Reasons to be Optimistic in 2013

As we enter a new year, it is easy to be overwhelmed by negative sentiment on the economy at home and abroad. There is no question that the U.S faces a number of significant economic and political challenges in the years ahead. Also, other regions and countries such as Japan and Europe face arguably bigger problems. The media, however, can tend to look backwards rather than forwards and as a result can miss important developments in the economy. We, at Rocaton, are not economists and this memo is not designed to be predictive. We also are not prone to excessive optimism. But, we would like to challenge certain prevailing opinions and raise awareness of the concept of improving fundamentals rather than the gloom which for some in the media and financial markets has become an obsession.

The objective of this memo is to be thought provoking, informative and to challenge excessively pessimistic expectations. Previous generations in the U.S. and overseas have faced bigger problems than we currently face, have overcome them and prospered. We have assembled a list of positive developments and trends in an attempt to focus investors on fundamentals. This is followed by a summary of the main challenges facing global economies and markets. These are not to be taken lightly. Any single challenge could overwhelm many of the positives we have listed here; risks are never non-existent. All in all, we believe that absolute pessimism may be unwarranted and that there are plenty of reasons to be optimistic!

The Fundamentals of the US Economy are improving,

1. There has been a modest but sustained improvement in housing prices in the last 12–18 months, driven by decreased housing stock and record low rates.
2. Deleveraging, particularly by households and the financial sector, has shown meaningful progress.
3. Quantitative easing has lowered the cost of capital for firms and consumers.
4. The American financial sector has made significant improvements in recovering from the credit crisis.
5. Innovation in the domestic energy sector has the potential to significantly impact long term growth fundamentals for America:
6. The domestic corporate sector has built significant balance sheet strength and flexibility:
7. The U.S. economy still has structural advantages in terms of labor mobility, flexible wages, strong consumption-led demand, and deep, flexible capital markets.

and there are bright spots elsewhere.

8. While BRIC economic growth disappointed in 2012, other emerging (or re-emerging) giants look set to drive continued gains in developing world capital markets.
9. China, having navigated the political / economic uncertainty of 2012 without major incident, may have (i) avoided a "hard landing" and (ii) gained leaders who are prepared to move the country into its next stage of development.
10. In Europe, national governments have made progress, however haltingly, towards a workable framework in several key areas.
11. And there is progress in parts of the European periphery.

Much of the world still faces significant economic and political challenges:

12. Developed country debt levels remain elevated.
13. Political gridlock looks set to persist in the US and EU.
14. Despite its positive short term effect thus far, central bank activism may yet have unintended consequences such as inflation or unsustainable asset price bubbles:
15. Geopolitical pressures remain a threat to economic activity, and, particularly in the case of potential conflict in the Middle East, energy prices.
16. Muted levels of economic and employment growth, consistent with historical post-asset bubble experiences, persists across the developed world.
17. Underinvestment by corporations in the face of economic and policy uncertainty continues to hold back domestic macroeconomic recovery.
18. Aging populations and significant existing deficits in private and public pension funds across the developed world will weigh on long-term expectations for economic growth, taxes, and government debt.

But, risks are never non-existent. All in all, absolute pessimism may be unwarranted: there are plenty of reasons to be optimistic.

The Fundamentals of the US Economy are improving,

1 There has been a modest but sustained improvement in housing prices in the last 12–18 months, driven by decreased housing stock and record low rates:

* The S&P/Case-Shiller index of home prices has risen by 4.3% in the last twelve months and 18 of 20 major urban centers showed increases in prices during that period[1]
* The supply of unsold homes at the current sales rate dropped below 5 months of inventory in February 2012 for the first time since 2005, and dropped down to 4.7 in November.[2]
* Additionally, foreclosures fell 28% year-over-year nationally through January, 2013[3]

2 Deleveraging, particularly by households and the financial sector, has shown meaningful progress:

* Household debt to GDP has fallen from a peak of 98% in 2009 to 81% as of mid-2012, a level last seen in 2003.[4]
* Financial sector corporate debt peaked at 122% of GDP in early 2009 and has fallen to 87% as of mid-2012, a level last seen in 2001.[5]
* Non-financial sector corporate debt peaked at 82% early 2009 and has fallen to 77% mid-2012.[6]

> "Household debt to GDP has fallen from a peak of 98% in 2009 to 81% as of mid-2012, a level last seen in 2003."

3 Quantitative easing has lowered the cost of capital for firms and consumers:

* High yield issuance broke records in 2012 with $231B of new issuance through October,[7] and yields on sub-investment grade debt are currently well below 6%[8]
* Average rates for 30-year fixed rate mortgages have dipped as low as 3.31% and remain near that record low.[9]

4 The American financial sector has made significant improvements in recovering from the credit crisis:

* The return on equity for all US banks rose to 8.9% as of mid-2012, up from a low of negative 1% in early 2009 and just 30% below the 20 year average of 12.4%.[10]

5 Innovation in the domestic energy sector has the potential to significantly impact long term growth fundamentals for America:

* Hydraulic fracturing (fracking) and other new processes to recover "unconventional" oil and natural gas deposits have the ability to allow the US to become the world's top producer of oil by 2017, a net oil exporter by 2030, and self-sufficient in energy in 2035.[11]
* Investment activity in related infrastructure has created an estimated 1.7 million jobs and could create up to 3.4 million by 2035.[12]

* Long term, less reliance on energy imports would reduce the current account deficit and lessen the drag of net energy imports on GDP.
* Additionally, lower domestic energy and materials costs for manufacturers could provide a boost to long-term GDP growth rates by up to 0.85% over the next decade.[13]

6 The domestic corporate sector has built significant balance sheet strength and flexibility:

* Low interest rates, exuberant bond markets and underinvestment due to uncertainty has led to growing cash balances and lower debt to equity ratios on corporate balance sheets, positioning firms well for both future growth and increased M&A activity.[14 15 16]

7 The U.S. economy still has structural advantages in terms of labor mobility, flexible wages, strong consumption-led demand, and deep, flexible capital markets:

* Labor mobility, long a relative strength for the US versus other developed economies,[17] dipped during the recent recession but has increased recently[18]
* Chinese manufacturing costs are projected to reach parity with the US by 2015, spurring talk of "reshoring" some manufacturing: in a recent Boston Consulting Group survey, 48% of manufacturing firms with revenues over $10 billion reported planning or actively considering shifting production from China to America[19]
* Despite the drag of rebuilding household finances, Real Personal Consumption Expenditures have strongly rebounded, recently hitting a record of $9.6 trillion, up from a low of $9.0 trillion in 2009.[20]
* As banks retrench across the developed world in the face of increased regulation, other players in America's dynamic capital markets are well positioned to continue to facilitate investment by corporate borrowers.[21]

> "Chinese manufacturing costs are projected to reach parity with the US by 2015, spurring talk of "reshoring" some manufacturing."

and there are bright spots elsewhere.

8 While BRIC economic growth disappointed in 2012, other emerging (or re-emerging) giants look set to drive continued gains in developing world capital markets:

* In Asia, Indonesia's GDP may exceed $1 trillion in 2013 (+6.3%) and has posted amongst the most consistent growth of any developing economy over the past decade, while the Philippines is expected to gain an investment grade credit rating and is expected to grow by 5% in 2013.[22]
* Mexico GDP growth outpaced Brazil for a second year in 2012 and its new president has committed to privatizing petroleum energy investment as well as major education and labor reform; further, rising Chinese production costs are expected to drive Mexican imports ahead of China's as a share of total US imports by 2018 (16% to 15.8% versus 12.3% to 17.9% currently).[23 24]

* South Korea and Turkey (together with Mexico and Indonesia, dubbed the "MIST" economies by GSAM) join 6 other developing market economies in the Goldman Sachs "Next-11"' fund, which showed strong performance in 2012 relative to other EM funds, underscoring the continued strength of aggregate emerging market growth prospects.[25]

9 China, having navigated the political / economic uncertainty of 2012 without major incident, may have (i) avoided a "hard landing" and (ii) gained leaders who are prepared to move the country into its next stage of development:

* Chinese policymakers successfully cooled economic growth levels without a rapid slowdown in growth, known as a "soft landing", with year-over-year GDP growth of 7.4% in the third quarter of 2012 marking a low[26] and growth accelerating to 7.9% in the fourth quarter[27]
* Power was peacefully transitioned to a new generation of leaders[28], who have acknowledged the need for reforms in key areas about which the country's restive middle class is beginning to agitate (official corruption, press freedom, judicial reform)[29]
* Chinese leadership has also acknowledged the need to shift the economy away from export-led growth towards a consumption led economy, and future policymaking should reflect this[30]

10 In Europe, national governments have made progress, however haltingly, towards a workable framework in several key areas:

* In September, the ECB released the details of its powerful bond buying program, Outright Monetary Transactions ("OMT"), which was announced by Mario Draghi over the summer and significantly contributed to stabilizing EU government bond prices by demonstrating the extent of the ECB's commitment to maintaining low rates across the Euro-area.[31]
* Other major components of Euro-area stability mechanisms are underway or are in place, including: a permanent sovereign bailout mechanism (the European Stability Mechanism, active as of October 2012[32]), agreement on the details of a unified system of banking supervision by the ECB (agreed in December 2012[33]), and a fiscal compact between Euro-area member states (treaty effective January 2013[34]).

11 And there is progress in parts of the European periphery:

* Ireland escaped recession (growth of 0.4%) and has regained access to sovereign funding markets as yields on its bonds due in 2020 have fallen from 8.5% to 4.5% over the course of 2012[35]
* Despite recent political setbacks, Italy is projected to see a primary budget surplus of 3.5% in 2013 and structural reforms already passed by outgoing Prime Minister Mario Monti are projected by the IMF to raise Italian GDP by 6% over 5 years.[36]
* Spain has also passed banking and labor market reforms and has seen exports grow, pushing the current account into surplus; however, analysts anticipate a further 1.5% contraction in GDP and myriad problems persist in the financial system as well as housing and labor markets[37]

Much of the world still faces significant economic and political challenges:

1 **Developed country debt levels remain elevated:**

* Consensus around meaningful fiscal reform in the U.S., without which debt could grow to 200%+ of GDP by 2040[38], continues to elude Congress and the White House
* It is also widely assumed that prolonged policy uncertainty around taxes and spending has dampened levels of investment and consumption, further damaging the economic recovery[39]
* Euro area sovereign debt to GDP ratios continue to climb, already hitting 90% of GDP in the second quarter of 2012[40]

2 **Political gridlock looks set to persist in the US and EU:**

* In the US, the New Year 's Eve fiscal cliff compromise merely pushed out meaningful decision making, and Congressional factions are positioning for another round of brinkmanship regarding raising the national debt ceiling in February.
* Political processes in Europe add additional uncertainty, with Germans and Italians heading to the polls for national elections in 2013.

3 **Despite its positive short term effect thus far, central bank activism may yet have unintended consequences such as inflation or unsustainable asset price bubbles:[41]**

* Are U.S. Treasury securities in a bubble? The ten-year U.S. Treasury note yields less than the rate of inflation. Much of the current demand for 10-year notes comes from the Federal Reserve as a result of several rounds of Quantitative Easing.

4 **Geopolitical pressures remain a threat to economic activity, and, particularly in the case of potential conflict in the Middle East, energy prices:**

* In Asia, beyond continued troublemaking by North Korea, multiple neighbors are at odds with China over territorial disputes involving small islands; the risk of broader conflict with China over the Senkakus/Diayus (in the case of Japan) and Spratleys (in the case of Southeast Asian nations) is increasingly real.[42]
* Heightened risk of broader conflict in the Middle East persists due to civil war in Syria, the stalled Israeli-Palestinian peace process, fragile political change in Egypt, and continued nuclear development by Iran.

5 **Muted levels of economic and employment growth, consistent with historical post-asset bubble experiences, persists across the developed world:**

* Research on historical post-financial crisis recoveries suggests that economic growth is muted for an average of 10 years after credit bubble related banking crises[43]

* Consistent with this research[44], the most recent per capita US GDP figure remained 2.6% below its pre-crisis peak as of late 2011, while, unemployment remains 3.4% above its pre-crisis low of 4.4%,[45] and is expected to remain above 7% through at least 2014[46]

6 Underinvestment by corporations in the face of economic and policy uncertainty continues to hold back domestic macroeconomic recovery:

* A *Wall Street Journal* survey found that in November 2012 that 50% of the nation's 40 biggest publicly traded corporate spenders had announced plans to curtail capital expenditure due to easing demand and uncertain macroeconomic growth prospects[47]
* Reflecting this lack of investment activity, cash on corporate balance sheets swelled to $2.05 trillion by 3Q2012, up $648 billion since early 2009[48],
* Further, many firms have focused on buying back stock in lieu of capital expenditure, with $273 billion of announced buybacks through October 2012, which was more than 5x the level in 2011[49]

7 Aging populations and significant existing deficits in private and public pension funds across the developed world will weigh on long-term expectations for economic growth, taxes, and government debt

* Increases in life expectancy and a concomitant decrease in birthrates are projected to send the ratio of workers to pensioners down from 4.6 in 2010 to 2.6 by 2050 in the United States. This pattern is expected across both the developed and developing world: the ratio is projected to shrink from 3.7 to 1.5 in Spain, 4.4 to 2.3 in Australia, 8.6 to 2.5 in Mexico, 9.8 to 3.2 in Turkey, etc.[50]
* Pension funding levels are low, implying the need for increased taxpayer/corporate contribution needs in the future. This is particularly true in the United States, where the average private defined benefit plan was 76% funded as of December 2012[51] and the average state pension fund was approximately 75% funded.[52]
* Due to these trends, OECD public spending on pensions benefits has been growing faster than national output, rising from 6.1% of GDP in 1990 to 7% in 2007. It is forecast to reach 11.4% of GDP by 2050.[53]

But, risks are never non-existent.

All in all, absolute pessimism may be unwarranted: there are plenty of reasons to be optimistic.

Disclosure Statement:

Endnotes

1 *Bloomberg*, December 2012. http://www.bloomberg.com/news/2012-12-27/sales-of-new-u-s-homes-increased-in-november-to-two-year-high.html

2 Federal Reserve Bank of St. Louis.

3 RealtyTrac via CNBC.com, http://www.cnbc.com/id/100460456

4 Federal Reserve Bank of St. Louis.

5 Federal Reserve Bank of St. Louis.

6 Federal Reserve Bank of St. Louis.

7 *Forbes*, November 2012. http://www.forbes.com/sites/spleverage/2012/11/12/high-yield-volume-continues-to-soar-in-october-as-annual-volume-hits-record/

8 Barclays US HY Index YTW 5.75% on January 14, 2013.

9 Federal Reserve Bank of St. Louis.

10 Federal Reserve Bank of St. Louis.

11 Reuters. http://www.reuters.com/article/2012/11/12/us-iea-oil-report-idUSBRE8AB0IQ20121112

12 U.S. Chamber of Commerce via Midwest Energy News, http://www.midwest-energynews.com/2013/01/10/u-s-chambers-fracking-job-boom-behind-the-numbers/

13 Bridgewater Associates.

14 Treasury Strategies via *Wall Street Journal*, http://online.wsj.com/community/groups/financial-services-regulation-458/topics/treasury-strategies-record-high-us

15 Federal Reserve Bank of St. Louis.

16 *The Economist*, http://www.economist.com/news/business/21571475-urge-merge-could-be-about-return-shall-we

17 *The Economist*, http://www.economist.com/blogs/freeexchange/2012/07/labour-mobility

18 *Bloomberg*, http://www.bloomberg.com/news/2012-11-01/americans-on-move-buoying-economy-with-mobility-rebound.html

19 *The Economist*, http://www.economist.com/news/special-report/21569570-growing-number-american-companies-are-moving-their-manufacturing-back-united

20 Federal Reserve Bank of St. Louis

21 *The Economist*, http://www.economist.com/news/briefing/21568365-europes-banks-are-shrinking-what-will-take-their-place-filling-bank-shaped-hole

22 *The Economist*, http://www.economist.com/news/21566393-new-neighbour-hood-heavyweights?zid=306&ah=1b164dbd43b0cb27ba0d4c3b12a5e227

23 *The Economist*, http://www.economist.com/news/leaders/21567081-america-needs-look-again-its-increasingly-important-neighbour-rise-mexico

24 *The Economist*, http://www.economist.com/news/americas/21568729-plans-improve-security-and-schools-coming-out-swinging?zid=305&ah=417bd5664dc76da5d98af4f7a640fd8a

25 *Bloomberg*, http://www.bloomberg.com/news/2012-08-07/goldman-sachs-s-mist-topping-brics-as-smaller-markets-outperform.html

26 *The Independent*, http://www.independent.co.uk/news/business/news/slow-ing-growth-suggests-china-soft-landing-8217285.html

27 *Wall Street Journal*, http://online.wsj.com/article/SB10001424127887323468604578248491257898414.html?mod=WSJ_hps_election_middleStories

28 CNN, http://www.cnn.com/2012/11/14/world/asia/china-leadership-transition/index.html

29 *The Economist*, http://www.economist.com/blogs/theworldin2013/2013/01/chinas-new-leader?zid=306&ah=1b164dbd43b0cb27ba0d4c3b12a5e227

30 McKinsey China, http://www.mckinseychina.com/2012/11/15/whats-next-for-china

31 European Central Bank, http://www.ecb.int/press/pr/date/2012/html/pr120906_1.en.html

32 European Financial Stability Facility, http://www.efsf.europa.eu/about/index.htm

33 *Financial Times*, http://www.ft.com/intl/cms/s/0/2946cbfe-44d4-11e2-8fd7-00144feabdc0.html#axzz2IGdH9B51

34 Council of the European Union, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/134543.pdf

35 *The Economist*, http://www.economist.com/news/finance-and-economics/21569049-irelands-success-attracting-foreign-investment-has-its-drawbacks-fitter-yet?zid=310&ah=4326ea44f22236ea534e2010ccce1932

36 *The Economist*, http://www.economist.com/news/finance-and-economics/21567936-mario-monti-has-restored-italys-credibility-much-more-must-be-done-restore

37 *The Economist*, http://www.economist.com/news/europe/21569755-spanish-government-newly-optimistic-many-spaniards-are-not-rosy-scenario

38 Congressional Budget Office (Extended Alternative Fiscal Scenario), http://www.cbo.gov/sites/default/files/cbofiles/attachments/06-05-Long-Term_Budget_Outlook_2.pdf

39 Moneynews.com, http://www.moneynews.com/Economy/Fiscal-Cliff-Small-Business-Hiring/2013/01/09/id/470617

40 Eurostat, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-24102012-AP/EN/2-24102012-AP-EN.PDF

41 Martin Feldstein via National Bureau for Economic Research, http://www.nber.org/feldstein/projectsyndicatemarch2012.pdf

42 *The Economist*, http://www.economist.com/news/leaders/21569740-risks-clash-between-china-and-japan-are-risingand-consequences-could-be

43 Reinhart & Rogof, "This Time is Different: Eight Centuries of Financial Folly", ISBN 9780691142166

44 Reinhart & Rogof, editorial via *Bloomberg News*, http://www.bloomberg.com/news/2012-10-15/sorry-u-s-recoveries-really-aren-t-different.html

45 Federal Reserve Bank of St. Louis.

46 *CNN Money*, http://money.cnn.com/2012/09/13/news/economy/federal-reserve-forecasts/index.html

47 *Wall Street Journal*, http://online.wsj.com/article/SB10001424127887324595904578123593211825394.html

48 Treasury Strategies via *Wall Street Journal*, http://online.wsj.com/community/groups/financial-services-regulation-458/topics/treasury-strategies-record-high-us

49 *Washington Post*, http://www.washingtonpost.com/wp-dyn/content/article/2010/10/06/AR2010100606772.html

50 *The Economist*, http://www.economist.com/node/18502013

51 *Bank of New York Mellon via Pensions & Investments*, http://www.pionline.com/article/20130104/DAILYREG/130109951/bny-mellon-corporate-db-funding-ratio-ends-2012-at-763

52 *Bloomberg*, http://www.bloomberg.com/news/2012-10-23/pension-funding-scare-won-t-frighten-all-states.html

53 *The Economist*, http://www.economist.com/node/18502005

