



Welcome Back To Reality

After a cumbersome sailing against the wind, fighting the investment community's and media's overrating of Greece's macro-relevance and the way too optimistic recovery expectations in Europe and North America, I appreciated the refocus of both on the factual data points relevant to the world economy. Before dipping into the world of indicators, let me outline some macro remarks. My current analysis still confirms the early January 2010 formulated [mid-case scenario](#) as the most likely course of recovery.

In January's „[Suchbildrätsel Weltwirtschaft I](#)“ („Puzzle Picture World Economy“) I concluded:

„What error in analysis accounts for the strong positive market sentiment? I find it in the assumption of a consistent crossover from a liquidity –flooded state of emergency to a demand-driven recovery.“ // (original in German: *„Wo liegt der Fehler des positiven Marktsentiments im Suchbild? Ich finde ihn in der Annahme einer tücken- und lückenlosen Überleitung des liquiditätsüberfluteten Ausnahmezustandes hin zu einem nachfragebasierten Wirtschaftszyklus.“*)

We are actually at the described crossroad. Shocked by the strength of market reactions to the daily news cycle, (see the test of political commitment in the case of Greece), politicians currently keep themselves busy by

- ❖ populist lamentations against speculators and hypocritical regulatory steps a la 'naked short ban' in Germany (nothing wrong with banning it. I agree that markets don't need this mechanism for increasing their efficiency, but a ban needs a professional procedure in place. In the case of Germany, not even the BaFin was informed of it, not to speak of being involved in the ban preparations)
- ❖ Finalizing austerity packages after massive stimuli-interventions in 2008 and 2009
- ❖ strengthening their efforts for international coordination

While a) is pure grandstanding, b) and c) are based on necessary insights. But necessities come with a price tag.

b) Is strongly interwoven with the deafening EUR-hysteria. My two cents:

We should be thankful for Greece's slyness in terms of creative accounting and the exploitation of inefficiencies in the Maastricht treaty (ie cheap debt financing due to eurozone membership). Our hellenic friends created a current showcase for the often quoted Rogoff study „[This Time Its Different](#)“ and its conclusion about a self-fuelling vicious circle after passing a certain public debt/ GDP threshold.

Greece's marginal relevance for the world economy allows the rest of the debt-financed countries to learn from it hopefully early enough. Spain, Italy, Portugal, even France are examples of countries, whoms governments adopted laws for their austerity measures within a few weeks. Although speculative forces are blamed for the EUR attack, I believe in the wisdom of the crowds, which will figure out the populist red herring. Restoring financial stability after debt-financed stimuli has always meant to be done by cost-cutting programs. Why the surprise?

As much as austerity programs are needed to maintain long-term solvency for debt-financed countries, they poison the few green shoots of an artificially stimulated recovery. Already in summer 2009 I pointed out that governments will have to choose between credit rating and spending programs soon.

[Here a flashback:](#)

„When countries are forced to decide between further spending programs or the protection of their credit rating, they will go for the latter. This decision will be the trigger for the second leg of an economic W formation.“ // (original in German: *„Bei einer Zuspitzung der Situation ob weitere/weitergeführte Sozialprogramme oder Schutz des Kreditratings, gehe ich davon aus, dass sich die Staaten für das Kreditrating entscheiden müssen. Diese Entscheidung wird IMHO der Auslöser für das zweite leg des W's sein.“*)

That's where we stand right now. My dear optimists, welcome back to the world of realists.



Due to the ongoing dominate deflationary tendencies in the USA and Europe, interest rate hikes are highly improbable throughout 2010. The combination of generous central banks, austerity packages of governments, anxious consumers in the old world, and booming emerging markets on the other end of the spectrum, will lead to a volatile bottoming process in the business cycle, with asymmetric outcomes by regions depending on the interplay of factors. Why developed, non commodity-based economies cannot expect a demand-driven recovery yet, has been explained in my commentary [mid March](#).

In short, structural reforms need time. Admittedly, by passing healthcare reform and financial reform (good [summary of the current, pre-reconciliation status](#) by David Tate) the US has established two solid cornerstones for a sustainable recovery, but reforms aimed at regaining industrial competitiveness are only effective slowly and with a time-lag. The immediate widening of its trade deficit, once synthetically generated growth kicked in, clearly shows that structural inefficiencies haven't been resolved sufficiently. The Obama administration recognizes the need to walk a tightrope, as demonstrated by the rather meager [mini-stimulus of up to Usd 200 bln](#). It respects the fragility of the demand side while taking its empty pockets into account. As all stakeholders (governments, consultants, business owners and investors) enter unknown territory, the search for fair-value will be volatile, for Main Street a much as for Wall Street.

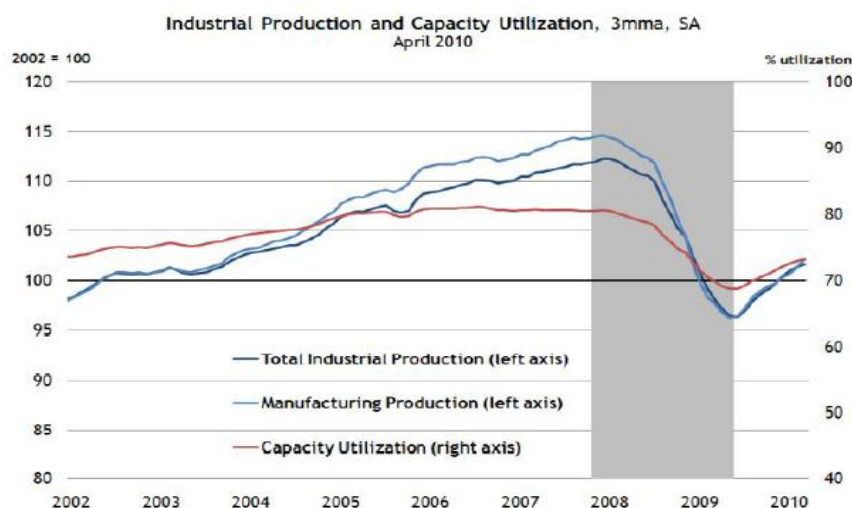
Ad c) Dani Rodrik (Harvard Professor) compellingly [summarizes the current challenges of governments in their urgent need to collaborate supra-nationally](#):

„Deep down, the crisis is yet another manifestation of what I call “the political dilemma of the world economy”: economic globalization, political democracy, and the nation-state are mutually irreconcilable. We can have at most two at one time. Democracy is compatible with national sovereignty only if we restrict globalization. If we push for globalization while retaining the nation-state, we must jettison democracy. And if we want democracy along with globalization, we must shove the nation-state aside and strive for greater international governance.”

The first era of globalization, which lasted until 1914, was a success as long as economic and monetary policies remained insulated from domestic political pressures. These policies could then be entirely subjugated to the demands of the gold standard and free capital mobility. But once the political franchise was enlarged, the working class got organized, and mass politics became the norm, domestic economic objectives began to compete with (and overwhelm) external rules and constraints.

As cosmopolitically thinking and living individual, a further optimization towards the two triangle points GLOBALISATION and DEMOCRACY is way sufficient..

Let's continue with the US indicators.



Capacity utilization still too low to generate inflation pressure.

Source: Federal Reserve Board

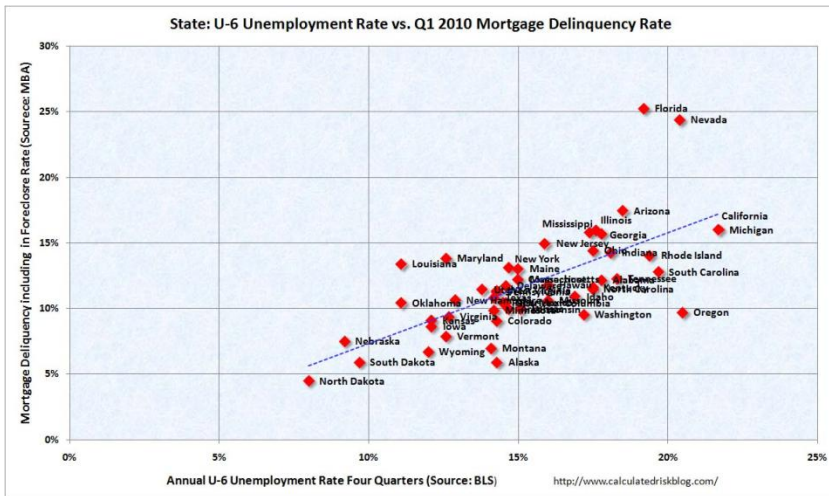
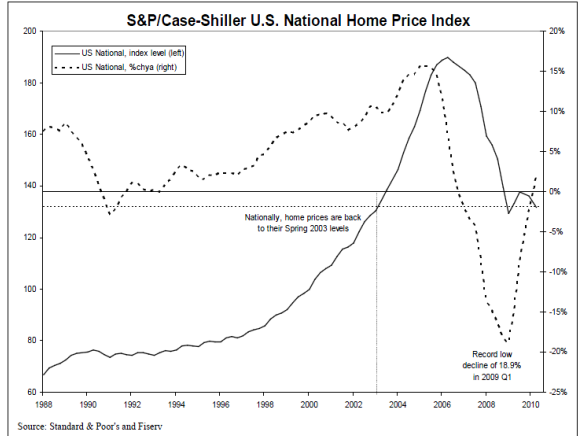
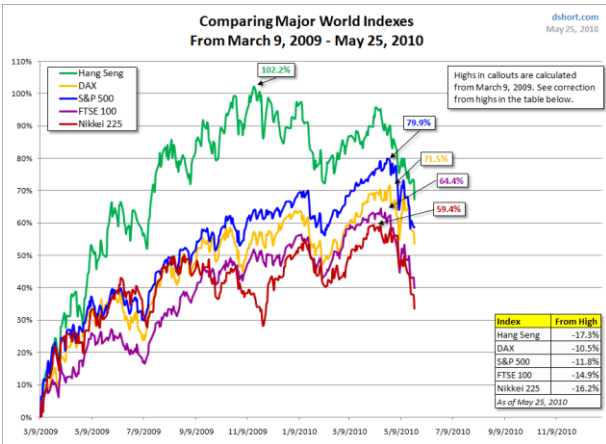
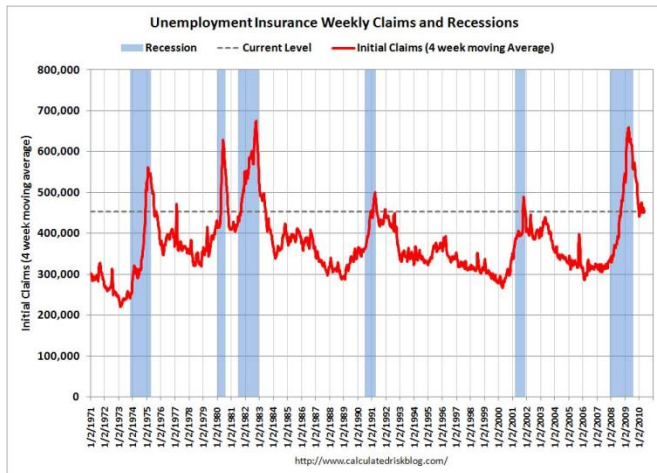


Chart Above
[The First Quarter of 2010 Indicates Some Weakening in Home Prices](#)

Chart Left
[Unemployment Correlation with Mortgage Delinquency](#)

Chart Below
[CBO: Stimulus raised GDP 1.7% to 4.2% in Q1](#)



		Change Attributable to ARRA, GDP change (percent)	
		Low Estimate	High Estimate
2009	Q1	0.1	0.1
2009	Q2	0.9	1.5
2009	Q3	1.3	2.7
2009	Q4	1.5	3.5
2010	Q1	1.7	4.2
2010	Q2	1.7	4.6
2010	Q3	1.4	4.2
2010	Q4	1.1	3.6

DOL reports on weekly [unemployment insurance claims](#): In the week ending May 15, seasonally adjusted initial claims were 471,000, an increase of 25,000 from the previous week's revised figure of 446,000. The 4-week moving avg was 453,500, an increase of 3,000 from the previous week's unrevised avg of 450,500.

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