;</td>
<td>&quot;Rising Prices Hurt Consumer Confidence&quot;</td>
<td>&quot;Economic Fears Hit Global Markets&quot;</td>
<td></td>
</tr>
</tbody>
</table>

Source: Wolfe Trahan & Co., Various News Sources
8. The Fed's Inflationary Policies Set To Reinforce Deflationary Pressures

Trade Growth Unlikely To Carry The GDP Torch In 2011

There's no doubt a lower dollar lifts exports …

… but it ALSO lifts import prices (i.e. inflation).

8. The Fed's Inflationary Policies Set To Reinforce Deflationary Pressures

The Composition of U.S. GDP Is Unlike Any Other Country

Difference Between Consumer And Export Sector

The U.S. Has The Largest Size Difference Between “C” and “X” ...

... a devaluation in the currency would hurt the consumer sector more than help the export sector.

Economies that can use exports to boost their way out of a domestic slowdown.

8. The Fed's Inflationary Policies Set To Reinforce Deflationary Pressures

A Weak-Dollar Typically Leads To Higher Import Prices Which Translates To Rising U.S. Inflation

CPI and import prices tend to move hand in hand.

Import prices continue to rise!

8. The Fed's Inflationary Policies Set To Reinforce Deflationary Pressures

Inflationary Pressures Tend To Weigh On Leading Indicators


Investors Focus On The "Bad News" More When Overall Growth Begins To Weaken

The likelihood of a "tail-risk" event occurring increases dramatically as growth slows (i.e., ISM falls into contraction territory).

Euro Crisis
U.S. Double Dip
China Hard Landing
Etc ...

Muni Defaults
Bank run
Social Unrest


Decelerating Money Supply In The Eurozone Suggests Slower Growth Ahead

Lack of further central bank easing leaves little room for money supply growth ...

... slower money supply growth typically begets slower economic growth (with a lag).

Eurozone Real GDP Growth (YoY % Chg, L)  Eurozone M1 Growth (YoY % Chg, Adv 12m, R)


Lower Confidence In Europe Is Indicative Of Slower Growth Ahead

The CDS Domino-Effect Continues To Spread Around The World ... What's Next?

10. Crisis In Developed Economies Set To Weigh On Secular Emerging Market Story

Brazil Central Bank Unexpectedly Cuts Its Overnight Rate To 12.0% From 12.5% Following Observations Of "Substantial Economic Deterioration"

What They Said …
“Reevaluating the international scenario, the committee considers that there has been substantial deterioration, shown by, for example, generalized and large reductions in growth projections for the principal economic blocks.”

“The committee understands that this increases the chances that restrictions that are today seen in various mature economies will prolong themselves for a longer period than expected.”

“The committee also notes that in these economies, there appears to be limited space for the utilization of monetary policy and that a restricted fiscal scenario prevails.”

… What They Mean
Growth is slowing …
… contagion risk from developed economies is increasing …
… monetary policy is no longer working and austerity is coming!

10. Crisis In Developed Economies Set To Weigh On Secular Emerging Market Story

The Pace Of Policy Tightening Is Picking Up Alongside Inflation

We expect more rate hikes in many emerging economies in 2011.

Higher inflation = tighter policy!

10. Crisis In Developed Economies Set To Weigh On Secular Emerging Market Story

Policy Tightening Is Likely To Continue To Weigh On Chinese Production

Industrial Production in China is likely to face headwinds through at least the end of 2011.

10. Crisis In Developed Economies Set To Weigh On Secular Emerging Market Story

Analyzing Global-Growth Prospects Via The Supply Chain

This is yet another sign that U.S. leading indicators will likely deteriorate ahead.

Why We Think 2012 Will Be Better Than 2011 For Equities

Alleviating Inflation Pressures Would Be Good News For 2012

Anticipatory Signs Of A Rise In LEIs In 2012

- **1. A Peak In U.S. Inflation (CPI)**
  - CPI Likely Near/At A Peak

- **2. Continued Decline In Prices Paid Indices**
  - Trough In LEIs In Q1 2012?

- **3. Outperformance Of Early vs. Late-Stage Cyclicals**
  - Trough In LEIs In Jan 2012?

- **4. The Monetary Flow Indicator Finds A Footing**
  - Trough In LEIs In March 2012?

- **5. Central Banks Slow Rate Hikes**
  - Drop In Oil Likely To Slow Rate Hikes Around The World. Brazil Rate-Cut Last Week.

- **6. The USD Begins To Strengthen**
  - Dollar Still Trying To Find A Footing. It’s Been Flat For 5 Months.

Source: Wolfe Trahan & Co. , Bloomberg
Why We Think 2012 Will Be Better Than 2011 For Equities

If Gas Prices Move Sideways From Here ... CPI Is Likely To Peak In Q3 2011

Here is what fuel inflation may look like if prices stay flat.

CPI Likely At The Peak

United States Headline CPI YoY (L)  Unleaded Gasoline Spot Index (YoY, R)

Why We Think 2012 Will Be Better Than 2011 For Equities

Regional Prices Paid Suggest There Is A Light At The End Of The Tunnel

Many prices paid indices peaked earlier this year ... ... does this foreshadow an H1 2012 rise in LEIs?

Potential trough of regional LEIs

Leading indicators tend to trough 6 to 9 months after their “prices paid” components peak.

Recent peak in regional prices paid indices

Source: Wolfe Trahan & Co. Data Insight
Why We Think 2012 Will Be Better Than 2011 For Equities

The Monetary Flow Indicator Has Ticked Up … Good News For 2012!

A rise in the MFI often precedes a rise in leading economic indicators.
Why We Think 2012 Will Be Better Than 2011 For Equities

The Relative Performance Of Early To Late-Stage Cyclicals Tells Us Good Things May Be In Store For 2012

Early cyclicals typically begin to outperform about nine months before LEIs rise.

ISM Manufacturing Index (L)
Early/Late-Stage Cyclicals Relative Perf. (Adv 9m, YoY % Chg, R)

This series suggests 2012 could be the return of stronger LEIs.

Source: Wolfe Trahan & Co. / Factset
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