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CAPITOL MARKET REVIEW

4th Quarter Overview, Can the System Take More Intransigence? Has Crisis Watch Obfuscated Macro Trends? Recession or Redemption?

Quarterly Benchmarks: SPX 1131 US10Y 1.7% Gold $1640 Oil $76.00

The inaugural Capitol Market Report was drafted June 30th and made a series of predictions. Many services preach the gospel of "*what's happening now*," few examine their macro calls. As CMR looks into *year-end*, it's also important to look back.

The US Economy

The June 30th report predicted green shoots were an illusion and instead forecast below trend growth would be the *new normal*. June's GDP prediction was 2%. At the time, CMR was far more bearish than consensus; now 2% would be welcomed.

In the space of 3 months, GDP expectations have been cut in half by many economists and the Fed itself. The bear-camp is predicting a recession. Considering that we're now solidly into an election cycle, the White House economic spin is unintelligible as are its economic predictions. Suffice to say that the toughest job in the Administration is that of a spokesman for economic policy. CMR believed previous GDP estimates were unrealistic. However, the current economist group-think may now have it right.

Growth will flirt with near recessionary numbers in certain economic categories, but CMR does not see a recession in the US for the 4th quarter. While 2% growth now seems optimistic, a range between 1.5% to 1.75% is attainable even in light of current concerns. However, the "kick-the-can" nature of global policymakers, (fiscal and monetary alike,) means multiple economies remain vulnerable to recession, which could impact the US.

As per a series CMR daily reports, the notion of *stall-speed* has now been introduced into the trading calculus which means even less confidence will be manifest in equity indexes. At some point, known deep-rooted economic problems left unchecked erode the global GDP model and enthusiasm for bidding up valuations of equity shares.

Outside the technical definition of a recession, the US will remain uneasy. Ongoing employment, housing, (and sadly,) political gamesmanship will continue to grind on the populace. However, interest rates are at historic lows; the US Dollar is relatively weak thus making US goods competitive in world markets. And the ingenuity and spirit of American entrepreneurs should never be under estimated.

Zero interest rate policy, ongoing cautious investing by leading US corporations and even slowing global growth will all allow the US to out-perform many economies not as dynamic as ours. In spite of political rhetoric to the contrary, the US economy still reins supreme.

US Employment

CMR expects the US unemployment rate will remain elevated. Currently at 9%, even a drop to 8.5% will do little to change the mood of the country. Beyond the nationalized number sub-categories, minorities, younger Americans (to name a few,) are much higher. Obviously the unemployment rate in “rust-belt” States is also much higher than federal statistics indicate. Again, considering the need for President Obama to win the youth vote and key Democrat and swing voters in Pennsylvania, Ohio, Michigan, Wisconsin and Indiana, unemployment well above 9% in many of these States poses a serious problem for the President’s re-election bid.

CMR has mused that The Administration understands that it will not win the Obama Jobs Bill vote and instead plans to run against targeted Republicans who will be blamed for its failure in Congress. This assertion will be advanced even though many Democrat Senators up for re-election also find this bill untenable.

Europe

In the June 30th Report, CMR maintained that the Greek crisis was the first of many Euro Member-States who would experience a sovereign and bank debt crisis. In three months the problem has become worse.

There is no plan on the table. The best that can be said is that there is now a plan to meet and make a plan. In the past few days, Merkel of Germany and Sarkozy of France have pledged to solve the problem by the end of October; a date many have pointed to because of a planned G-20 Summit in November.

While the world waits, banks are starting to fail. Dexia is a major Belgium bank that was nationalized and split into pieces requiring a rescue from Luxemburg, France as well as Belgium. Many of Europe’s leading banks are rumored are said to be in need of capital.

Risk to the Eurozone is in the trillions, (EUR.) And many observers are fearful there isn’t enough capital within the Eurozone to solve the macro problem. Furthermore, there is a reluctance to use the tools that would be required to make up the difference. In the last few months, the idea of “Euro-TARP” and the creation of full blown “Euro-Bond,” (as opposed to the current single country sovereign,) have been floated and thus far, rejected. Concerned that the current structure of the Eurozone may not be able to solve the problem, the IMF has created a leveraged lending vehicle. But rumors persist over the health of many leading investment banks.

In the past week, the financial press reported that BNP Paribas would require an equity injection of 7B Euros. Soc Gen is said to need 4B euros. Both banks immediately said

their equity capital is strong and they do not require an equity infusion. These statements are reminiscent of those who recall Bear Stearns, Lehman and Merrill Lynch.
The US bank said to have the most exposure to the Eurozone is Morgan Stanley and its shares rise and fall every day based on the mood in Europe. MS has become a proxy for Euro bank health due to the fact that short-selling in Euro banks has been prohibited

In June CMR also predicted below trend growth for the Eurozone. As has been posted in several daily reports, this call is now being altered. CMR sides with those who are convinced the Eurozone will enter a recession soon.

Even the most optimistic economists and strategists, (defined as those who believe the Eurozone will not implode,) still believe that so much structural damage has been done Europe cannot avoid its post credit-crisis “great recession.”

China/Emerging Economies

Much to the surprise of Brazil, Russia, India and China, (the BRIC’s,) a recession in Europe and below-trend growth in the US is having a negative impact on all global economies. CMR believes the leading Asian economies will continue to grow. However, when the GDP of emerging economies is cut in half, the dislocation for immature lending/capital systems can be quite similar to a recession.

Other than Japan, Asia lacks a mature “middle-class” that can sustain the region during global contraction cycles. Labor costs are rising, land values are soaring, strains on public and private banking institutions are evident throughout Asia and other emerging economies. These asset bubbles will burst as even the best central planners cannot tame the animal spirits of even semi-capitalist economies.

Concerns

In the initial CMR Report, the singular concern listed was the then budding Eurozone credit crisis. This macro view remains the single concern three months later. Bill Clinton would say, *“It’s Europe stupid.”*

Regardless of whether a short-term crisis is triggered by a bank or sovereign default, the damage has reached the point where any resolution now has negative global consequences. Metaphorically, the can has been kicked too-far down the road.

The crisis in Europe has become more than a credit event. It now challenges the union itself as well as the socialist nature of many Euro Member-States. Post World-War II Europe has been funded via high tax rates and political promises that would make even American politicians blush. Long standing Eurozone social contracts that allow for universal health care, pensions for many at age 55 and other well intended/noble State sponsored spending programs are now all at risk. Europe will have difficult days ahead. And while there are economic implications for the world, Europe will experience political and social upheaval not seen since the days of the Weimar Republic.