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# "By the Way"

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I was reminded recently of an old investment business axiom; more money is made when things are going from terrible to merely bad than when things progress from pretty good to good. The world's four major economies are at various stages along that timeline, with consequent effects on their stock markets. Here is my take.

The U.S. would seem to be furthest along in the process. Since the near meltdown after the Bear Stearns and Lehman Brothers disasters, the economy recovered and the stock market was up 175% to year-end 2014. So the easy money has been made. This is not to suggest that there are no more profits to be had, but as S&P 500 results so far this year have shown, more attention must be paid to industry and stock selection. With the likelihood of the Fed raising rates this fall, stronger GDP and earnings growth are required to keep markets moving higher. This has been the slowest US recovery since World War II, and the first quarter of this year was weak due to one-time events, but we see signs that the second half of 2015 should give us the growth necessary to support positive market momentum into 2016. For example, consumer spending surged 0.6% in May, and housing reports have shown a strong rebound. Employment continues to provide a tailwind, and core capex is growing at an annualized 6.6%. Not all reports are as strong as we may wish, but private sector momentum is positive, and with the government sector no longer a drag as the sequester wears off, we should see a second half GDP growth rate in the 3% range. On the earnings front, consensus growth estimates are around zero for this year, allowing for an upside surprise, which we think likely. Lastly, we note investor sentiment surveys show market bulls have fallen into the mid 20% range, leaving room for the almost 50% who are neutral to provide support as they move back into the market.

Europe would seem to be in the sweet spot of the above mentioned proverb. It was not long ago the survival of the Union was being questioned (the "terrible"); whereas today there are signs the worst is over ("merely bad" and moving toward "pretty good"). The Eurozone economy, as a whole, is just starting to show growth, the ugly specter of deflation has at least temporarily been removed, and the positive effects of Central Bank easing are taking hold. The most recent European Purchasing Managers Index increased to 54.1 which is firmly in expansion territory, consumer confidence is improving, and CPI in May was at 0.3% (at least it's positive). All is not sunshine of course, unemployment remains high in certain countries and the political risks in the Ukraine and Greece are still there. On the Greek situation we remain in the camp that a negotiated settlement will be found. It will not solve the problem, but will allow all parties to save face. The old buzzwords "pretend and extend" will help provide a solution to push the problem into the future. Do not bet the farm on this opinion; political forecasting is even more fraught with danger than its financial cousin. Whatever the outcome in Greece, despite any volatility experienced in the short term, we believe the combination of improving fundamentals and continuing monetary ease will serve to move European markets higher.

Japan, on the other hand, is having trouble escaping the "terrible" stage, but is providing proof that there is lots of money to be made in moving to "merely bad". There remains a disconnect between the market and the economy. Among the weak economic reports, the June Manufacturers PMI came in at 49.9 which is marginally in contraction territory, and deflation is still a real risk, but the Nikkei is up about 15% so far this year. The bulls point out that most economists expect consumer spending, exports and capital expenditures to drive growth, and with the Bank of Japan continuing to be aggressive on monetary policy, we could see a lot more upside.

China is much more difficult to categorize as the government continues its efforts to move toward a more consumer-centric economy, in a very volatile environment. Policies to slow growth have worked; hopefully not too well. GDP growth which was 10.4% in 2011 is expected to fall below 7%, and preliminary PMI data was 49.6, but remains below the expansionary 50 level. The stop/go nature of government policies, easing and then tightening, have added to the volatility in the economy, particularly in real estate prices and more recently the stock market. Some of the market numbers are quite awe-inspiring; this year through May 22nd, 29 million new stock accounts have been opened, as many as in the last four years combined. A recent decline of 11% still left the Shanghai Index up 125% year-over-year; the decline was in part precipitated by the first official restriction on margin debt, which was up 463%(!) year-over-year. Not for the faint of heart, but as one Chinese farmer said in a CNBC news report; "making money in the stock market is much easier than farm work". Maybe he is one of the many more new investors that will propel the market much higher. In my mind though, it is more like the shoe shine boy who gave Joe Kennedy stock tips in 1929, prompting Joe to sell the market.

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