September 2011

## Executive Summary

The European debt crisis we have been discussing for months has now taken center stage. European equity markets have taken dramatic hits with the German DAX down 31 percent and the France CAC down 26 percent from their April highs. Bank stocks in Europe are hitting new 52-week lows and many are down more than 50 percent over the past few months. The crisis is running ahead of government leaders as they have yet to implement a long-term solution to solve the European debt issues.[1]

The situation is somewhat similar to what the U.S. banking system faced in 2008. However, the troubled assets are not sub-prime loans; they are the government bonds of Greece, Ireland, Portugal, Italy, and Spain. Each of these countries is running large deficits and is in the early stages of implementing austerity programs to balance their budgets. Even if these countries can cut their spending to balance their budgets, the concern is that the European Union is falling into a recession which will curtail future tax revenues. Germany is the key to the situation with the largest EU country balance sheet and most powerful export economy. German citizens are tired of the idea that much of the burden will be placed on Germany to solve the problem. Thus, German Chancellor Merkel's party continues to lose support of the public for further EU guarantees of Greek debt, which is creating angst within the global capital markets.[1]

Following are a few possible solutions to the European debt crisis.

1) Re-capitalize the European banks. This is the most likely scenario based upon information from top authorities. This would be similar to what the United States did in 2009 with our banking system. The government forced capital infusions with government funds through TARP (Troubled Asset Relief Program), and then the banks raised capital from the private sector once the capital markets re-opened in the summer of 2009. According to one top analyst, the banks in Europe may need to raise over 3 trillion Euros of additional equity. Such a large sum may need to include the central banks of the United States, China, and Japan.[2]

2) Debt Forgiveness. Some form of haircuts on outstanding debt may be required since countries like Greece, Ireland, and Portugal do not have the ability to repay the large amounts outstanding. This, in return for deep government entitlement program cuts, is necessary to put these countries on a path of long-term prosperity. An orderly default may be the best solution for these countries.[1]

   With the pressure on the capital markets, we would expect to see some movement by European leaders toward one or both of these solutions to settle global market fears. If we do not see leadership and movement soon, the global capital markets will remain extremely volatile. One must realize that a credit crisis in Europe can create investor panics similar to 2008, where investors unloaded risk at any price for the safety of cash.

# Macro Economic Data

### Positives

+ Mortgage rates continue to move toward record low levels, providing opportunity for another refinance wave for those with sufficient home equity and credit scores. Thirty-year mortgage rates have fallen to near 4 percent, and 15-year rates are near 3 percent. This should help free up disposable income at the consumer level as mortgage payments drop.[1]

+ Emerging market countries are beginning to see their inflation problems reverse. This may allow the central banks in China, India, and Brazil to take their foot off the brake and begin to stimulate their economies in the second half of the year. Emerging market equities have lagged developed market equities for over a year due to the tight monetary policies of the central banks in key emerging markets. Simply holding steady rather than tightening further may be a tailwind for emerging market equities.[3]

+ The residential rental market remains extremely strong in the United States. Tighter credit standards, lack of confidence in ownership, and declining credit scores are the primary drivers to this trend. At some point, rental rates are likely to move high enough that buying may become a more attractive solution for those with the means to buy. Housing affordability is now at its highest point in over 50 years.[1]

+ The U.S. service sector continues to slowly recover, auto sales continue to improve, and the U.S. energy sector is gaining traction in the Bakken region of North Dakota. We are not convinced that another recession is a sure bet. A muddle through (low growth) economy for the next two years looks more probable.[4]

+ China has announced that they intend to get involved to "shore up" the European debt crisis by buying European sovereign debt.[1]

### Negatives

– The U.S. Federal Government is on a path of spending $1.4 trillion more in 2011 than it receives in tax revenue. This is clearly unsustainable and could end badly if not corrected soon. We must cut expenses at the Federal level (entitlements, discretionary, and defense) and overhaul the U.S. tax system. In additional, Federal income tax receipts as a percentage of GDP is at multi-decade lows.[4]

– U.S. unemployment remains above 9 percent as the latest August employment report disclosed that the economy created a net zero new jobs. President Obama is feeling the heat of an ailing economy as his approval ratings hit an all-time low of 40 percent in August.[4]

– Some U.S. banking/financial stocks have recently hit a new 52-week low, which is alarming as the banking sector serves as the foundation to the economy. Concerns of a double-dip recession have created worries that the banks will face another round of credit losses. This, in addition to a flattening yield curve and heightened regulations, has left the banking/financial sector in turmoil.[5]

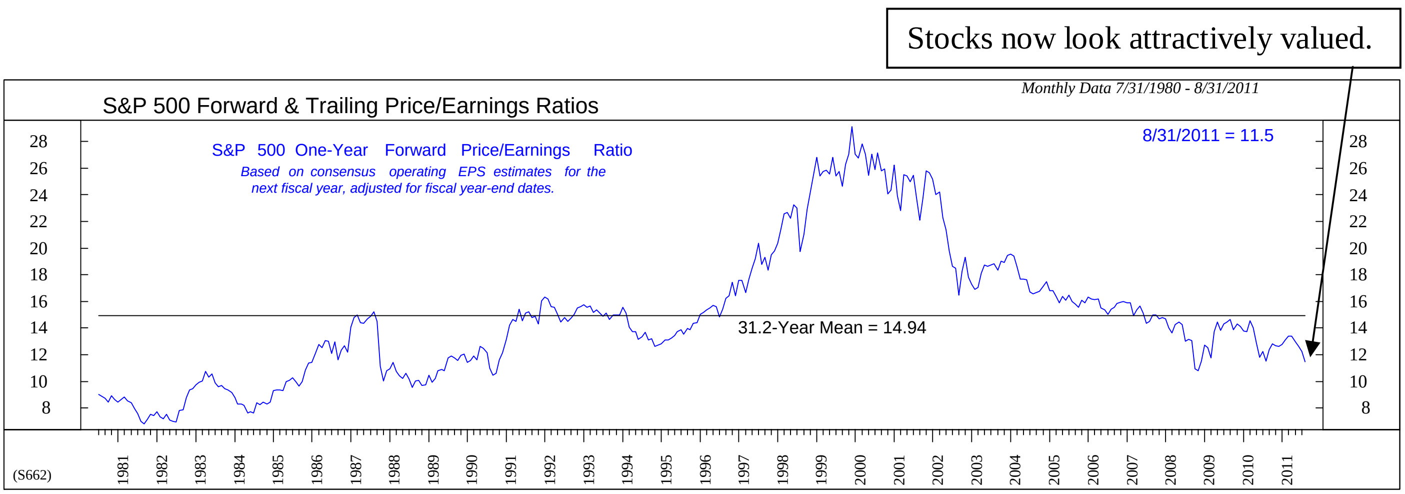
– The sovereign debt crisis in Europe continues to hamper growth and dampen confidence in the credit markets. Until a final resolution is reached, the issues in Europe will continue to weigh on global markets. If Germany enters a recession, the impact may be felt globally.[1]

# Technicals

For lack of a better word, the technical picture of the market is ugly. We had a similar technical structure last summer only to see equities break to new highs by the end of the year. This year may be different as we don't expect another round of quantitative easing or a dramatic rebound in second half global GDP. One would like to see the technical picture become more constructive before committing new funds to the equity market. A recapture of the S&P 500 200-day moving average would be a wise number to follow. The 200-day currently stands at 1283 (as of 9/8/11). To determine if an intermediate bottom is being formed, one will want to watch 1100 on the S&P 500. If we break below 1100 for any extended period of time, this would concern us that the cyclical bull market that began in March 2009 may have ended. Historically, September has been the worst month for the equity markets, so do not be surprised if we see continued volatility and an interim market bottom this month. We are now moving into what has historically been the "good six months" for the market. Of all market gains in the past 60 years, 85 percent have occurred during October 1 thru March 30.[6]

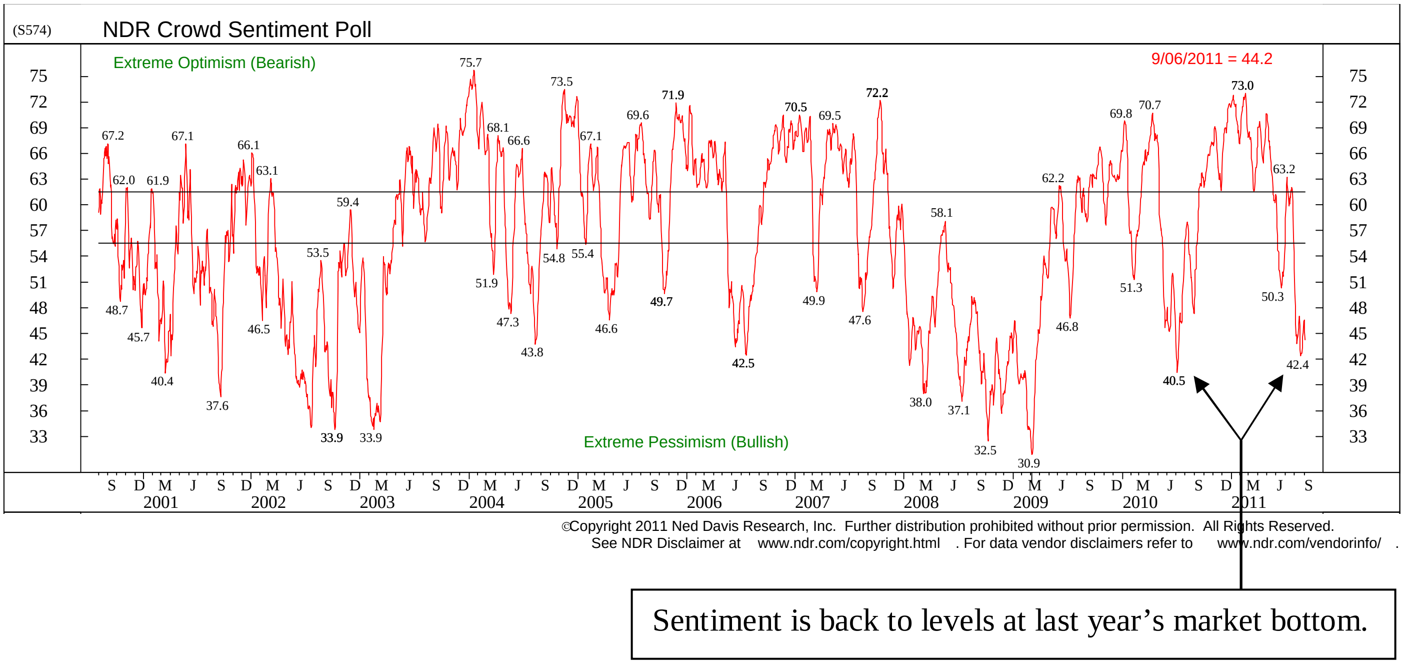
# Valuation

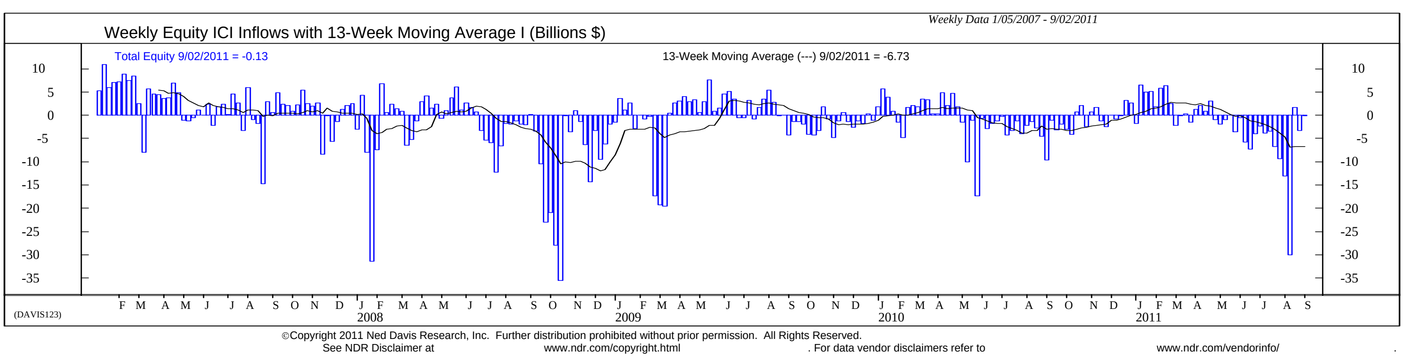
Equities are moving into attractive valuation territory. The U.S. equity market is trading near 11 times forward earnings and European equities are trading near 11 times normalize earnings.[6]



# Sentiment

Market sentiment moved near the lows not seen since last summer's deep correction. As one can see from the chart below, investor sentiment has moved down from the low 70s in April to the low 40s in August. This suggests that we now have more bears than bulls which may provide opportunities in the short-term in the equity market.[4]




Mutual fund investors have yanked money out of stocks in 13 of the past 14 weeks. It may seem counterintuitive, but that's yet another positive. A 25-year study published last year in *The Journal of Financial Economics* found that if you had simply invested in the S&P 500 when equity fund flows were negative (redemptions exceeded new investments) and into 90-day Treasury bills when fund flows were positive (new investments exceeded redemptions) you would have substantially outperformed the market while spending nearly half the time in riskless T-bills. In other words, it pays to buck the consensus.[4]

# Conclusion

Equity markets around the world look relatively cheap at current levels. Interest rates are extremely low, and any sign of a global economic recovery may move rates higher. This is a great time to refinance a mortgage or lock-in a floating rate line of credit. We are now moving into the seasonably “good six months” for the equity markets. The highest probability in our estimation is a muddle through economy for the next two years setting up the potential for a global economic resurgence in 2013–2014.

Sources:
[1] Bloomberg
[2] CNBC
[3] BCA Research
[4] Ned Davis Research
[5] Glusken-Sheff
[6] Leuthold Group.

*This Market and Economic Update is prepared by LarsonAllen Financial, LLC. If you have any questions, please call 1-888-925-2926 and ask to speak with a senior wealth advisor or one of our principals.*