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From acute to chronic: Europe and the health of stocks



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The hugely anticipated EU summit from December 9, has come and gone. The deal announced at the summit has come to fruition; not a change to the EU's treaty, which would've been a lengthy process, but a very strong agreement between governments to bring in stricter fiscal discipline. But in actuality, the reason the market climbed ahead of the treaty was because the Fed and 5 other central banks agreed to free up dollars to European banks. Yes, dollars are still the almighty despite what you've heard from the pundits. Anyway, this is the action that took "bank contagion" off the table long enough for the European Union to come up with a plan. You see, banks need to be funded constantly. If they need dollars to fund themselves, they have to use treasuries as collateral to get dollars, since treasuries are dollar denominated. In order to buy treasuries to get dollars, Euro banks had to sell Euro denominated assets, like European sovereign bonds. If one Euro bank sold Euro sovereign bonds, the bonds went down in price, forcing the next Euro bank to sell the same securities...they all had to sell at the same time. Hence, Euro banks ran out of means to borrow from other banks and from central banks in order to maintain their daily funding needs. This is what "bank contagion" means, by the way. This had to be stopped, and the 6 way central bank agreement did just that. The proof was when Italian 10 years went under 7%.

This big EU summit deal is far from perfect, but that's OK. Let me give you an analogy: the patient has been moved from the ICU to rehab. The ailment has gone from acute and needing life saving measures to a chronic illness whose symptoms will flare up big time occasionally. This translates into continued volatility, but the main issue of systemic risk, for now, is off the table. The battle now will be fought between stock market participants who desire growth policies and the bond market participants who desire austerity. Balance will be difficult to find, but at least now key policy makers have a key investment objective on their side; a longer time horizon to keep at it.

It has been my very strong contention that when the U.S economy slowed last spring...stopped would be more like it...was that it was temporary, that we aren't going into a new or double dip recession, and that after August, macro stats would turn around, as I wrote in my most recent column in the New York Real Estate Journal. Retail sales, auto sales, labor, manufacturing, consumer confidence, and durable goods have all turned around to an upward slope for sure. The real shame of it all was that no one noticed because of the European debt crisis. Well, now anyway, the major averages have bounced off their October 4th lows solidly and we can now focus on the good 'ol stuff like corporate earnings and the economy.

Here too, in the U.S. economy, things are far from perfect. But it is the environment for large publicly traded companies that guide my bullishness on individual stocks. Operating leverage, cash rich balance sheets, access to inexpensive financing (via debt or equity offerings), low P/E multiples, dividends, and overseas businesses and consumers that are desirous of American products, in my opinion, creates an environment that has historically favored investors who have been willing to look past the valley right in front of us. Contributing further are 3 key takeaways that are positive from the EU debt crisis, which are very real and are considered an important part of the valuation equation for equities in general; global inflation has come down, Germany has benefited greatly in terms of exports due to the weakened Euro (as Germany is the linchpin of the Eurozone and the greater European Union), and China has already begun easing monetary policy.

There is a growing list of companies that have raised their dividends recently, from companies in different sectors of the U.S. economy: industrial, automobile, and entertainment/theme parks. Aside from the fact that dividends are on the rise, which is a strong indication of management confidence, I see M&A activity picking up meaningfully...very meaningfully. M&A activity, my interpretation, grounded to a near halt because no manager would want to make a bold move when the financial/banking system could crumble very near term. But now companies can focus on tuck in deals, cost cutting deals, as well as the occasional transformational deals; the 3 kinds now defined for you. If investors are worried that companies can't keep growing their bottom lines, it is for this very reason that M&A activity should become more prominent as a theme. If organic growth is difficult to come by, companies have ample means to buy it.

Problems still abound and new ones will appear, but if you want the right set of conditions that are supportive of equity returns, you have them right now.

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