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This is the fourth in what will be a long running series of Gold Coast Wealth Management's commentary on the financial markets. These commentaries will not have a formal schedule and will be written when events or market related topics strike us as important.

"Return of the Bond Vigilantes and…Can the U.S. Equity Markets Withstand a Recessionary Europe?"

At Gold Coast Wealth Management there is a feeling of nostalgia in the air; it feels like 1994 all over again, and instead of searching New York City for cheap happy hours with free food, we are transported to Europe. Travelling with us is an old group of friends that we have not seen since 1994…the Bond Vigilantes. Boy did we miss them. They are the kind of friends that usually make an event or party more interesting. They were supposed to meet us a few years back, in the U.S., when the Fed started its money printing campaign but they were busy. Then just this past year when U.S. elected officials couldn't get their act together to raise the debt ceiling and cut the deficit, we thought we would see our good friends make an appearance, but again they were busy focusing on other things. You may wonder why we still like our friends because they have not been very reliable recently; missing a few command performances that we thought necessitated an appearance. And we were beginning to think the same.

Bygones, because it seems they were just getting in-shape for what could be a prolonged visit to Europe. By now, you may be asking who are these Bond Vigilante chaps? We've only known them since 1994, when they appeared out of the blue and promptly coerced President Clinton to increase taxes and cut spending in order to reduce the U.S. budget deficit. They are not an organized group, but rather a collection of bond market investors who as individual entities demonstrate their disdain for poorly run or excessively proliferate governments by either withholding credit altogether or demanding higher rates on the funds they do lend. Your next question must be, how could anyone 'force' a U.S. President do anything he didn't want to do?

The Bond Vigilantes accomplished it quite simply by going on a buying strike of U.S. government debt, thus raising the 10-year borrowing rate for the U.S. government from 5% to over 8% in a little more than thirteen months. Clinton, smart enough to get the message and smart enough to realize borrowing at 8% is not healthy or sustainable for the U.S. economy at that time, pushed to implement austerity measures to appease the Vigilantes deficit concerns. Soon after, Clinton's chief political advisor James Carville immortalized them by saying, "I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." He was right in 1994 and he is right in 2012.

Austerity Can Be Bad for Equity Markets

Currently, you can see the most open display of the Vigilantes handiwork in Greece, Italy, Portugal, Ireland, and Spain. In each of those countries, government borrowing rates were pushed high enough to force those standing governments to implement various deficit reducing austerity measures. It was those austerity measures that we were worried about when we asked the question in the title "Can the US equity markets withstand a recessionary Europe", because like it or not we are getting a recessionary Europe…compliments of our friends the Vigilantes. Like we said, they make things interesting. Let's look at a few pieces of data before moving on:

According to IMF[i] data the top 15 economies in the world using 2011 nominal GDP numbers are below:

Chart 1

	Country	GDP (in millions USD)
1	*European Union*	17,960,206
2	United States	15,064,816
3	China	6,988,470
4	Japan	5,855,383
5	Germany	3,628,623
6	France	2,808,265
7	Brazil	2,517,927
8	United Kingdom	2,480,978
9	Italy	2,245,706
10	Russia	1,884,903

Referencing "S&P 500: 2010 Global Sales", Standard and Poor's in-house research report issued by Howard Silverblatt and Dave Guarino in July of 2011, the chart below shows the percentage of S&P 500 sales coming from different foreign jurisdictions.[ii]

Chart 2

Region	2010 Foreign Sales (USD Millions)	% of Foreign Sales
Africa	$148,103	6.47%
Asia	$300,065	13.11%
Australia	$6,025	.26%
Europe	$666,398	29.12%
N. America	$104,115	4.55%
S. America	$97,628	4.27%
Foreign Countries	$966,145	42.22%
Total **Source: Standard and Poor's**	**$2,228,479**	**100%**

If Europe goes into a recession as a whole, then the above two charts should make you nervous for the U.S. equity markets. Chart 1 informs us using a simplistic but in our view very effective argument: when the largest economic block in the world is about to enter or is currently experiencing a recession, equity markets linked to it will feel pain. And unfortunately for the S&P 500, it is linked to the European Union. Extrapolating data from Chart 2 and the Standard and Poor's report referenced above[iii], we can safely conclude that almost 20% of S&P 500 company revenues are generated from Europe. If Europe is in trouble, S&P 500 earnings will take a hit, and that is just the direct consequences. If you start to look at second level issues like how will Europe's slowdown affect Asia and S&P 500 constituent's sales and profits from that region as well, then a clearer but less heartening picture develops.

We do not feel U.S. equity market investors have fully discounted the European recessions, nor do we think those investors realize how large the European market is to "U.S. companies" in the S&P 500. We are worried because we read opinion pieces and financial market pieces daily, and in these pieces well respected and well followed economists make a case for the U.S. slogging through on a low growth trajectory for the coming 2-3 years, which given current valuations for equities, would not be a bad scenario. Except, these economists dismiss Europe and are prone to using lagging or backward looking U.S. data when making their case. The monthly Payroll Report is not leading indicator, except if you read many well respected market commentators and economists they use the November and December reports as part of their foundation for the "U.S. slogs through at slow growth" or "U.S. will experience accelerated growth" in the next 18 months thesis's . To further explain our thinking we turn it over to John Hussman, President of the Hussman Trust, as he has been doing this much longer and can narrate an opinion much more crisply than we can. In his most recent letter "The Risk of a Blindside Recession" he writes (bold emphasis ours):

"Well, examining the past 10 U.S. recessions, it turns out that payroll employment growth was positive in 8 of those 10 recessions in the ***very month*** *that the recession began…The average payroll growth (scaled to the present labor force) translates to 200,000 new jobs in the month of a recession turn, and about 500,000 jobs during the preceding 3 month period"*

Please keep in mind, there are many factors and pieces of data to look at when making assessments on the future path of the economy, we mentioned payroll data anecdotally because it has been mentioned often recently and somehow made its way into our craw.

Recessionary Europe

In a recent letter we advised against believing European bankers and politicians regarding their comments on the current situation in Europe as it relates to Greece, Italy, France,…etc. It was not said from a soapbox because we agree that European officials cannot be fully honest with the media and public about what is going on in the trenches of the European banking system, the same way a sausage maker would not want to go into full detail about the inner workings of his sausage factory.

The conclusions one can draw from visible data is bad enough, we do not need officials giving their grim views to add gasoline to the fire. Although, one official did feel the need to get out in front and air her grievances. On December 15, 2011, Christine Lagarde, the newly minted head of the International Monetary Fund (IMF) in a visit to the State Department at Hillary Clinton's request said, "There is no economy in the world, whether low-income countries, emerging markets, middle-income countries or super advanced economies, that will be immune to the crisis that we see **not only unfolding but escalating**" [Emphasis ours]. Is Lagarde political? Yes, she is, but this is scary language coming from an international institution that in general would prefer stability over instability in the countries that historically were contributors to the IMF bailout funds, not receivers. In terms of foreboding warnings, she takes second place to Ben Bernanke's "significant downside risks" comment from a Fed statement earlier this fall.

Lagarde, although maybe a bit out of line and maybe a bit alarmist given her post, was prescient. On January 12, 2012 Germany released data confirming suspicions that its economy contracted in Q4 of 2011. Germany had been one of the only bright spots, essentially willing the rest of Europe to stay out of a recession. That all ended in the fourth quarter. The latest PMI (Purchasing Manager Index, similar to the ISM report in the U.S. where any reading below 50 means contraction) report, released on January 2, 2012 adds to the dour feeling with Austria (49), France (48.9), Germany (48.4), and the Netherlands (46.2) showing slight contractions, while Italy (44.3), Spain (43.7) and Greece (42.0) showed deeper issues.

Austerity, enacted to placate our friends the Vigilantes, is wreaking havoc on the sovereign's underlying economies and hence the social fabric that keeps the nations peaceful and happy. Italy, in its efforts to close budgetary gaps is trying to improve the collection of taxes. If only Greece would make the same effort, but the story below might be a reason the Greek bureaucrats have hesitated so far. According the Economist there have been 8 recent acts of violence against the Italian version of the IRS, Equitalia. On December 9th, the director-general suffered hand and face injuries when a parcel bomb exploded at his office. Since then, there were 3 other instances where bombs have exploded outside Equitalia branches[iv]. This is a populace making its views known on taxes, taxes that need to be collected in order to reduce their nation's large debt burden.

Anecdotal stories aside, we firmly believe, and this is not breaking news, that for world equity markets to move up from here we need the European issues put to bed. But the problem is that its oldest problem child, Greece, is still not close to being rectified. The program that was agreed upon in October of 2010 is coming under fire for not being big enough and not including a large enough haircut to existing bondholders. Let us be very clear on this, if they are having issues fixing Greece then we fear Europe has a colossal problem on the horizon as there are much larger and hence more intertwined economies behind Greece that also need restructuring. As we said before in previous letters, the lack of centralized decision-making structures is severely hampering the euro-zone from exiting this crisis. Europe is paying the price but so is the rest of the world. Until we get more clarity on Greece, and until we feel good about a process being in place to handle Italy and Spain we will remain underweight risk in our portfolios.

Moving on, European banks and the ECB are not doing much better than the sovereigns where they reside. After scrambling to find liquidity for months, on December 21st, over 500 European banks received $628 billion in three year loans at a rate of 1% from the ECB. This was part an effort to provide longer term funding to euro-area banks starved for credit that used to be provided by U.S. money market funds. As we discussed in our last letter, U.S. based money market funds have been drastically reducing exposure to Europe in recent months. But let's be clear this, with our tongue firmly in our cheek, this was not Quantitative Easing, the ECB does not engage in that sort of activity. Whatever the ECB wants to call it, we think this was one step in the right direction. European banks now have access to longer-term money and we hope they will lend it to consumers and businesses to kick-start growth in Europe.

But, alas, hope does not spring eternal, nor does it spur animal spirits and credit availability in Europe because over Christmas weekend those same European banks deposited more than $523B with the ECB, a new record[v]. Then another record was reached on Friday January 6th when €464 billion Euro's ($589 billion) was parked at the ECB. So instead of lending that money out to governments, businesses, consumers, or even lending it to each other in the inter-bank market, they parked it at the ECB. We cannot emphasize this last point loud enough, after the banks were essentially given free money (loans were struck at a rate of 1%) they did not go out and buy their own country's sovereign debt; they parked it in the safest place possible, at their central bank. Not quite what the ECB was looking for, but with upcoming auctions for French, Spanish, Italian, and Portuguese debt it is possible the parked money is earmarked for the above mentioned sovereigns.

US Banks

File this under not that important but interesting none-the-less: In the first week of January Citibank tapped the debt markets, selling $2.5 billion of 5-year notes at 3.2% over 3-month LIBOR[vi]. Although money within a bank is fungible it is reasonable to believe that the newly raised debt most likely replaced Citibank's borrowings from the U.S government liquidity programs, launched in 2009 to unfreeze credit markets. The interesting part to us was the difference in rates between the U.S. government loans and the market loans just obtained. Citibank borrowed from the government at about .30% over 3-month LIBOR for 3-year paper, versus the 3.2% over 3-month LIBOR they will pay on the current loans. Citibank is essentially swapping a 3-year loan where it is paying about .30% over LIBOR for a 5-year loan where it is paying 3.2% over LIBOR. We're not rocket scientists here but that's a difference of about 3% in interest, per year, or $75 million per year in interest payments, if you are counting. Also if you are counting, Citibank has more than $37 billion in outstanding loans from government programs that need refinancing this year. GE Capital and Bank of America are the two big names we are familiar with that will also be winding down U.S. government loans over the next 18 months. We mention this because banks constitute 13.5% of the S&P 500 index[vii], and with the cheap government funding coming to an end in the near future, combined with the lingering regulatory issues still to be determined, it is just one more hurdle that equity markets must climb in the short term.

Closing Comments

Contrary to previous letters, we are not all doom and gloom. We believe Europe has made some progress, although at a very slow rate. The 3-year lending program mentioned above is similar to the successful facilities the U.S. used in the wake of Lehman Brothers. The rhetoric coming from European leaders is also becoming more urgent, a positive sign for further stimulus programs gaining traction. We also find interesting that, in our view, the U.S. equity markets have not fully priced in a European recession, but if you look at forward looking price/earnings (P/E) multiples you could make a case that emerging-markets and European markets have priced in a slowdown in Europe. We are keeping a close eye on these valuations because they may reach a point in the near future where Europe and emerging-markets equities deserve to be upgraded in our client portfolios.

While we are still underweight equities as an asset class, we maintain our long standing bias towards allocating client capital to companies that have strong and historically increasing dividends. Additionally we favor equity managers that have proven long-term records, managers who have made money for clients during stressed and volatile environments. We have been fortunate enough to find and invest with managers on behalf of our clients that fit the above criteria, and fortunately for us and our clients, those equity managers continue to implement the same strategies and processes that have been successful for them in the past. In terms of fixed income exposure, we still favor 'total return' focused managers who have proven to protect capital over a full cycle. But, because of our concerns in both in Europe and the U.S., we will continue to advise clients to hold an over-weight cash allocation. An allocation that we hope to put to use in the near future.

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[i] "Nominal 2011 GDP for the world and the European Union.". World economic outlook database, September 2011. International Monetary Fund.

[ii] Standard and Poor's "S&P 500: 2010 Global Sales", Howard Silverblatt, Dave Guarino. July 19, 2011

[iii] According to S&P 46.3% of all S&P 500 constituent's revenue is generated abroad. Chart 2 gives a breakdown of that 46.3%. One problem with the data is that some company's do not break out foreign country revenue by region, so S&P classified that revenue as coming from "Foreign Countries". In our analysis we assumed that Europe accounted for 29.12%, the same as Europe's overall breakdown in foreign sales, of the generic "Foreign Countries" revenue. By using this calculation we estimated that Europe accounted for 41.41% of all foreign sales, and multiplying that by the 46.3% of total revenue generated abroad we came to our rough number of almost 20%.

[iv] Economist January 7, 2012 "Terrorizing the Taxman" page 45

[v] Economist December 31, 2011 "Hose and Dry" page 59

[vi] WSJ January 6, 2012. C4, Katy Burne, Matt Wirz

[vii] Standard and Poor's "Global Equity Strategy, U.S. Sector Outlooks" December 29, 2011

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