

Scout Investments

Global Economic and Market Outlook

Recession of Confidence

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2011 Outlook

GDP GROWTH:
1.8%

UNEMPLOYMENT:
9.0%

INFLATION:
1.75%

FED FUNDS RATE:
0.25%

We recently took the position that the world is probably not going to experience an outright recession over the next few quarters, but the probability of a recession occurring is rising. We assigned a probability of 35% that yes, indeed, the world would slip into a recession sometime in the next few quarters. According to *Barron's Magazine*, the "average" economist currently assigns a 27% probability to a recession occurring.

We stand by our prediction. In that piece, we highlighted five reasons why the world would probably stay out of recession, which is defined as two quarters of back-to-back negative GDP growth. However, is the renewed downward move in stock values and apparent shift of investor "preference" towards less-risky assets indicating that we are tipping into recession? Could business and economic indicators be fine, and the world's economy still tip into a contraction? It is rare, but it could happen.

Confidence Game

In a world of central banks and fiat currencies, confidence is of paramount importance. Let me explain. What makes the dollar bill in your pocket worth something? It isn't backed by anything "hard" (gold, etc). It is simply backed by the Federal Reserve. Look on the dollar bill in your wallet. On the face of that bill you will find printed "This note is legal tender for all debts, public and private". Basically, what gives the bill value is our belief that a person who has a good or service which we desire will take the bill as payment for that good or service. That's it. Beyond that expectation, the dollar bill (or any other fiat currency) has no real value. Consequently, "confidence" is needed in today's financial system for that system to function.

Let's look at another example of how confidence works in today's economy. How can a bank stay in business? Most banks' balance sheets include 90% liabilities and 10% capital (good banks, that is). If all depositors come into a bank at the same time and demand their cash from their accounts, most banks won't be able to honor all depositors' requests, as much of that cash was used for loans to various customers of the bank. Now, over a period of time, most banks will be able to honor all requests for withdrawals. But the reason most folks don't worry about the solvency of most banks is they have faith, or confidence, that the bank will stay solvent, and in the vast majority of cases the people are correct in this thought. At any rate, confidence in the system and the institution is necessary for the banking system to properly function.

Why are leaders appointed in positions of power, or elected? They are elected because people have faith, or confidence, in their capabilities to fulfill their roles and responsibilities. The same is true of institutions. The people of the U.S. – well most people – have a high degree of faith in the Federal Reserve, and other instruments of economic decision making and leadership. Our institutions went through the “fire” of confidence building during 2008 and 2009. European institutions are now facing a similar “fire”.

Consumer Confidence

Last Friday, the University of Michigan released results from their latest Consumer Confidence Survey. The index fell to 54.9 in August, down 23% from the June report. Over the last two months, according to this survey, consumer confidence in the U.S. has fallen more rapidly than any time since 1980! The decline was accompanied by data showing a 29% decline in the expectations segment of the survey (what people think of the future). As stated, consumers’ attitudes are worse now than they were during the Lehman Brothers meltdown and worse than during the national crisis on September 11, 2001.

What caused this huge decline in sentiment? The only issue we can think of is confidence. A lack of confidence has been building regarding our national institutions. Now the international institutions’ confidence levels are being assaulted in Europe and in other areas.

The ECB and Banks

To those who aren’t aware, the monetary, banking and financial system in Europe is currently under a high level of scrutiny. First there were the problems in Greece, Portugal and Ireland. Then there were the Italian and French scares. It has become obvious to all observers that changes are needed in the European central banking (ECB) system.

After a long, drawn-out process, it is now becoming clear in Europe that in order for the Euro to maintain its current monetary structure, the German population and other stronger economic countries may need to formally back other countries debts. Will this occur? We really don’t know. But for Europe to “float” a Euro-bond issue and take over legal responsibility for even a portion of sovereign debts, Germany is the primary country that will need to step into the breach and guarantee these debts. If the Greeks, or Portuguese or whomever, spend too much money, Europe may need to back these liabilities fully. In effect, this will lessen sovereign power of each individual country. Will the Germans and others go along with this?

The de-link continues. What do we mean? There exists in Europe a de-link between authority and responsibility at various national levels. For example, politicians in Athens, Greece have the authority to create budgets and spend money for the benefit of the Greek peoples. If they can’t finance those expenditures, the people of Germany may, in the future, be required to shoulder the responsibility of making sure the bond investors get paid. In our opinion, this de-link is creating real anxiety in various investment circles, as it should. At this time, we don’t know if the German people will go along with this process.

Are there other solutions to the European monetary, banking and financial mess? Suppose Germany or other countries would “leave” the ECB and strike their own currency. This would create a real mess. But that is another possibility. World-wide economic stresses and to some degree, chaos may ensue. Some in Europe are saying this “can’t” happen. Perhaps.

There appears to be no easy way out of the European currency problems. So, the lack of confidence issue has spread from the U.S. to Europe.

Final Word

Are these issues meaningful enough to spin the world's economy into recession? In a word, "yes". Will this happen? At this time, we don't believe so. However, it has become clearer that the economic risks the world is currently facing go well beyond typical cyclical economic pressures. It is becoming clear – the world is facing a confidence issue.



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