McVEAN
TRADING & INVESTMENTS, LLC

Weekly Economic Update

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The Euro crisis is once again at the forefront as Spain is threatened with becoming the latest and largest country exiled from the credit markets. Spanish long term interest rates spiked up to 7.67% before European leaders rushed to jawbone the markets. Thursday, ECB President Draghi promised "The ECB is ready to do whatever it takes to preserve the euro.... And believe me, it will be enough." Friday, Merkel and Hollande issued a joint statement saying "France and Germany are fundamentally tied to the integrity of the euro area….They are determined to do everything to protect it." True, there were some caveats from the ECB about remaining within their mandate and from Merkel (and Hollande) about states fulfilling their obligations – but the markets moved as expected on the headlines. The Bundesbank, as expected, protested the possibility if the ECB buying more sovereign debt, but they don't get a vote. The ECB took a major step by indicating that they might issue the European Stability Mechanism (ESM) a banking license, if the German courts approve. Due to strong support from the German legislature, we expect the court to approve and a huge new European bank to be created. This may mark a turning point in the euro crisis and shift the advantage to Europe, as the US continues to struggle with how to recapitalize its banks.

Creating a new bank, as opposed to simply buying more bonds, is a critical departure, because it brings back the possibility of money creation – and stronger nominal growth. The US, UK and ECB have all exploded their central bank balance sheets during this crisis by buying government bonds to help finance deficits and drive down long term interest rates. They have paid for those bonds not by printing currency (which would be purely inflationary), but by buying the bonds from banks and replacing them with newly created bank reserves. Typically, the banks would loan out these reserves, expanding the money supply. However, the privately owned banks of the developed world have been reticent to make new loans given the undeclared losses on their books and the calls for increased capital. Rather than take on more risk, they are accepting near zero returns on the reserves from the central banks.

The proposition behind quantitative easing is that by buying up existing bonds, the central bank will drive down long term interest rates and stimulate economic activity. The most passive of investors, those who buy risk free long term sovereign debt, would be forced out into the riskier investments, driving down all rates and generating more demand for credit. However, given the weakness in real GDP growth, governments have been running huge deficits -- so the supply of bonds grew as fast as the artificial demand from central banks. Bottom line, private investors saw only moderate changes in the supply of debt available to them compared to before balance sheet expansion. Basically the central banks financed a spending binge by their governments. In the US, the 1.5 trillion expansion in the Federal Reserve's balance sheet over the past four years amounts to 10.4% of US GDP, during a period when nominal GDP has risen 8.3%. As Federal Reserve Chairman Ben Bernanke has posited, it is hard to know how much of the central bank financed government spending resulted in real growth versus inflation. However, assuming we were facing deflation in 2008 without the balance sheet expansion, the majority of the 10% increase was translated into inflation, which rose a modest 5.4% from Pre-Lehman until now. Thus, despite heroic efforts, not much real growth resulted because the spending was not leveraged through the banking system. Moreover, even smart government spending, like on needed infrastructure, is not likely to generate measurable improvements in real GDP, as much as forestall declining GDP from increasing logistic bottlenecks. Each successive round of quantitative easing that follows this pattern is likely to generate even less growth as the best government ideas are used up first. To generate stronger growth, we need QE without an expansion in government spending – so that more private sector players are enticed into new risk taking efforts by lower rates.

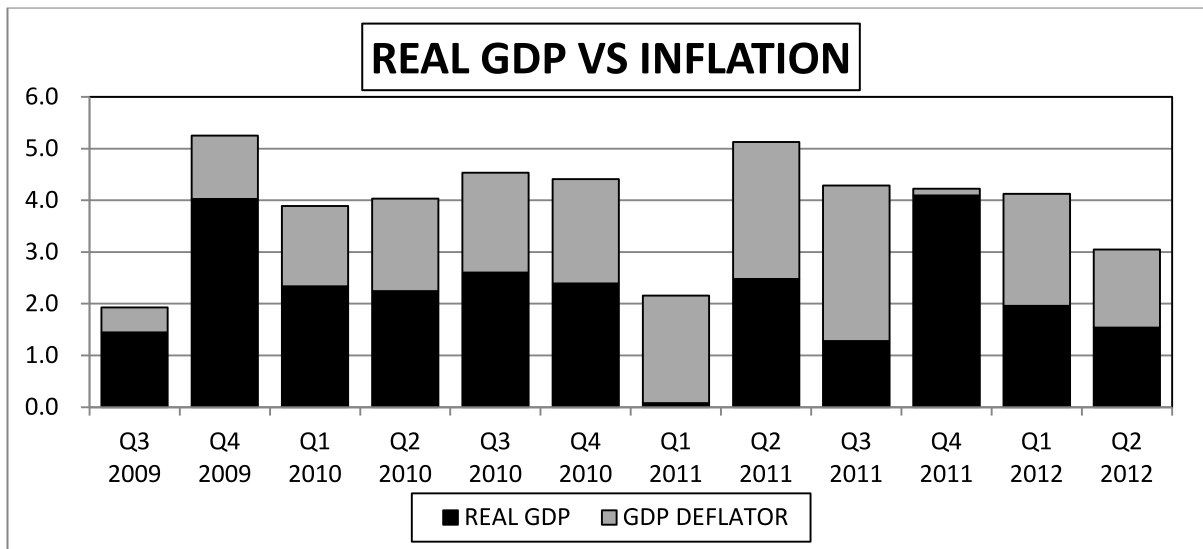
The proposal to give the ESM a banking license creates a new bank with 700 billion euros in capital. The assumption is that this will be done to give the ESM access to ECB funding, which the ECB has so far resisted since the bulk of ESM investments are expected to be to bail out weakened sovereigns and big national banks. However, another promising path exists in that, with a banking license, the ESM could issue its own debt – like the European Investment Bank (EIB) – and buy higher risk sovereigns and bank debt using leverage and the 700 billion euros as capital. As we noted a few weeks ago, the growth package being talked about in Europe will largely be funded via the EIB – which looks a lot like Eurobonds to us. The access to ECB funds simply provides them with an unlimited backstop, creating the bazooka effect that TARP generated in the US.

Note that one gripe about ESM has been that as more countries go under, the burden of funding the ESM falls on an ever smaller group. However, Spain's commitment to the ESM is 83 billion euros, roughly the same as the 100 million euros the ESM is expected to directly lend to Spanish banks. Channeling the money through the ESM, rather than directly from the Spanish government, increases investor confidence. Spain's actual contribution to an ESM bank would be substantially smaller than their 83 billion euro commitment, just as its actual contribution to the EIB is only 5% of their commitment. Of the 232 billion Euro in subscribed capital for the EIB only 11 billion is actually paid in, because losses have not occurred to trigger a call. The presence of the ECB as a backstop makes it possible to borrow at near German rates, while the small paid in capital makes it possible to limit damage to national debt to GDP figures. Good plan – will the US adopt that idea?

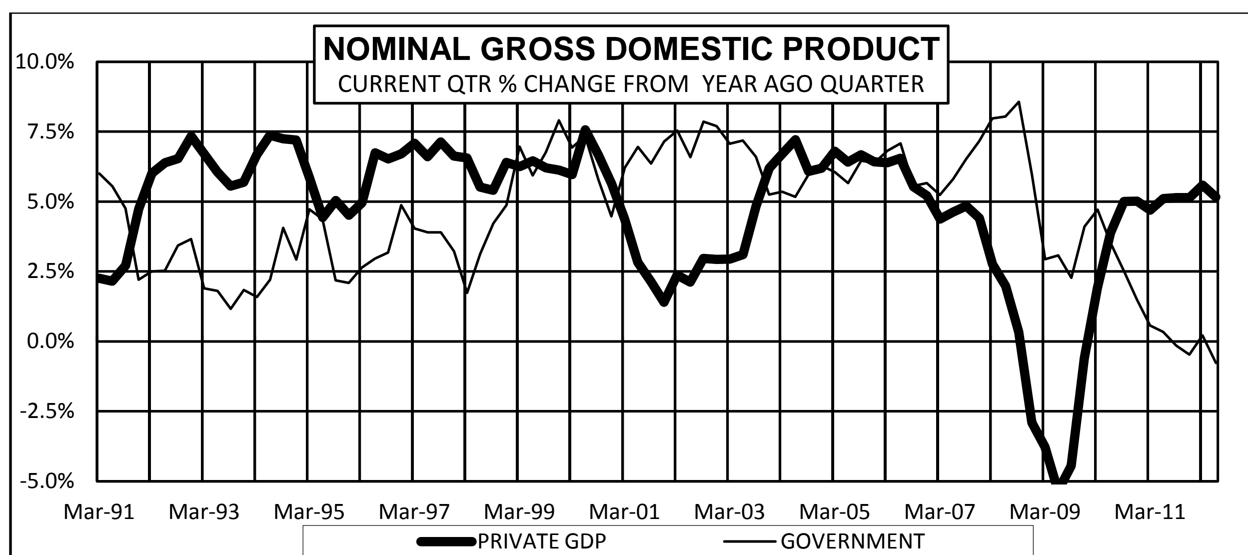
We have argued for some time that this is one of the best times possible to start a de novo bank. Unfortunately, the FDIC has barred any new bank start-ups as its mandate is to ensure the security of existing, already underwater, banks. If they allowed de novos, there would surely be an increase in existing failures – since that is in fact what the invisible hand demands. Instead, the price of starting a new bank is to buy an old troubled charter and expand from there. Many such efforts are underway, but far less new capital is being attracted than if fresh starts were allowed. It is clear from a macroeconomic point of view that fresh capital for the banking system would be a good thing for the overall economy, as these banks would lend rather than accepting 16 basis points from the Federal Reserve. Their lending would expand the money supply generating both real growth and inflation. Given slack in the economy and pent up demand for risk investment by small and medium sized companies that banks traditionally serve, we would expect more real growth. In any case, with increased bank lending there would be more tax revenue, and narrowing fiscal deficits, and the reduced need for government spending would partially offset rising private investment, etc., etc., etc. If Europe goes with a big new bank (still a big if) and the US does not, we see the advantage swinging to the euro until we copy their lead.

Still Muddling Along

Growth in second quarter real GDP came in at 1.5% annual rate, roughly as expected, and annual revisions going back three years did little to revise the consensus about the path of the recovery so far. Unfortunately, the GDP deflator was also low at 1.6%, leaving nominal GDP at a meager 3.1%. This increases the risk the economy will need a boost just to make it to the election without recessing. We focus on nominal GDP, rather than real GDP, because we believe the main problem in the US economy is too much debt, rather than too little employment. Solve the debt burden and you will generate enough growth to create jobs. However, if too much existing debt limits fresh bank lending, we are doomed to modest growth – both nominal and real.

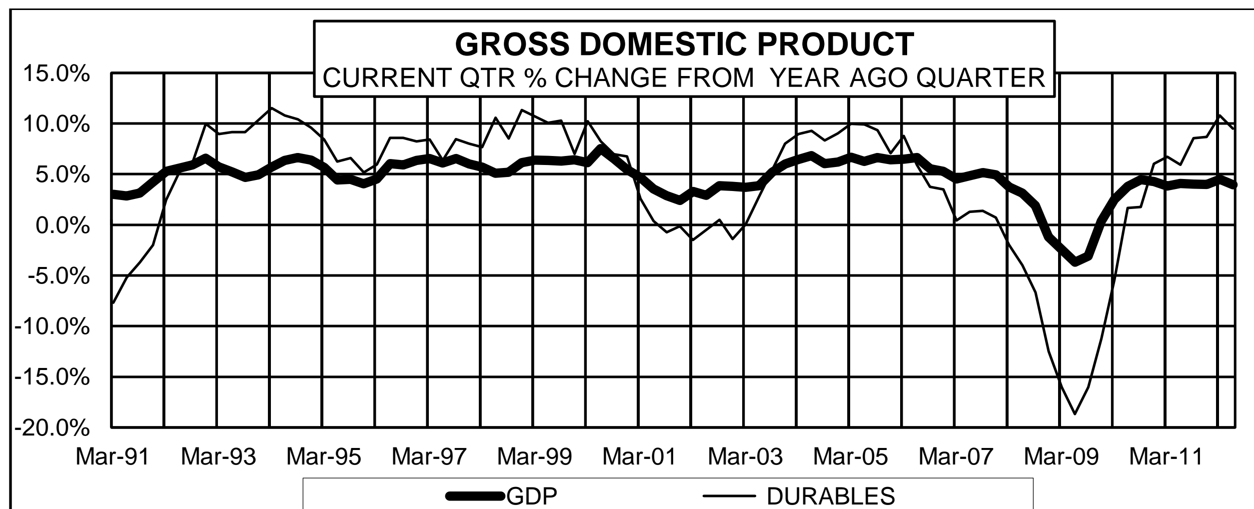


Over the past four quarters, nominal GDP grew 3.9%. In the previous four quarters, nominal GDP grew 4.1%. In the first four quarters of the expansion, from the second quarter of 2009 to the second quarter of 2010, nominal GDP grew 3.8%. Sound like a pattern? The weakest quarter of nominal growth (seasonally adjusted at an annual rate) at 2.2% in the first quarter of 2011 when the Japanese Tsunami hit, was followed by the strongest growth, 5.2% -- averaging to 3.7%. Will third quarter nominal GDP growth come in at 5.3% to lift the two quarter average up to the 4.2% average in the fourth quarter of 2011 and first quarter of 2012? This is not in the consensus forecast, which currently is looking for 2.4% real growth and maybe 2% inflation. Of course it was looking for 2% plus real growth in the first and second quarters as well, only to be disappointed. The low starting point for the third quarter, due to three straight declines in retail activity, increases the risk of another quarter with sub-4% nominal growth – that is, without fresh stimulus from the Federal Reserve or, miraculously, from the Government.



The problem remains the same. Though the private sector experienced 4.0% nominal GDP growth (2.2% real), government spending – which accounts for 20% of GDP – fell by -0.8% (-1.4% real) dragging down the total. Durable goods spending – which is the combination of consumer spending on durables plus all capital spending (residential & nonresidential construction plus producer's durable equipment)—was up a hefty 9.5% over the past year in nominal terms. This is roughly the level of economic peaks in the past – and occurring three years into the cycle about as expected. Thus, we do not expect even more strength in durables to be the driver of better growth. Rather, the path to stronger real GDP is a question of whether the drag in the government sector lets up quickly enough to allow decent private sector growth to shine through. Since the vast bulk of direct government spending (as opposed to transfers) is for labor, we are closely watching government employment. However, employment is only a coincident indicator, so the question is whether state and local budgets are getting strong enough for layoffs to end. Three years ago, 39 state governments had problems heading into their July 1 fiscal year. Last year, it was 19. This year, it was 9. However, 13 states are cutting back on Medicaid, the federally administered but state funded health program. Just getting to balance is not enough. We note that growth in personal

taxes is running well ahead of growth in personal income. Similarly, corporate income taxes grew much faster over the past year than corporate revenues. This is promising if the economy starts to click, but also indicates that all governments are still lifting taxes and fees in search of stronger balance sheets. We don't expect them to back off layoffs yet – but they should moderate as we move into fiscal 2013 (which started July 1, 2012.)



Dear Clients and Friends,

McVean trading will be participating in a Global Interdependence Center conference in Buenos Aires, Argentina on November 1st. The conference, co-sponsored by the Argentinean stock exchange, was planned to examine what lessons the European periphery might glean from Argentina's default and subsequent experience without access to global credit markets. Given the recent turn of events in Argentina with nationalization of their oil industry and fears of pesification of their economy, we expect a vibrant discussion. Add in the recent parabolic price movements for corn and soybeans and the discussion on the outlook for next year's South American crops will be center stage.

We hope that your travel plans allow you to attend. Registration and a preliminary agenda are available at GIC's website: http://www.interdependence.org/programs-and-events/event-registration/programs/argentinas-economic-experience-lessons-for-europes-periphery/.

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