

# Scout Investments

## Global Economic and Market Outlook

### Taking stock in our thematic views

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#### 2011 Outlook

**U.S. GDP GROWTH:**  
1.20%

**GLOBAL GDP GROWTH:**  
2.85%

**UNEMPLOYMENT:**  
9.0%

**INFLATION:**  
1.75%

**FED FUNDS RATE:**  
0.25%

#### Is there a way to break the stalemate?

As the political and economic world shudders with the banking dislocation occurring in Europe, we are reminded of 2008-2009. Are we going through the same “dark hour” that we passed through three years ago? What will happen indeed if Greece defaults on their bonds? At the end of the day, what is the way out of this economic stalemate in which we find ourselves?

The world faces many questions. This piece is somewhat philosophical in nature. However, during times of extreme stress it pays to step back, take a breath and think through the issues at hand.

#### The Long, Hard Slog

As many readers know, we like themes. They keep us on track and focus our thoughts. The over-riding theme which we have stuck with has been The Long, Hard Slog. We first introduced this theme late in 2007, outlining economic stresses which had the potential to slow overall economic growth rates on a systemic basis. Since then many market pundits have created similar themes, including the “New Normal” concept. Debt is the main culprit of the systemic economic slowing, and debt problems have many locations and sources. This theme is still intact. The latest episode of this theme rests squarely in Europe – and not just in Greece but in Lisbon, Madrid, Dublin and Rome. We can throw Berlin and Paris in that mix for good measure, but for different reasons.

We have written on the stresses and the dislocation in Europe for a number of months. We have highlighted the problem from the standpoint of responsibility/authority. It has bothered us that there exists, at the end of the analysis, a difference between those who have the authority to balance fiscal budgets and those who have the responsibility of funding excessive debt structure. In life and business in general, a separation of responsibility and authority seldom works. Think about it. Let us assume a co-worker has the authority to get a task done, and you have the responsibility to see it does get done, but you have limited or no control over the co-worker. A matrix work situation can easily become an untenable spider web.

In Europe's case, Greece, Spain, Portugal and all other sovereign countries have the "authority" to balance their budgets. Germany, the Netherlands, Finland and others have the "responsibility" to respond to the financial markets if those who have the "authority" don't do their jobs. This is what has happened in Europe. What is the endgame to this problem? We believe Greece defaults. The Germans and French build a "ring-fence" around their banks with capital infusions (not more debt). **A confidence crisis is building in Europe and liquidity injections (additional debt) will not feed the bulldog.**

At the end of the day, this too shall pass, and The Long, Hard Slog will come to an end. We just aren't there yet.

## The Main Event

Another theme which we outlined some time ago which is still in play is The Main Event. This theme attempts to detail the reasons behind The Long, Hard Slog. Debt structure is highlighted as the main factor behind The Long, Hard Slog. Consequently, the excessive debt structure highlighted in this thematic piece is the piece of the puzzle which needs to be monitored and addressed. In other words, The Long, Hard Slog is the result of The Main Event.

Various parts of the U.S. economy have been busy paying down debt, effectively addressing The Main Event. According to our friends at Ned Davis Research, the total credit market debt outstanding, measured as a percentage of GDP has fallen from 375% to 351% (down 6.4%). Household debt as a percentage of GDP has fallen from 98.4% to 88.7% (down 9.9%). Conversely, government debt (federal, state, local and GSE) as a percent of GDP has continued to rise over this period, setting a new high at 158.8% of GDP (as of 3/31/11). So, The Main Event is being addressed, but it will take time until we as a society are out of the woods.

The same is now obvious in Europe. Many countries within Europe have, like the U.S., lived well beyond their means over the last number of years (decades in many cases). A lack of growth in GDP (income statements) was offset by rising national debt levels. In many cases, this increased debt structure was "moved" to the national income statement and spent on non-investment items. This is akin to mortgaging a home and spending the money on a boat or clothes (sound familiar, America?). So, in many cases, the national "balance sheet" was levered to benefit short-term income "wants".

**The financial markets are, in many cases, not kind and gentle, but they tend to be fair. When risks become extreme and borrowers treat lenders poorly, investors react. In other words, the cost of capital rises, and in the extreme, investors "strikes" can and do take place. This is when the markets tend to swoon. These are the results of The Main Event which Europe is currently reaping.**

## Cyclical Concepts

Between The Main Event and our more recent Black Swan theme we outlined two other themes, both cyclically positive. One theme "Attempting to Gain Traction" was launched towards the beginning of 2009. At that time, we saw that the economy was probably going to recover and called for an end to the awful recession of 2008-2009. This occurred, and the stock market rallied – hard. From an intra-day low of 666 on the S&P 500 Index, the market moved upwards until May of this year when the S&P hit 1361, a gain of 104%! Along the way, we created pieces such as "Standing on Shifting Sands" in which we expressed concern about the sustainability of the economic recovery.

"Attempting to Gain Traction" and "Standing on Shifting Sands" were put forward as "cyclical" themes which were probably going to contain limited shelf-life. During this period of time, we consistently fell back on our "Long, Hard Slog" theme, in which debt structure and slow systemic economic growth were the true centerpieces of our economic and market thoughts.

## Black Swan

Late last year, we launched our Black Swan theme. In this theme, we came to the conclusion that the real issue at hand regarding the debt creation wasn't that it resulted from spendthrift lifestyles and governance, as the theme of rapid debt creation was not specifically an American phenomena. We came to the

conclusion that overleverage was a “developed world” problem – infecting economic growth not only in the U.S., but also in Europe and Japan.

The concept centers on the world’s economic “income statement”. Something started happening in 1985 – where equity market volatility started increasing rather dramatically from the trends investors witnessed from 1945 to 1985. Market volatility is a reflection of uncertainty. Markets tend not to like to be surprised. As surprises (particularly negative) occur, markets tend to swoon. We witnessed periods, starting in the mid-1980’s, where the daily volatility of the markets increased rather dramatically. We asked ourselves what had happened about that time. A number of issues were brought forward in this analysis.

But one major, fundamental factor continued to resurface. The “developed” world was losing world-wide GDP share to the developing markets on a rapidly accelerating pace. That phenomenon coincided with a rapid increase in the developing world’s debt creation habits. Developed nations, and their peoples were rapidly increasing debt levels, and not always investing the proceeds from the debt. In many cases the increased debt was being used to finance increased consumption – primarily by governments and consumers. Additionally, entire financial systems were increasing leverage. Banking systems eschewed capital (owners’ equity) as leverage increased dramatically within the world’s major banking organizations. As leverage was increasing, market volatility was rising – enter the Black Swan – unforeseen market events (surprises) which led to major equity market contractions.

One unforeseen (by many) negative of the leverage which had been created by the western world is “balance sheet” risks have risen dramatically. Normally, economic contractions occur due to excesses in an economy’s “income statement” (demand or supply disruptions). The last recession we witnessed was driven by “balance sheet” (debt) excesses. Indeed this is still the case – where the major “imbalance” in the developed-world’s economies tends to be centered on balance sheet leverage – mainly for consumers and businesses. We have written extensively on this issue in the past. This excess remains, and is currently what is driving economic/banking/currency risks higher in Europe.

### Final words and multi-trillion dollar questions

So, now it is time to pay the piper. Much of the world is being force-marched to lower leverage. The U.S. banking system started down this path in 2009. The European banking and governmental systems are now being force-marched down the same path by the world’s financial markets. The developed world is now locked into a major decision process – **what do we as a people want from our government institutions and what are we willing to afford?**

**This question is being asked aggressively in some cases and passively in others, but make no mistake. This is the question of our age, and it will be answered.** If we as a people don’t answer this question, the world’s financial markets will answer it for us. We probably won’t like the answer. Kind or not, this is the environment which we face.



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