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January 3, 2012

Decoupling – Wishful Thinking or Opportunity?

- **U.S. growth expected over 2% -- health non-inflationary growth**
- **Europe's recession is expected to be manageable and have a smaller effect on the U.S. economy than previously thought**
- **To the extent that fear of a U.S. recession still keeps spreads wider than normal, this is a buying opportunity in U.S. corporate bonds**

Nice to see that a concept I floated several months ago is finally getting some additional discussion by top economists. “Decoupling” the U.S. from the recession-headed European economy is the idea, and my old buddy **Maury Harris** of UBS, one of the top economists in the world, recently said it:

“There is a sense of decoupling... we can still have a decent year here in the U.S. even with the rest of the world slowing down.”

Cast your mind back six months, and everyone seemed to be panicking that Europe going down would mean a recession in the U.S. To give economists credit, few of them changed their forecasts to a recession for the U.S., but everyone did lower their forecasts for the U.S. Then the economy caught a tailwind of a stronger-feeling consumer, and even the housing market showed a few glimmers of improvement. Finally, the overreaction to mid-year debt-ceiling theatrics and the minuscule downgrade of the U.S. gave an exaggerated sense that our country was entering some sort of an economic and/or fiscal crisis. To the extent that this led to wider spreads for a while, there is still this residue of fear which keeps spreads wider than normal.

Economists such as JPMorgan Chase (+2.5%, up 0.6% from prior forecast), Barclays Capital (+2.5%), Morgan Stanley (+2.2%) and UBS (+2.1%) are a typical group forecasting the U.S. real GDP in 2012. Not only are their forecasts far from a recession, their forecasts are also somewhat improved from prior forecasts made in the latter part of 2011.

The opportunity is stark in its simplicity – simply put, the market doesn't believe Maury and his fellow top economists! Fighting the last battle, investors choose instead to overplay the extremists of the profession, such as Nouriel “Black Swan” Roubini, who in a mid-December article forecast “anemic growth at best” for the U.S. economy in 2012. That implies a mid-point forecast of a recession, in my opinion. By any reasonable person's definition, growth of 2.3% in 2012 (the average of the other top economists I

listed) would not be termed “anemic” – in fact it would be enough to continue making a dent in our already-falling unemployment rate.

There’s little doubt, by contrast, that Europe is tumbling into recession. Britain is fading fast, and its bond yields (at record low levels, under 2% for 10-year gilts) reflect that expectation. Italy and most peripheral countries will be in recession, France is a toss-up, and even Germany will probably experience such low growth as to cause the Eurozone as a whole to be in recession.

What has changed is the correlation coefficient with the U.S. Always a highly subjective thing, the idea that we can reach +2.3% while Europe goes down 1% is finally catching on a bit, as shown by recent spread tightening in corporate bond spreads and slight improvement in the U.S. stock market.

For decades the U.S. had growth rates in excess of two percentage points above Europe’s. Although I do not expect this to continue indefinitely, there is also no reason to believe we will suddenly commence an era of growth only fractionally above Europe’s. Our population growth is much higher, our population is younger, and our regulations are less onerous. Our West Coast is better-positioned to serve the rapidly-growing Asian market (China’s and India’s expected growth rates were just ratcheted up a bit today based on better news). Finally, the outlook for U.S. trade with Latin America hasn’t been this good (both the Latin growth rate and our relationships) since the early 1960’s, in my opinion.

Yes, India and China are experiencing bumpier times, less predictable growth, and haven’t yet gotten fully untracked in the wake of the Great Recession, followed by the European fiscal crisis. But let’s not forget the obvious – structural changes which have already occurred in those two rising countries have made much more of a positive difference than external factors.

One only has to look at the dismal 50’s and 60’s for both India and China, decades when both Europe and the U.S. grew significantly richer, to see the lack of easy correlation. In fact one can view the progress of India and China as a major cycle of world economic history -- clawing their way slowly back to a semblance of their former glory. Two hundred years ago they combined for half of the world economy! That fell all the way to single-digits in the dismal early and mid-20th century. If they only get back to 30% of the world economy (with over 30% of the world’s population), that will continue to help the entire world grow more quickly than it would have if they had never reawakened.

Yes, we live in bumpy times. Hardly new or startling – Roubini’s conclusion “Fasten your seat belts – we’re in for a bumpy year” is so cliché-ridden, even he recognizes it by saying it’s a paraphrase from some old Bette Davis movie! [Earth to Roubini – this phrase is not even close to being unique to a Bette Davis movie, nor does the average investor learn from aphorisms from Hollywood movies. J.P. Morgan himself said, “The market will fluctuate” and that’s equally unhelpful.]

We can still profit from favorable economic trends, if we do not over-react and remain paralyzed by the voices of doom. They will always be there, in good times and bad. I strongly believe that doom & gloom is the current rage, since it has created celebrities who use it as a brand, just as Joe Granville did back in the 1970's recession. The key is who to opportunistically ignore – and if that sounds like an aphorism, at least it's mine!

Good luck and good investing,

Stephen Smart, CFA
Chicago (630-363-8511) stephen.h.smart@gmail.com
Carolina Capital Markets
Chapel Hill (919-960-0807) smart@bonddog.com
The Smart Bond Guy

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