Chicago Tribune

U.S. economic data encouraging, but Europe muddying the picture

Hedge fund managers hesitant to invest in stocks, fear slowing global growth

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November 16, 2011

If only Europe weren't so menacing, American investors probably would be feeling less apprehensive about the economy and stock market.

U.S. economic data Tuesday was better than expected: not extraordinary but not recessionary either. There was enough of a lift in October retail sales to assure analysts that American consumers aren't paralyzed and are doing their bit to propel the service sector, which encompasses 70 percent of the U.S. economy.

"Households many not be in an especially celebratory mood, but they do seem willing to ramp up purchases in the final months of the year," said economist **Bernard Baumohl of the Economic Outlook Group**. They have increased their spending on goods for a fifth straight month, and that "foreshadows a fairly vigorous holiday shopping season," he said.

JPMorgan economist Michael Feroli said the 0.5 percent increase in October retail sales suggests consumer spending should be up 3 percent on an annualized basis in the last quarter of this year and provides confidence that the economy will grow at a 2.5 percent rate. That's less robust than needed to start chipping away at unemployment, but it's more encouraging than in August. Then, amid the nation's debt drama in Congress, consumers grew wary, and economic data pointed at recession.

Besides retail sales, analysts Tuesday also took encouragement from a New York Empire State manufacturing survey that showed modest growth and an improvement from recent negative numbers.

Still, there are questions about just how consumers are coming up with their spending money.

"With wages falling behind the cost of living all year, joblessness at 9 percent and household wealth still eroding, a sustained pickup in consumer spending has to be viewed with concern," said **Baumohl**.

He noted that savings are down, suggesting that people might be ramping up their use of credit again at a time when they still have a lot to pay off from the last decade of borrowing with abandon.

Some of the increase appears driven by necessity, since higher food costs may be a reason for higher sales numbers at grocery stores. But beyond necessities, consumers increased purchases at electronics and appliance stores 3.7 percent, the most in two years, said Feroli.

Consumers seem to be feeling better than hedge fund managers.

After meeting with a variety of hedge fund managers recently, JPMorgan strategist Thomas Lee said that concern about a financial blowup in Europe has made them anxious and indifferent about investing in stocks. They are concerned about their poor investing performance this year and think the global economy will slow, said Lee.

That view was also born out by a Bank of America Merrill Lynch survey of global fund managers.

Merrill Lynch, which has been surveying fund managers for years, reported Tuesday that the most recent survey "suggests a picture of dogged bearishness, with European sovereign concerns dragging down global growth optimism and deflating risk appetite" for investing, said European equity strategist Gary Baker.

Among the fund managers surveyed, 84 percent think European Union growth will deteriorate in the next 12 months, and corporate earnings will decline along with growth. Typically, when the economy and profits decline, stocks do too.

"The pattern looks ominously similar to 2008," said Baker.

In 2008, the collapse of Lehman Brothers infected banks worldwide, setting off a serious global recession, and the stock market fell 37 percent for the year. Now, neither fund managers nor economists are optimistic that Europe will find the political will to skirt the threats to European banks. Because there is little clarity about the entanglements of banks globally or the severity of a potential recession, the stock market in Europe and the U.S. has plunged and surged repeatedly based on European expectations.

"They are spasms of the unknowable," said Russell Investments chief market strategist Stephen Wood.

Market experts are at a loss to anticipate possible results, he said, because the European financial crisis is "a political problem with political solutions," and a misstep could end poorly.

At a Chicago Federal Reserve conference on financial stability last week, economists from throughout the world said they think the European Central Bank could stop the financial contagion that is afflicting a broad array of European countries. But that would have to mean that 17 European countries agree to commit well more than the $600 billion that's been offered so far for a bailout, a politically unpopular move that has not been widely embraced.

As investors worry that troubled countries such as Greece and Italy might default on debt payments, investors are demanding higher interest rates throughout the eurozone. Recently, bond yields have been rising in France, Belgium, and Austria, strong countries that are considered riskier because of their exposure to the debt crisis. When healthy countries are forced to pay higher interest to access loans, they can end up financially stressed too.

In the Merrill Lynch survey, fund managers said they are reluctant to invest in European bank stocks. And Merrill's chief global equity strategist, Michael Hartnett, said it is time to reduce exposure to stocks. In a model portfolio, he suggested dropping stock exposure to 60 percent from 65 percent, and increasing bonds to 35 percent. He favors U.S. corporate bonds and emerging-market bonds.