MORNING BRIEFING
July 26, 2012

The Best & the Brightest
(1) Weill, Greenspan, and Blankfein have seen the light. (2) Bair is flabbergasted. (3) The Great Barofsky. (4) Other Peoples' Money. (5) Capitalism's weakest link. (6) Geithner's turn to come clean. (7) Nowotny's golden opportunity? (8) Don't bank on bank stocks. (9) Europe has very good Health Care for investors. (10) China's tax revenues confirm slowdown.

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Mea Culpa. Live and learn. Sandy Weill, the inventor of too-big-to-fail banks, has had an epiphany. The man who created Citigroup thinks that creating TBTF banks was a big mistake. That's what the 79-year-old ex-Citi chief said on CNBC: "What we should probably do is go and split up investment banking from banking, have banks be deposit takers, have banks make commercial loans and real estate loans, have banks do something that's not going to risk the taxpayer dollars, that's not too big to fail." He added: "I find that, over time, fences are jumped, firewalls are drilled through and you end up with bad outcomes." It wasn't a real mea culpa, though, since Mr. Weill claimed that "the earlier model was right for that time."

Former FDIC Chairman Sheila Bair told CNBC she was flabbergasted by Weill's comments. She said, "It's a little ironic, I must say, given the fact he and his institution were in the lead in pushing for the repeal of Glass/Steagall. And then, of course, Citigroup is the poster child for too big to fail in the bailouts during the 2008 crisis. So it is truly ironic, but obviously I agree with him. As I've said repeatedly, I think these banks are too big to manage centrally. They're too big to regulate and they don't produce good shareholder value either."

Neil Barofsky, the Special Inspector General in charge of TARP oversight, has written a book about his experience in DC. It's called *Bailout: An Insider Account of How Washington Abandoned Main Street While Rescuing Wall Street.* Gretchen Morgenson of the *NYT* reviewed it on Sunday. She also interviewed the author, who said, "The suspicions that the system is rigged in favor of the largest banks and their elites, so they play by their own set of rules to the disfavor of the taxpayers who funded their bailout, are true." Like Mr. Weill, Mr. Barofsky believes that the big banks need to be split up.

Earlier this year, on February 8, I weighed in on this subject as follows: "The problem with banks is that they tend to blow up on a regular basis. That's because bankers are playing with other people's money (OPM). They consistently abuse the privilege and shirk their fiduciary responsibilities. Whenever they get into trouble, government regulators scramble to bail them out first and then to regulate them more strictly. Without fail, the bankers respond to tougher rules by using some of the OPM to hire financial engineers and political lobbyists to figure out ways around the new regulations.

"In my opinion, banks are the Achilles' Heel of capitalism. They really do need to be regulated like utilities if their liabilities are either explicitly or implicitly guaranteed by the government, i.e., by taxpayers. Banks should be permitted to earn a very low utility-like stable return. Bankers should receive compensation in the middle of the pay scale for government employees, somewhere between the pay of a postal worker and the head of the FDIC. It should be the capital markets, hedge funds, and private equity investors that provide credit to risky borrowers instead of the banks."

By the way, Sandy Weill's isn't the first noteworthy mea culpa from notable contributors to the great financial crisis. Here are a couple more confessions from:

(1) *Alan Greenspan*--after a long and celebrated career on Wall Street and in Washington, D.C., and after cashing in with consulting contracts and a bestseller about his career and how the world works--confessed he was wrong all that time. In his prepared remarks for congressional testimony on October 22, 2008, he said: "As I wrote last March: those of us who have looked to the self-interest of lending institutions to protect shareholder's equity (myself especially) are in a state of shocked disbelief. Such counterparty surveillance is a central pillar of our financial markets' state of balance. If it fails, as occurred this year, market stability is undermined."

During his Q&A exchange, he admitted: "I found a flaw in the model that I perceived is the critical functioning structure that defines how the world works, so to speak." He added, "That's precisely the reason I was shocked, because I had been going for 40 years or more with very considerable evidence that it was working exceptionally well."

(2) *Lloyd Blankfein,* the chief executive of Goldman Sachs, wrote an article in the February 8, 2009 *FT* titled, "Do not destroy the essential catalyst of risk." He observed that it should have been obvious that there was something not right about CDOs: "In January 2008, there were 12 triple A-rated companies in the world. At the same time, there were 64,000 structured finance instruments, such as collateralised debt obligations, rated triple A. It is easy and appropriate to blame the rating agencies for lapses in their credit judgments. But the blame for the result is not theirs alone. Every financial institution that participated in the process has to accept its share of the responsibility."

Who's next? How about a mea culpa from US Treasury Secretary Tim Geithner stating that he knew that Libor was a rigged rate back in 2008, when he was President of the FRBNY, but did nothing about it. Today's *Washington Post* reports: "Still, the Fed proceeded to use Libor as a benchmark to determine how much insurance giant American International Group would pay back the government during its bailout. The measure also was used in the fall of 2008 to set the interest rate for the emergency lending program called the Term Asset-Backed Securities Loan Facility, or TALF.

"'That number [Libor] determined how the taxpayer would be compensated,' said Neil Barofsky, who was the chief watchdog of the financial system's $700 billion bailout. 'That's putting the Federal Reserve's imprimatur on a rate it has suspicion to think was fraudulent. The Federal Reserve's use of that and Treasury's use of that in the bailout sends a powerful message to the market: 'Hey don't worry about this, we're endorsing it.'"

Strategy. Gold might have some upside again. That's because central bankers are telling reporters that they are looking for even more novel ways to pump liquidity into the global economy. Yesterday, the spot price of an ounce of gold rose 1.1% in dollars and 0.8% in euros on reports that the Fed is considering using new tools to boost US economic growth, as I discussed yesterday (*Fig. 1* and *Fig. 2*). (We update our *Currencies and Gold* chart book daily. Add it to your Home Delivery and MyPage by clicking)

In addition, gold was pumped up yesterday after ECB Governing Council member Ewald Nowotny said there were arguments for giving Europe's new permanent rescue fund, the European Stabilization Mechanism, a banking license. That would enable the ESM to borrow unlimited funds from the ECB and prop up the bonds of debt challenged euro zone governments. Other ECB officials previously opposed the idea. Then again, this morning, ECB President Mario Draghi said during a speech in

London: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."

I've argued in the past that central banks are likely to continue to purchase their governments' bonds if that's what it takes to avert the dreaded "Endgame" scenario (*Fig. 3* and *Fig. 4*). Admittedly, that might only postpone it. Bank stocks certainly aren't acting well despite all the monetary easing, as well as the bailouts and regulatory tolerance of TBTF banks. Here are a few shockers: The 200-day moving average of the S&P 500 Other Diversified Services (BAC, C, JPM) is actually just below its 2009 low (*Fig. 5*). The same is true for S&P 500 Investment Banking & Brokerage (ETFC, GS, MS, SCHW). Ditto for MSCI European Banks and Diversified Financials (*Fig. 6*, *Fig. 7* and *Fig. 8*).

Yesterday, I argued that global stock investors seeking safe havens should come to the US and consider Health Care stocks. Actually, there have been big moves so far this year in these stocks even in Europe (*Fig. 9*). In fact, they've actually been flying in recent days. The MSCI European Health Care sector is up 6.7% ytd (vs. 7.0% in the US). Here is the year-to-date performance derby so far for the sector's four major industries: Pharmaceuticals (5.6% vs. 7.0% in the US), Health Care Equipment & Supplies (10.0% at a new record high vs. 6.8% in the US), Health Care Providers & Services (13.7% at a new record high vs. 4.2% in the US), and Biotechnology (50.5% vs. 19.4% in the US).

China. Recently, lots of doubts have been raised about the accuracy of official economic measures released by China's government. Debbie and I don't doubt that the quality of much of the data is questionable. We regularly update our *China* chart book and try to assess the big picture as best we can using all the available data as a whole. (Add it to your Home Delivery and MyPage by clicking ★)

We are constantly on the lookout for more data to add to our chart book. I recently asked our consultant, Sailesh Radha, to work on China's official tax revenues. He found the latest official release in Chinese and used Google's translation utility to read it. He ran two charts showing tax revenues in yuan and relative to GDP during H1-2012 (*Fig. 10* and *Fig. 11*). A third chart shows the y/y growth in revenues during H1-2012 versus during H1-2011 (*Fig. 12*).

The data were released by the Ministry of Finance on Tuesday of this week and outlined in a story appearing in the English version of xinhuanet.com. The data confirm a significant slowdown in Chinese economic growth during the first half of this year:

(1) *Tax revenues* rose only 9.8% y/y during H1-2012, down from 29.6% over the same period a year ago. Growth rates were down across all 11 major revenue sources.

(2) *Personal income taxes* actually declined 8.0%. A year ago, they rose 35.4%. Corporate income taxes rose 17.3%, but that was down from 38.3% a year ago.

(3) *Revenues from property transactions* took a hit. The ones from "Land Value Increment" rose 14.7% vs. 91.1% a year ago. "Deed" revenues fell 9.9% after rising 27.5% a year ago.

CALENDARS

US. Thurs: Headline & Ex Transportation Durable Goods Orders 0.6%/0.2%, Jobless Claims 380k, Consumer Comfort Index, Pending Home Sales 0.9%, Kansas City Fed 4. **Fri:** Real GDP & GDP Price Index 1.2%/1.6% (saar), Consumer Sentiment 72.0. (Bloomberg estimates)
Global. Thurs: Germany Consumer Confidence 5.8, Japan Headline & Core CPI 0.0%/-0.5% y/y,

Japan Retail Trade 1.1% y/y, Japan Large Retailers' Sales -1.6% y/y. **Fri:** China Industrial Profits, Germany CPI 1.7% y/y, Germany CPI-EU Harmonized 1.9% y/y. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Earnings, Revenues, & Valuation (*link*): Industry analysts were mixed on earnings and revenue growth prospects last week, but profit margin expectations edged lower. Forward revenues for S&P 500 companies rose but remain below their record peak (September 2008). Forward earnings slipped from their early July record high. The projected revenue growth rate edged up to 3.0% from 2.7% for 2012, holding steady at 4.4% for 2013. Expected earnings growth for 2012 dropped to 6.8% from 7.0%, and the 2013 estimate fell to 12.0% from 12.4%. Projected profit margins edged lower for both years (to 9.4% from 9.5%, 10.1% from 10.2%). Ex-Energy, projected revenue growth in 2012 rises to 6.3% from 3.0%, earnings growth to 9.8% from 6.8%, and the margin to 9.9% from 9.4%.

S&P 500 Sectors Earnings, Revenues, & Valuation (*link*): Analysts' forward revenue expectations headed south last week for seven of the 10 sectors, but forward earnings weakened for nine sectors. The forward revenue forecast edged up for Consumer Staples, Energy, and Materials; forward earnings rose for Financials. Financials and Utilities were the only sectors to score a gain in their 2012 earnings estimate in the past week, and Energy was the only sector to have its 2012 revenue estimate increase. Forward earnings are off recent record highs for five sectors: Consumer Discretionary, Consumer Staples, Health Care, Industrials, and Tech.

S&P 500 Q2 Earnings Surprise Monitor (*link*): With 43% of the S&P 500 companies finished reporting, the Q2-2012 earnings season is off to a mixed start. Of the 215 reporters to date, 65% have exceeded industry analysts' estimates, but only 43% beat sales estimates. In comparison, in Q1-2012, 66% of the companies in the S&P 500 beat the consensus earnings estimates and 65% beat the sales forecast. Earnings for the 215 are up 13.0% y/y on a sales gain of 3.4%--heavily skewed upward by the Financials sector. Ex-Financials, earnings are up 2.1% y/y on a sales gain of 3.6%. Excluding Apple's miss, the S&P 500's earnings surprise rises to 5.3% from 4.0%, and the revenue surprise improves to -0.2% from -0.4%.

US ECONOMIC INDICATORS

New Home Sales & Prices (*link*): Single-family sales dropped by an unexpectedly large 8.4% in June, but the news wasn't all bad. Single-family home sales sank to 350,000 units (saar), though May's sales pace was revised up from 369,000 to 382,000, the best since April 2010 (just before the expiration of the homebuyers' tax credit). Sales were 15.1% above a year ago, and the quarterly average has increased steadily from 298,000 (saar) during Q3-2011 to 363,000 units last quarter. The number of new homes on the market (144,000 units) was little changed from May's record low of 143,000, down 13.3% y/y. The months' supply remained below 5.0 for the fourth straight month. The median new home price fell 3.2% y/y, after four months of positive readings.

Mortgage Applications Survey (*link*): Mortgage applications edged up 0.2% during the week of July 20 after jumping 16.9% the prior week. The refinancing index more than reversed recent declines, soaring 23.9% over the past two weeks to a new three-year high. The new purchase index fell 3.3% over the past two weeks after rising 3.3% during the prior week. It remains on volatile flat trend around recent lows.

GLOBAL ECONOMIC INDICATORS

UK Real GDP (*link*): The UK economy is shrinking. Real GDP fell for the third straight quarter, dropping 0.7% last quarter--the largest drop since Q1-2009--following losses of 0.3% and 0.4% the prior two quarters. Weakness was broad-based, with construction (-5.2%), production (-1.3%), and services (-0.2%) all in the red. However, special factors (effects from the Queen's Jubilee holiday and the wettest Q2 on record) exaggerated the decline. The UK is struggling to recover. The IMF weighed in this month, saying that "further monetary stimulus is required" and that the government should consider "scaling back" its fiscal tightening if growth still lacks momentum going into 2013.

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