



IT'S GREEK TO ME

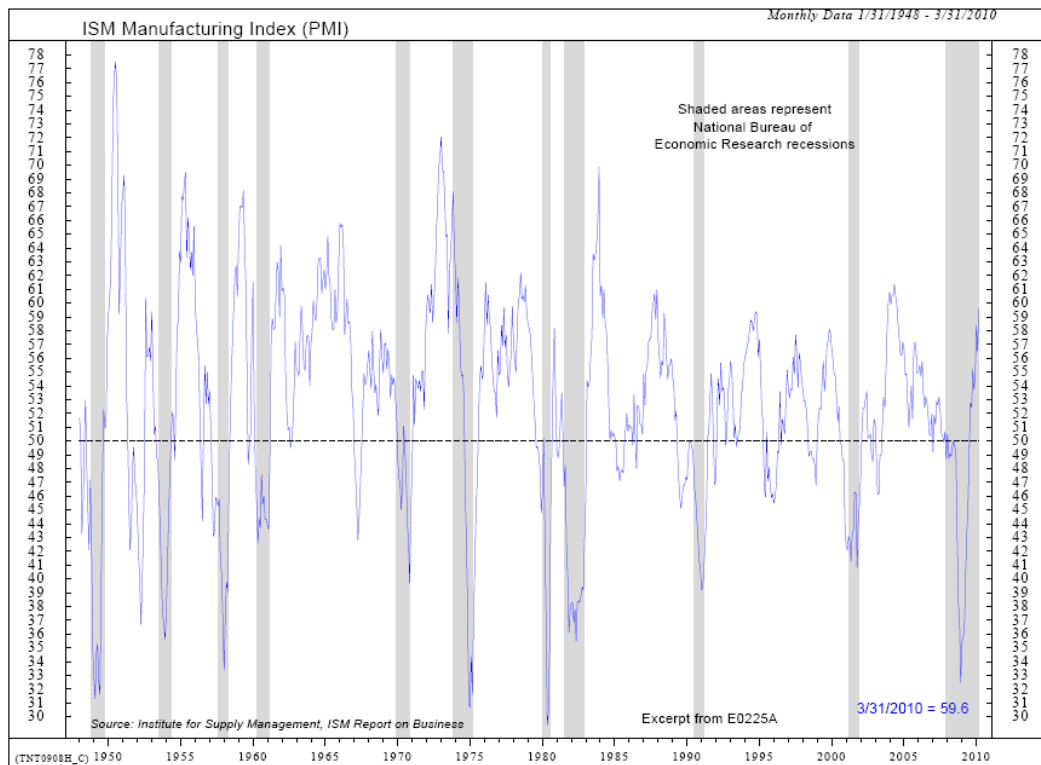
In January, I laid out my expectations for the year ahead and how I thought the market might play out. I also included a list of potential surprises and one of them, the possibility of a Sovereign Debt default, has me particularly intrigued.

So let me start out with an update on the economy because it's important to understanding my views on the market, and then I'll elaborate a bit on government debt.

Economy

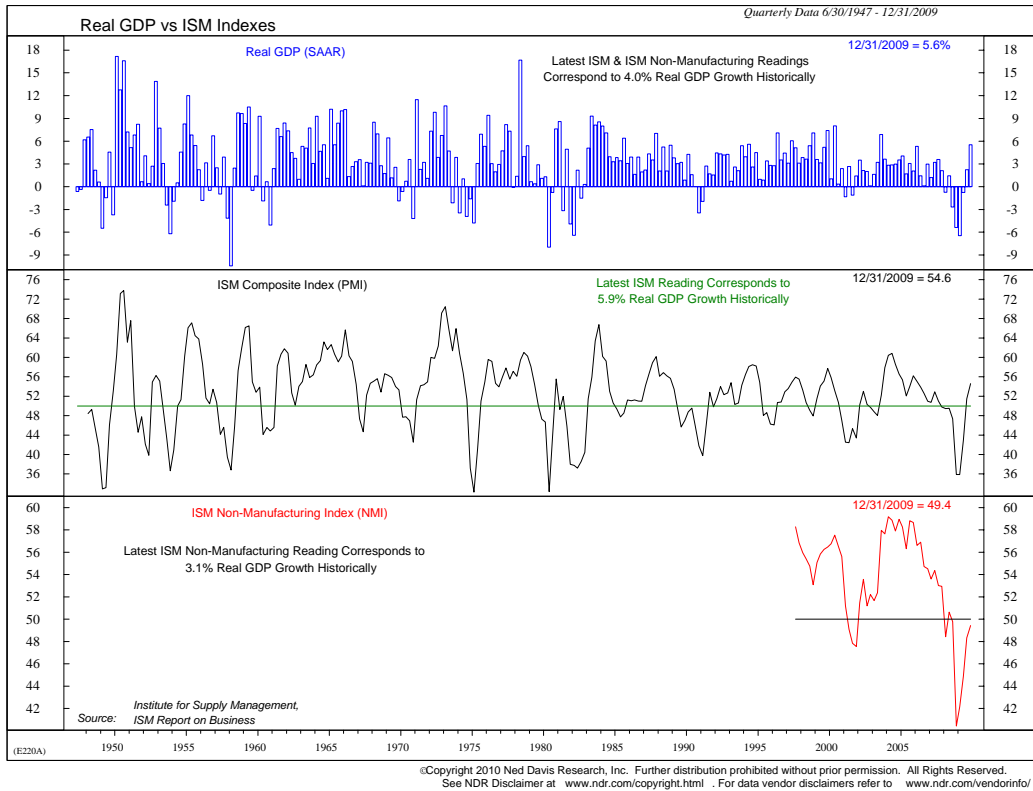
4th Quarter GDP came in at 5.7%, not far off the 6% average of the last 6 recovery cycles. As expected, a recovery in inventories accounted for a large portion of this gain.

Since then, a number of key economic variables have remained strong. I've mentioned the benefits to GDP from inventory building in the past, and improvement here should show up in stronger manufacturing, which it is. The ISM composite index (PMI) rose 3.1% in March to 59.6.



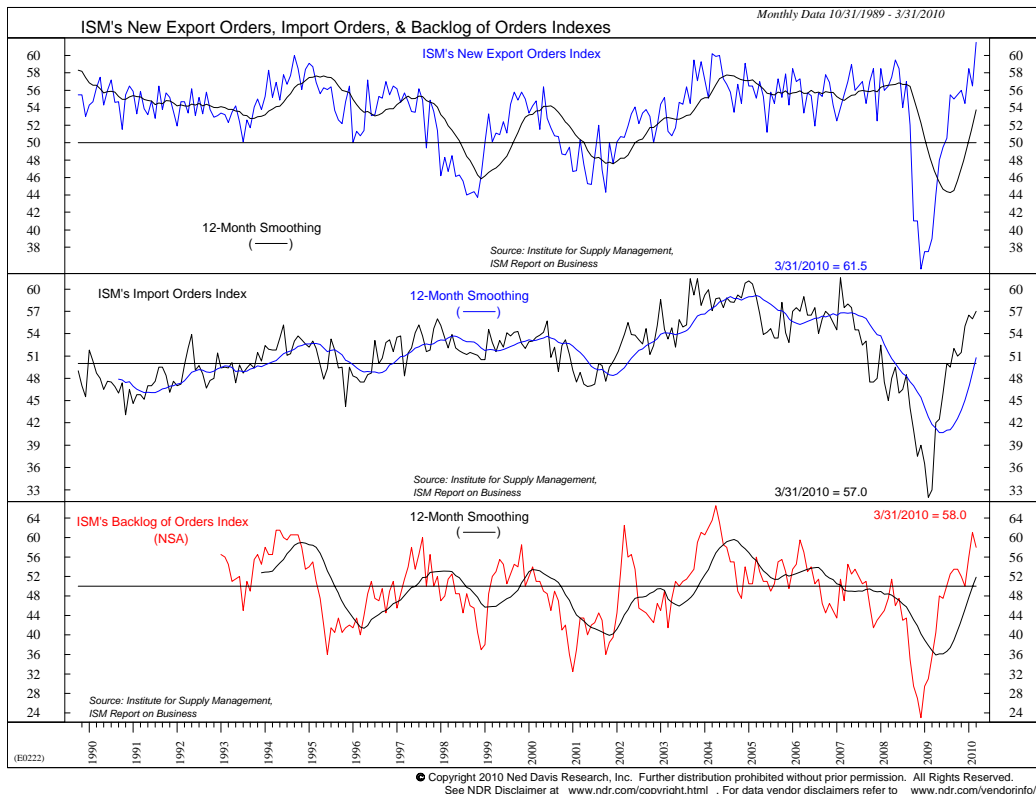
© Copyright 2010 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/.

This was the highest reading since July 2004. Most of this was due to an 8 point gain in the ISM inventories index, the most in 22 years and the highest since 1984.



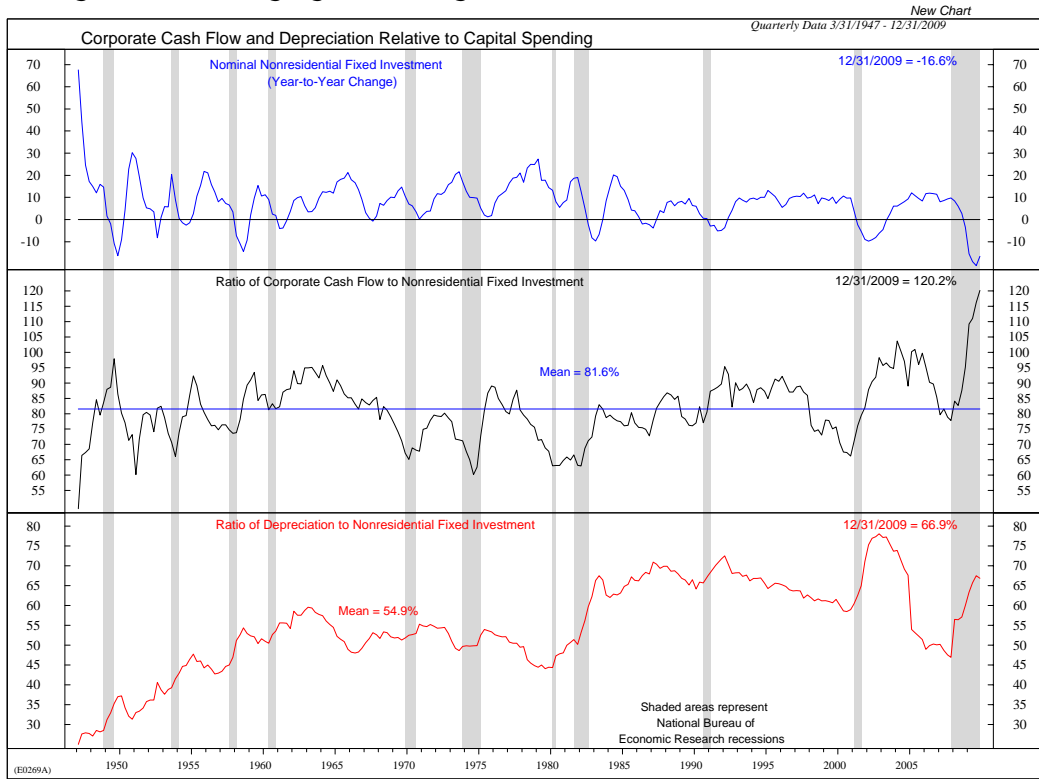
As can be seen in the middle clip of the above chart, the PMI index corresponds to 5.9% real GDP growth.

Another positive index is one that tracks U.S. exports.



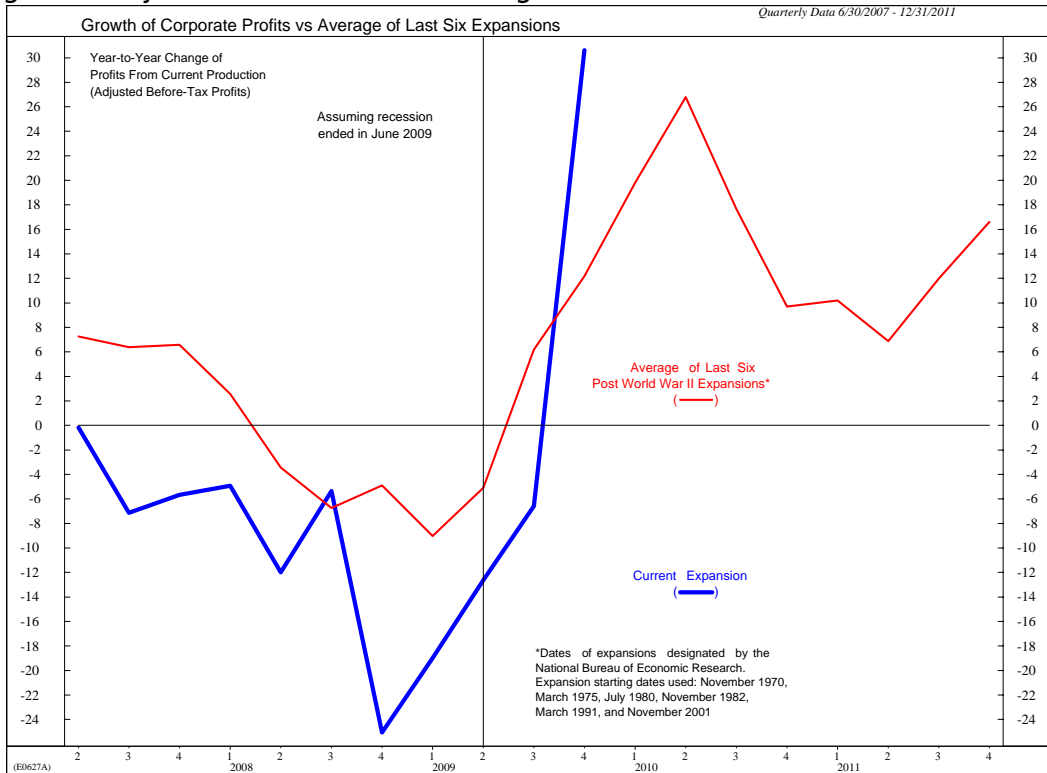
As seen in the top clip, the new export orders index has now reached a record high.

Capital spending is also showing signs of taking off.

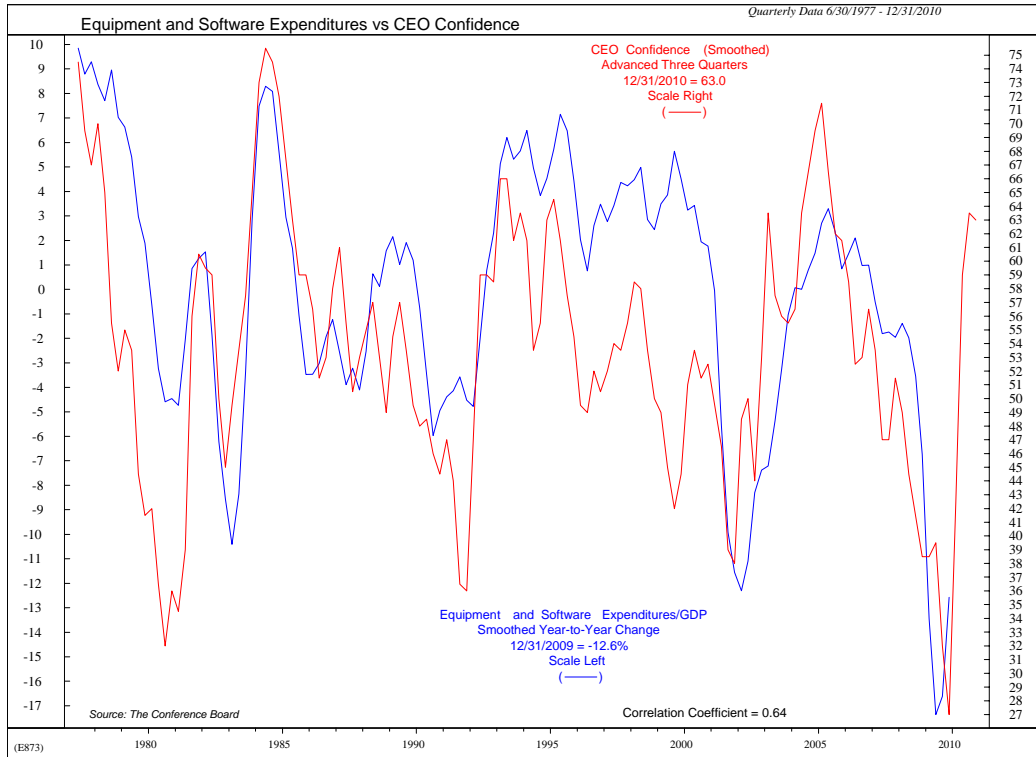


The middle clip here, shows that corporate cash flow as a percentage of capital spending reached a record 120.2% last year and cash and other liquid assets make up a record 13.8% of corporate net worth.

Corporate profits are also rising faster than average for this stage of the cycle as seen below, which says something about why the market has been so strong.

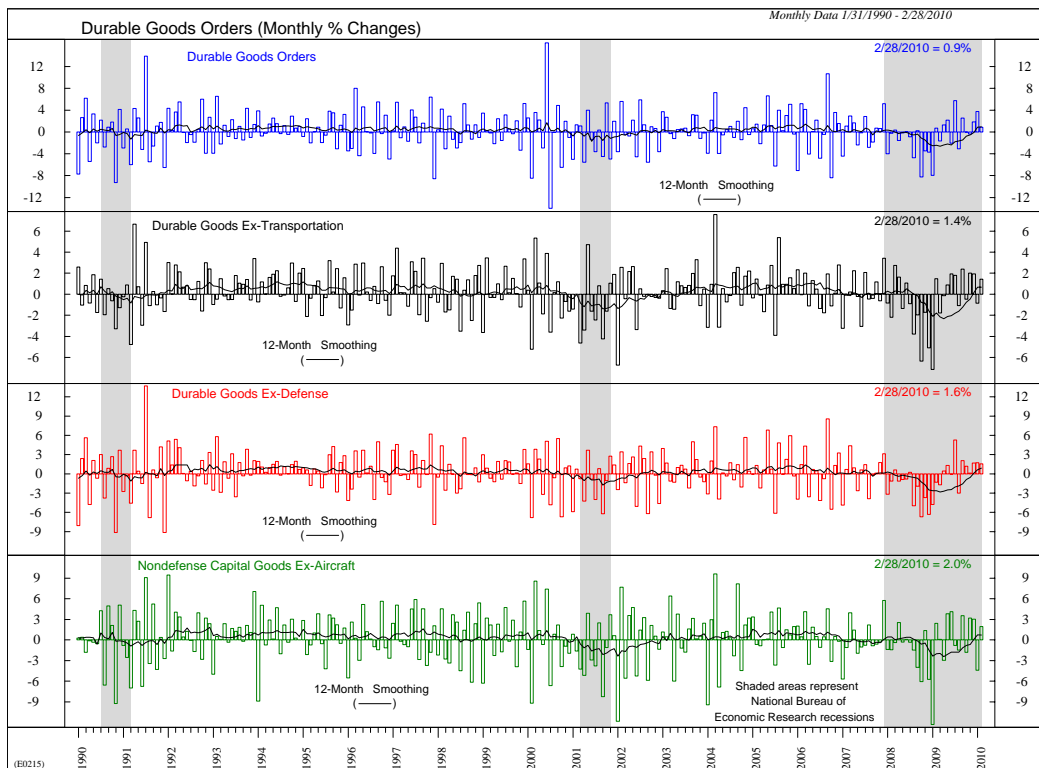


So, the wherewithal to spend is there and it would appear that current CEO confidence, which corresponds well with a pick-up in equipment and software expenditures, is favourable.



©Copyright 2010 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved.
See NDR Disclaimer at www.ndr.com/copyright.html . For data vendor disclaimers refer to www.ndr.com/vendorinfo/ .

Furthermore, non-defense capital goods orders, a proxy for capital spending, almost doubled from its earlier estimates.



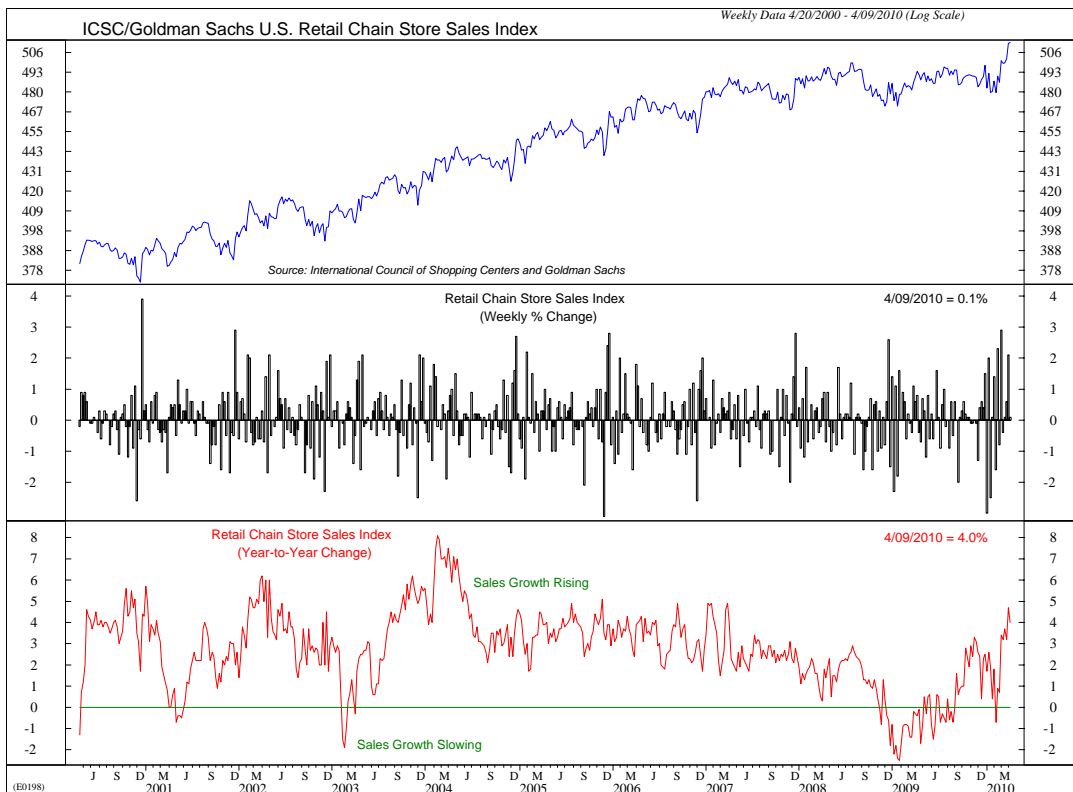
©Copyright 2010 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved.
See NDR Disclaimer at www.ndr.com/copyright.html . For data vendor disclaimers refer to www.ndr.com/vendorinfo/ .

Now, most of the Bears on the economy won't refute this improvement but they would caution that most of this has a one time impact and once it has passed, there is little to sustain economic growth, especially once government stimulus has ended. And there are some facts that support their side, so I wouldn't totally discount their conclusion.

- It's true that personal income has been propped up by government transfers. Over the past 12 months through February, personal income is up \$242.6 billion while Government transfers are up \$242.9 billion. Those receipts account for 18.2% of personal income.
- Tax credits for homebuyers will expire at the end of April and the FHA is tightening its lending standards.
- In 2011, there will be a personal tax increase with the highest tax rate going to 39.6% from 35% and capital gains taxes being pushed to 20% from 15%.
- Interest rates have been held at artificially low levels and will increase to the detriment of the general economy.

I would contend that all of this is of course true, but it is usually the case after the government stimulates the economy after a recession. However, in past cases this initial "pump priming" has given way to self reinforcing economic gains as employment rebounded and capital spending picked up. So, I'm not willing to concede to the "This time it's different" crowd, and will bet that the economy does become self-sustaining.

What gives me some hope are the very sectors that the Bears say will hold us down and that is the lack of consumer spending. From their perspective, consumers are expected to retrench by deleveraging and saving more. Unemployment is to stay high while taxes increase. So the question is, if that is the case, why has real personal consumption increased by 3.1% over the last three months through February?



©Copyright 2010 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/.

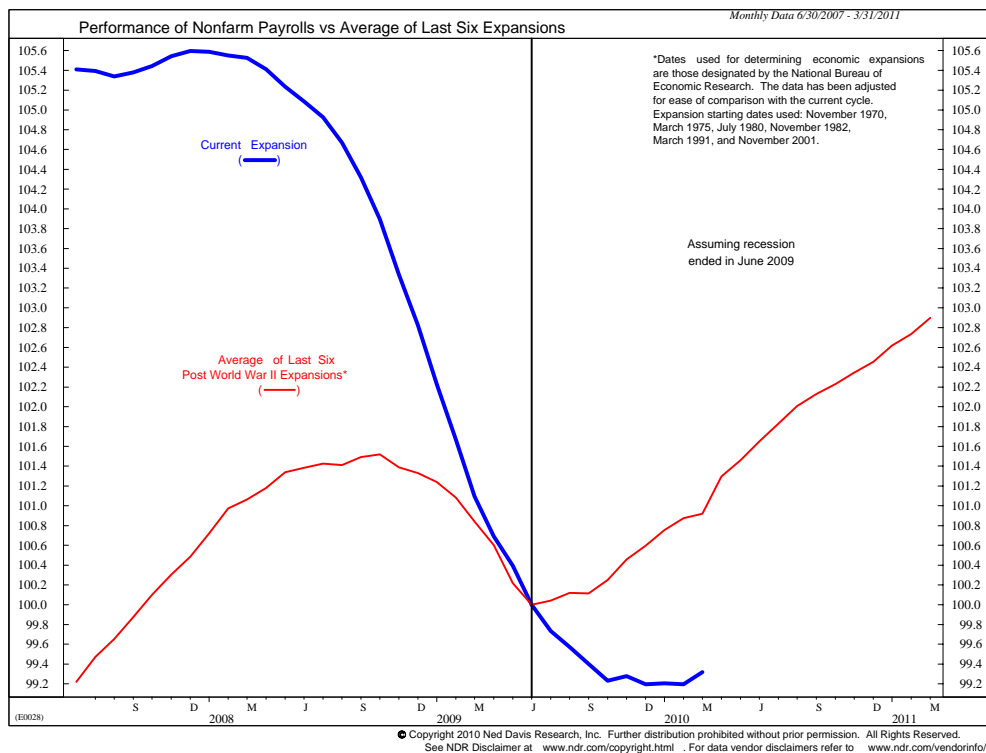
The ICSC/Goldman Sachs Retail Chain store sales index, shown on the previous page, rose 2.1% the last week of March which puts the index 4.0% above the year ago level, the most in three years. They also revised their March year-over-year sales expectations to a gain of 8% to 10%, which was the biggest advance in 16 years.

Also in March, light vehicle sales jumped 13.6% to an 11.8 million unit annual rate with most of these going to domestic producers. What's driving this seems to be a return of financing. GMAC is offering 0% interest loans and discounted leases to buyers of GM and Chrysler vehicles, while at Honda leases account for over half of their sales.

Pending home sales also recovered by 8.2% in February, which is the most since October, 2001. According to Ned Davis Research, based on pending sales, their model suggests existing home sales will climb to 9% in March. Surprisingly strong? Probably not as government assisted housing programs end in April, so there is likely a push to get in under the wire.

And finally, there is employment which is probably one of the most important variables in the economic puzzle and one that is inconclusive.

The latest report showed an increase of 162,000 people to the work force. It was the 3rd gain in the past 5 months and the most since March, 2007.



However, as can be seen in this chart, it is one of the few economic variables that is lagging the typical recovery of past cycles.

Within overall employment, temporary help is showing a typical "V" shaped recovery while the goods producing sector added 41,000 jobs, the first increase since March 2007.

Also the alternative "Household Survey" which is broader, showed that employment rose by 264,000 and for three months suggested employment is up by 1.357 million people.

Although employment seems to be slow to recover, it is not off track from more recent recoveries. In 1991, the economy bottomed in March and unemployment peaked 15 months later while improvements didn't come for an additional 12 months. The recession ended in November, 1991 but employment didn't turn positive for 22 months.

This time, the recession ended in June, 2009, unemployment peaked in October and started to improve in March, only 9 months after the end of the recession.

So, for the balance of this year, I'll give the economy the benefit of the doubt and bet that it continues to grow and if there is to be a surprise, that it will be on the positive side.

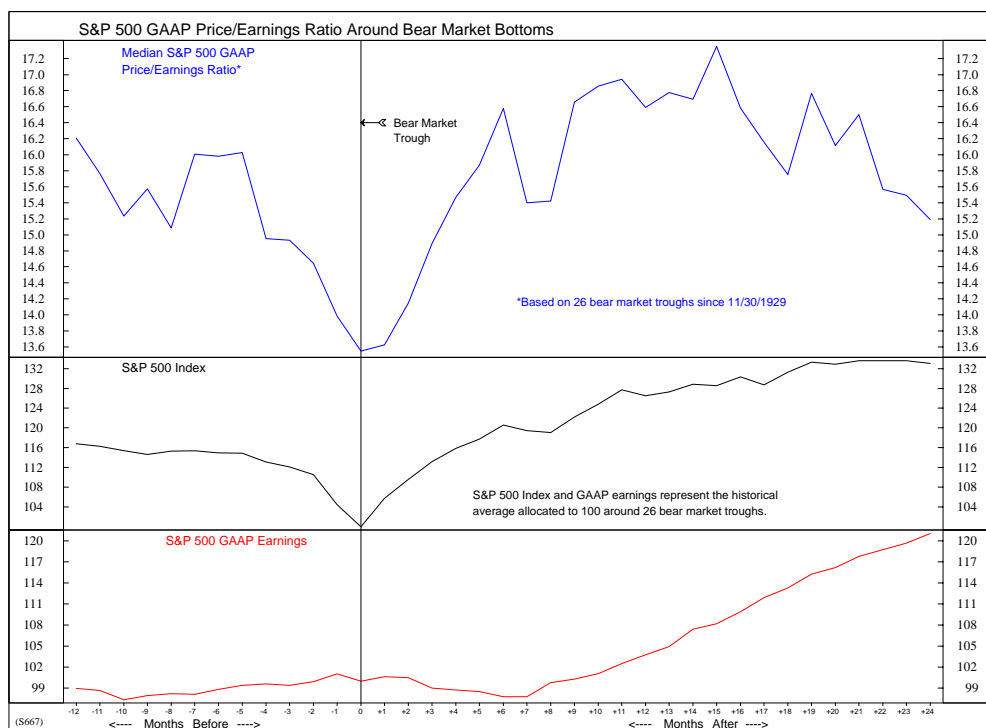
If the Bears are right, I think it's a story for 2011. Certainly I share some of their concerns, one of which I will address shortly.

Stock Market

As for the stock market, I am concerned. Not that I think we're on the verge of a bear market or a retest of last year's lows, but I do think we're due for a solid correction.

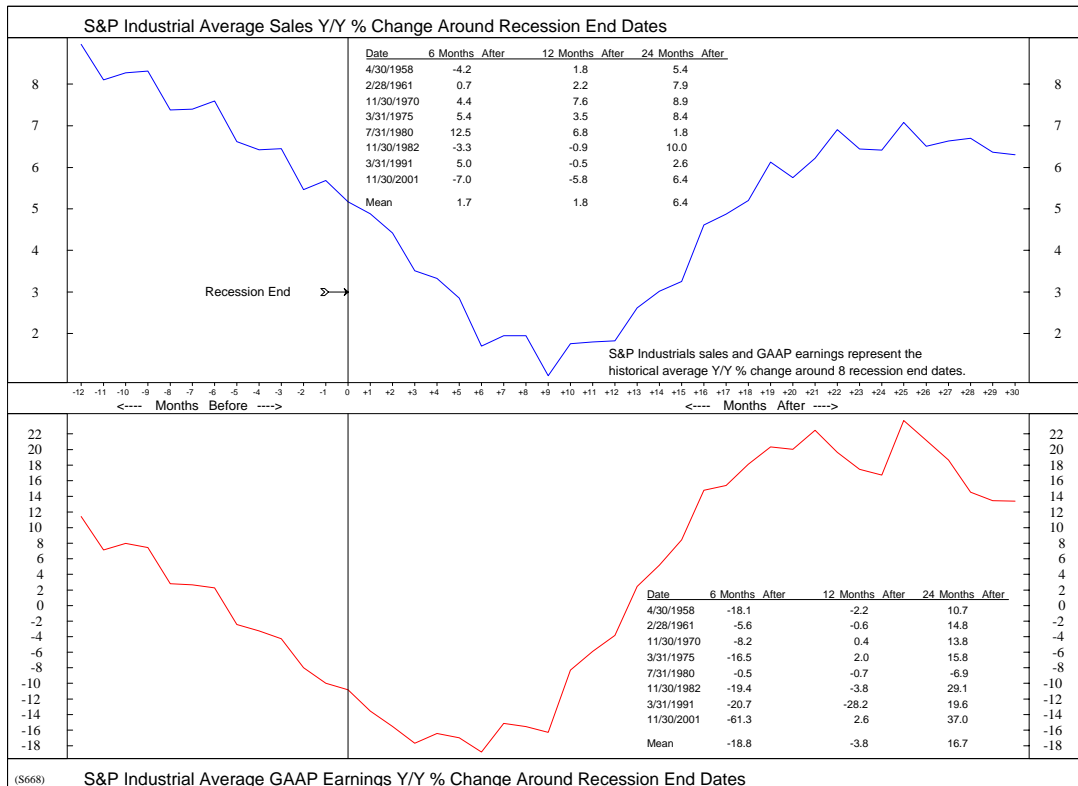
Unlike many others, this isn't because I think the market is that overvalued. It isn't cheap given the recovery we've seen, but if earnings come through it is no worse than fairly valued.

I've referred to the lead times of the market over economic and earnings troughs before, but maybe the following two charts will help put the current market into perspective.



© Copyright 2010 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/.

Stock markets generally bottom well ahead of economic troughs and generally about 6 months before earnings bottom, as shown in the bottom clip of the previous chart. So, during the initial phase of a market recovery, price earnings multiples expand quite sharply as the market discounts the earnings improvement. As the above chart indicates in the top clip, P.E. ratios rise along with the market while earnings improvements lag. It's generally about 15 months after the start of a bull market that P.E.'s peak. So what we have seen so far is not out of the ordinary.



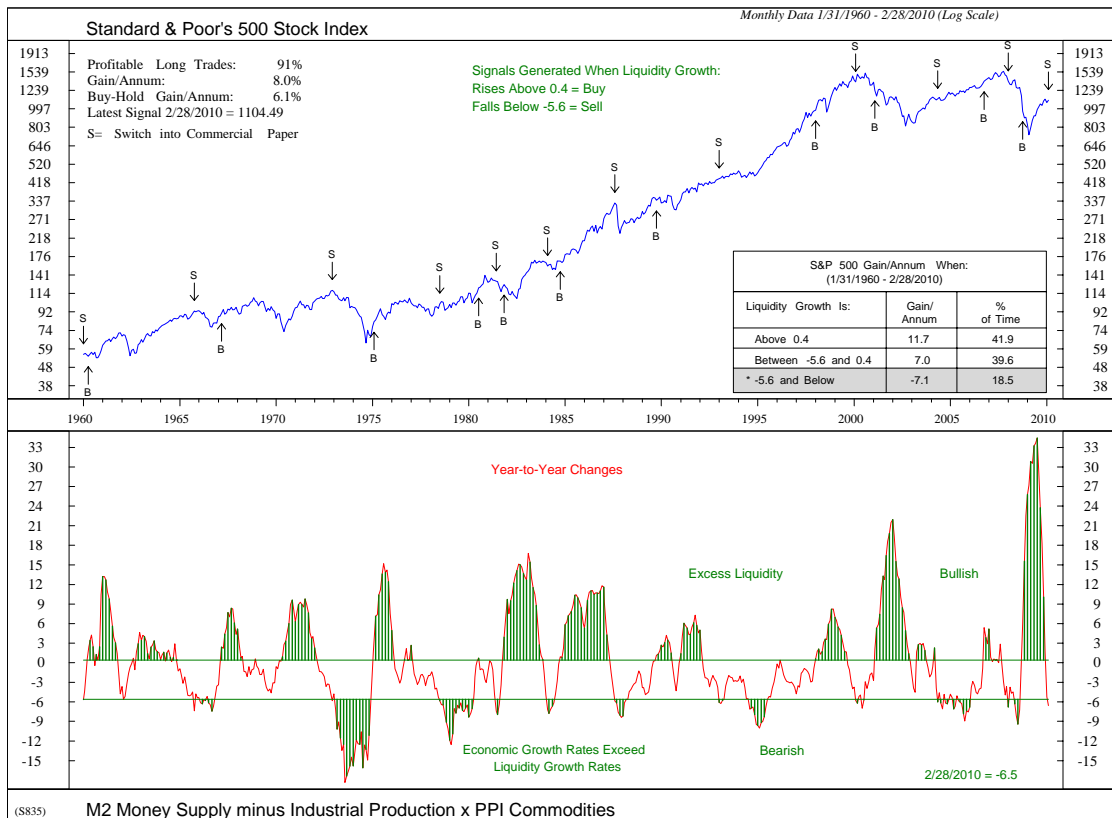
This chart shows that corporate sales growth, as shown in the top clip here, doesn't usually pick up until 3 months after earnings start to improve, as seen in the bottom clip. That's why in my earlier quarterly commentaries, I suggested that 2009 was a margin improvement story while 2010 will be all about top line growth.

So why a correction? Well, it has a lot to do with my views on the economy and what makes the market go, and that is liquidity.

If I'm right about the expansion, we're to going to see:

- Expanding inventories
- More capital spending
- Greater consumer spending
- Export growth

And they all require capital.



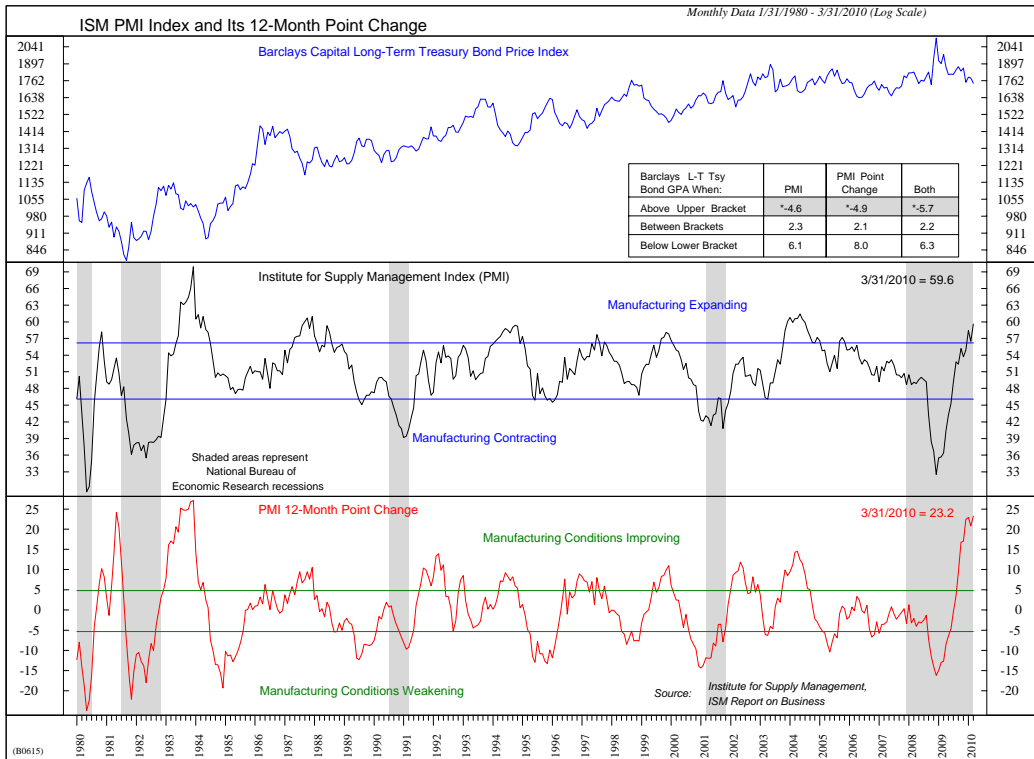
© Copyright 2010 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved.
 See NDR Disclaimer at www.ndr.com/copyright.html . For data vendor disclaimers refer to www.ndr.com/vendorinfo/ .

I showed this chart last quarter and it's become more negative since then. It reflects the amount of liquidity that is being consumed by the economy which then will not be available to the stock and bond markets.

Add to this the fact that monetary policy is about to shift from very accommodative to neutral, which will probably be enough of a change to induce a correction but not an end to this bull market. A further shift from neutral to tightening will be required to end this rally.

Exactly when the Federal Reserve will raise interest rates is still open to debate, but restrained liquidity will come as the Fed stops buying mortgage backed securities, as it now has, and will tighten further as the U.S. Central Bank starts to contract its balance sheet and withdraws the "Crisis Stimulus" that we saw provided in 2008.

Usually, the all clear signal for the Fed is an improvement in the employment figures which we now have. They may delay raising rates but the bond markets already sense that the timing is getting close as 10 year U.S. Treasuries recently hit 4%.

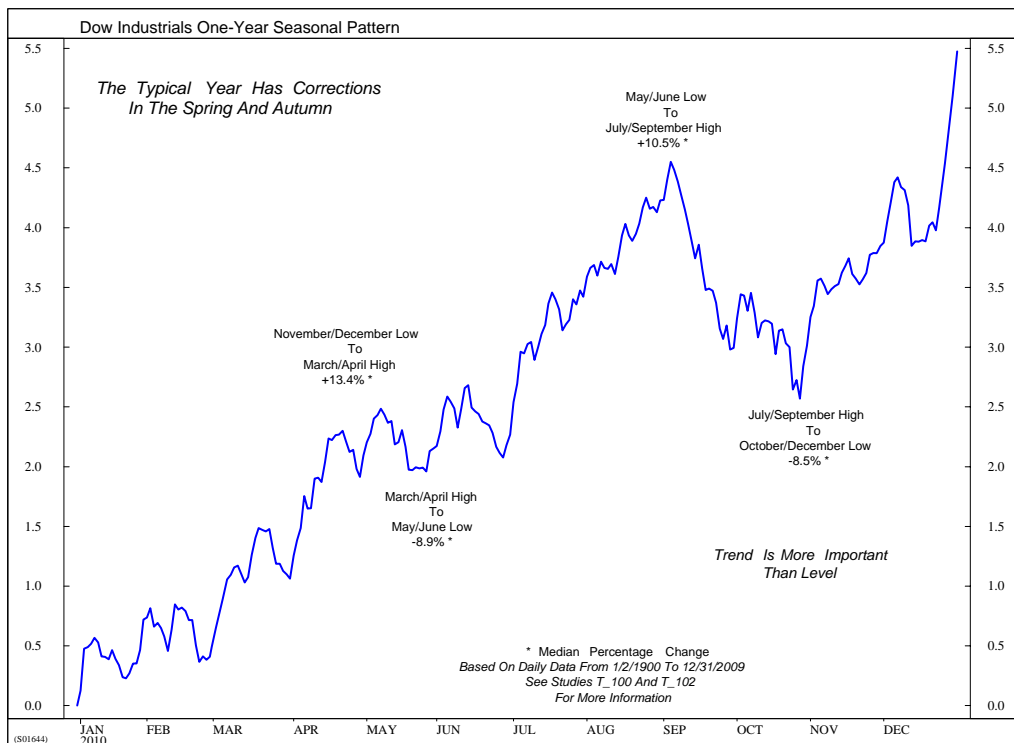


© Copyright 2010 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/.

Furthermore, there is a correlation between an improving ISM index, which I mentioned earlier, and rising interest rates as seen in the table in the first clip.

So between rising interest rates and the loss of liquidity, there is ample reason to be cautious.

Throw in the seasoned pattern of the stock market and you don't need much more motivation to start taking some profits.



© Copyright 2010 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved. See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/.

As seen here, since 1900 the Dow Jones averages have corrected 9% between the March/April high and the May/June low. The historical trend is for a higher year end close, which could again be true this year should the economic expansion prove to be sustainable into 2011.

Sovereign Debt

Potential Sovereign debt defaults was one of my 10 surprises for 2010, and what is happening in Greece has me particularly intrigued. If there is one mechanism that could put us back into recession and a liquidity crisis, I think this is it.

The financial crisis could go full circle from the solvency of banks to the solvency of Sovereign countries. If it does, it could again result in solvency issues for the banks that hold the government debt that has to be written down, which would again impair bank lending and their ability to borrow.

Greece only accounts for 2.7% of the Euro-Zone's GDP; but if they default, the other troubled countries Portugal, Italy, Ireland, Greece and Spain (PIIGS) would all see their cost of borrowing rise dramatically, impairing the balance sheets of the banks holding this paper. It would also call into question the ability of Central Banking to once again bail out the system.

I won't go into a lot of detail, which I could easily do after reading 292 pages of "This Time is Different" by C.M. Reinhart & K.S. Rogoff. The book covers the 66 countries and over 8 centuries of government defaults and for those of us in the investment business, it's the non-fiction equivalent of a horror novel.

But let me start with Greece because it's a good case study.

Statistically, Greece has debt equal to 112% of its GDP and a budget deficit of 12.9%, which is Europe's highest. They have had three debt downgrades recently from A- to triple B- only a week ago, and the rating agencies have signaled possible further downgrades as industrial production fell 9.2% year-over-year in February.

This inopportune downgrade came as Greece has to raise 54 billion Euros this year, 22 billion Euros in April and May, with interest costs for 10 year bonds at 7.5% or about 3 ½% more than what Germany has to pay. So one can imagine what impact this additional borrowing cost has on their budget deficit.

At any rate, the Euro countries managed to maneuver around their rules banning a bailout and came up with a 30 billion Euro facility of three year notes at roughly a 5% yield. An additional 15 billion Euros is coming from the IMF, and the conundrum for Greece is that the European money is more expensive, but has fewer restrictions while less costly IMF funds would impose some severe conditions.

Regardless, the bailout seems to have soothed the concerns about default which has been weighing heavily over the Euro exchange rate, especially into U.S. dollars. So, you can see some of the potential fallout from a potential default; skyrocketing interest rates and a collapsing currency – not good for anyone holding this type of paper.

However, I can't get comfortable with the resolution. Greece's problem isn't getting access to funding. In fact, the statistics are only symptomatic of deeper underlying structural problems that have to be solved, not just access to the debt market.

Bottom line, they have an uncompetitive economy that is fraught with tax evasion and overwhelmed by civil servants and corruption.

Just by way of example:

- Of a total population of 11 million, 700,000 are civil servants and that excludes 300,000 that work for regional governments and public sector companies.
- Public notaries, lawyers and other professionals are sheltered from competition and get paid for unnecessary work.
- Entrepreneurs have to get dozens of permits to open a business or pay bribes to bypass them. It's estimated that Greeks paid 750 million Euros in bribes in 2008 usually to tax auditors. Currently it takes approximately 38 days to register a new business.
- Greece has 4 times as many teachers per student as Norway whose education system is superior.
- Civil servants enjoy constitutionally guaranteed lifetime job-protection.
- The legal retirement age was 61, just raised to 63, while in most of Europe it is 67. Consequently, unfunded pension costs are one of the largest causes of the budget deficit as workers get 96% of pre-retirement earnings.
- They have a benefit known as the 14th salary where all public employees and many private workers get an extra two months pay each year as a mandatory bonus.

The Government's Austerity Budget will cut 4.8 billion Euros of spending and impose tax increases to make up the rest of their promised deficit reduction such as increasing the sales tax from 19% to 21% and imposing a higher duty on luxury items such as alcohol, cigarettes, cars and yachts.

As the Greek economy collapses, they are in effect being forced to do exactly the opposite of what other European countries are doing to stimulate their economies.

To demonstrate their resolve, the government has said that it must strike a balance between budget cuts and keeping its "social partners" happy.

Furthermore, when it comes to other European countries loaning to Greece, one quickly realizes that many of these "would be" lenders are nearly as broke as their ancient Mediterranean cousin. In other words, how do the other PIIGS come up with the money, as they are already paying substantially more to borrow?

Besides, there has to be resentment in most other countries for having to support such a profligate nation. After all, Spain just cut 50 billion Euros from its spending and raised the retirement age to 67. Portugal is planning a 6 billion Euro cut in spending, while Ireland will reduce public workers wages and some welfare payments.

In my opinion, loan guarantees from within Europe are simply deferring the problem and as I said, Greece is just one case study on what might lie ahead.

When you start looking globally, the picture isn't very pretty. This year national governments will issue an estimated \$4.5 trillion in debt, almost triple the average of the preceding five years. And it's not just sovereign debt that is the worry, the concern should also include bank debt because private banking assets tend to become a public problem during financial crises as we saw in 2008.

On a list that Forbes magazine constructed, out of 85 countries, the U.S. ranked 35th while the U.K. was 38th and only two notches above Slovenia, both only marginally better than average.

When one includes bank debt, the U.K.'s debt to GDP soars to 500% versus 200% in the U.S. In Ireland, sovereign debt to GDP is only 41%, but includes their banks and it adds another 800%.

In the book I read, it is suggested that 90% government debt to GDP is the tipping point for economic growth and that the usual cause of accelerating government debt is either a war that must be funded or a financial crisis which requires bank bailouts, but mostly result from a collapsing economy as the banking system becomes incapable of lending to the real economy.

On average, this results in nations adding about 86% to their debt loads within three years of the crises. This deterioration usually results in higher interest rates and further debt downgrades.

Bringing it closer to home, let's look specifically at some numbers coming out of the United States. Their 2011 budget, which starts in September, calls for \$3.8 trillion in spending and a \$1.3 trillion deficit. That's on top of \$1.4 trillion in 2009 and a projected \$1.6 trillion this year. It is projected, by the government, that interest on the debt will quadruple by 2020 to \$800 billion. Between 2010 and 2020 the Obama administration is proposing a 56.7% increase in federal outlays. To deal with this, there will be roughly \$800 billion in additional taxes on households earning more than \$250,000.

Right now, Moody's predicts that the U.S. will spend more on debt service as a percentage of revenues, this year, than any other top-rated country, except the U.K. According to the Congressional Budget Office (CBO), interest costs will amount to about 8.9% of tax revenue in 2009 and will reach roughly 12.7% by 2015 and that is using interest rate assumption of 2.4% in 2010, 2.7% by 2012 and the 3.8% by 2015. Why is this important you might ask?

It's because it is one of the key determinates of a country's debt rating. In their March Sovereign Debt Monitor, Moody's suggested that a double digit percentage is the boundary between a triple A and a double A rating. The fact is, that the U.S. hit this level between 1980 and 2001 without any penalty. But today that might be different.

Recently, Grants Interest Rate Observer produced an interesting table that compares the CBO budget projections using the above mentioned interest rates to a set of projections put together by Skip Olinger that adjusts the interest rate assumption to 3% in 2010, 4% in '11; 5% in '12 and 6% in 2013.

Stress testing federal finances (in \$ billions)

<i>CBO projections</i>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>	<u>2014</u>	<u>2015</u>
Receipts	\$ 2,105	\$ 2,175	\$ 2,670	\$ 2,964	\$ 3,218	\$ 3,465	\$ 3,625
Total non-interest outlays	3,331	3,317	3,417	3,333	3,423	3,544	3,646
Net interest expense	<u>187</u>	<u>207</u>	<u>233</u>	<u>280</u>	<u>333</u>	<u>396</u>	<u>459</u>
Total outlays	<u>3,518</u>	<u>3,524</u>	<u>3,650</u>	<u>3,613</u>	<u>3,756</u>	<u>3,940</u>	<u>4,105</u>
Deficit	(1,413)	(1,349)	(980)	(649)	(538)	(475)	(480)
Effective interest rate on public debt	2.5%	2.4%	2.4%	2.7%	3.0%	3.4%	3.8%
Interest expense/receipts	8.9	9.5	8.7	9.4	10.3	11.4	12.7
 <i>Olinger's Stress Test</i>	 <u>2009</u>	 <u>2010</u>	 <u>2011</u>	 <u>2012</u>	 <u>2013</u>	 <u>2014</u>	 <u>2015</u>
Receipts	\$ 2,105	\$ 2,175	\$ 2,670	\$ 2,964	\$ 3,218	\$ 3,465	\$ 3,625
Total non-interest outlays	3,331	3,317	3,417	3,333	3,423	3,544	3,646
Net interest expense	<u>187</u>	<u>266</u>	<u>400</u>	<u>549</u>	<u>716</u>	<u>768</u>	<u>820</u>
Total outlays	<u>3,518</u>	<u>3,583</u>	<u>3,817</u>	<u>3,882</u>	<u>4,139</u>	<u>4,312</u>	<u>4,466</u>
Deficit	(1,413)	(1,408)	(1,147)	(918)	(921)	(847)	(841)
Deficit, base case	(1,413)	(1,349)	(980)	(649)	(538)	(475)	(480)
Increase in deficit due to higher int. exp.	-	(59)	(167)	(269)	(383)	(372)	(361)
Revised interest rate on public debt	2.5%	3.0%	4.0%	5.0%	6.0%	6.0%	6.0%
Revised interest expense/receipts	8.9	12.2	15.0	18.5	22.3	22.2	22.6
Debt held by public, base case	\$ 7,544	\$ 8,797	\$ 9,785	\$ 10,479	\$ 11,056	\$ 11,556	\$ 12,055
Increase in base-case debt		1,253	988	694	577	500	499
Revised debt from higher int. exp.	7,544	8,856	10,011	10,974	11,934	12,806	13,666
Increase in revised debt		1,312	1,155	963	960	872	860
Publicly held debt, base case, as % of GDP	53%	60%	65%	66%	65%	65%	65%
Publicly held debt, revised, as % of GDP	53	60	66	69	71	72	73

sources: Congressional Budget Office, Skip Olinger, *Grant's* calculations

On the bottom line of the CBO projections, you can see that the interest expense to receipts ratio doesn't hit double digits until 2013, and then only 10.3% going to 12.7% in 2015.

Under the adjusted interest rate projection, the interest expense to receipts line hits 12.2% in 2010 on its way to 18.5% in 2012 and over 22% in 2015.

If this should come to pass, it would most likely result in a debt downgrade for the U.S. with damage to their economy as taxes would have to be raised and social welfare programs cut.

With a weak currency, any government financing would have to come from internal sources which would further depress consumer spending.

An unlikely scenario? Well history is littered with real cases. Could the U.S.A., through social spending causes fostered by the Obama administration while exempting over 1/3 of its tax filers from paying any taxes, start down that slippery slope? By historical standards I wouldn't exclude it.

Already, U.S. government bonds yield more than similar bonds in Germany, France and Canada. There have also been accounts of corporate issues that yield less than their government bonds which is almost unheard of.

But, I point to the U.S. just as an example. If one can build a plausible case for deterioration in the United States, then there are a lot of countries between the U.S. and Greece and, my bet is that if things are to come undone, it will start at the fringes and work its way up transmitted by the banking system.

It's worth watching, but not unlike the housing bubble which we wrote about at least two years before the collapse, identifying the problem is one thing but forecasting the timing of its consequences is quite another.

In the meantime, it's probably worth spending some time on how to benefit or at least protect one's self against this possibility. Gold comes to mind as does owning other hard assets. In fact, throughout history, stocks got hurt in a sovereign collapse but bounced back reasonably quickly and certainly faster than a defaulted bond.

GRC/amh
April 10, 2010

Credits: Ned Davis Research
 Grants Interest Rate Observers
 Forbes Magazine
 Yardini Research Inc.
 Globe & Mail
 The Book - "This Time is Different"
 - C.M. Reinhart & K.S. Rogoff.
 (8 centuries of Financial Folly)