Outlook for April, 2010

"A slow and steady slog"

The global economy is in the midst of a slow and steady slog – a recovery - that at first blush looks quite promising, but is unlikely to fulfill the promise of a "V" shaped recovery. The process of deleveraging (both by individuals and corporations) is well underway, but sovereign borrowers appear to be doing their best to bridge the gap. We believe that all the excess global liquidity (pushed into the system by Central Banks) is finding its way into financial markets. While tenuous, we hope the up-move in markets is probably for real and may continue at least into late this summer.

Economic data released in the US shows a glimmer of hope: Non-farm payrolls added 162,000 jobs for the month of March despite the politically sensitive unemployment rate remaining stubbornly stuck at 9.7%. The increase in jobs represents the third month in a row of gains – implying that the turnaround in the employment sector is slow but nonetheless steady. Among the sectors, manufacturing added 17k, construction added 15k, education and health services added 45k, while information (-12k) and financial activities (-21k) were the laggards.

The Bureau of Labor Statistics also intimated that the infamous birth/death model that is used to capture changes in the make-up of the population had added about 85k jobs and census hiring by the government was responsible for an increase of 48k jobs. The hours worked posted a small increase but the average hourly earnings witnessed a small decline for the month of March. All in all, it was an encouraging report suggesting that the labor market is stabilizing, but it is still quite far from creating enough jobs to bring the unemployment rate down significantly.

In other economic data, the Institute of Supply Management's PMI index rose to a reading of 59.6 in March from a 56.5 in the previous month. Indeed, many of the indicators including those on production, new orders, prices and new export orders posted nice gains – again suggesting that the economy appears to have clearly turned the corner. The Bureau of Economic Analysis of the US Department of Commerce pegged GDP growth at a revised 5.6% for 4Q2009 – a slight downward revision from the previous estimate, but still a fairly robust increase for the period.

Given contemporaneous economic data, our estimate of 1Q2010 GDP is for a print around the 4.0% (q/q, saar) mark – which would make for two consecutive quarters of fairly strong growth. The real question surrounding GDP is whether this rate of growth is likely to be sustained over the rest of the year and into next year once the effect of the fiscal and monetary stimulus starts to wane. The jury on this question is still out in our opinion.

The Federal Open Market Committee of the Federal Reserve for its part held the Fed Funds Target steady at 0 to 0.25% at their meeting in mid-March. The FOMC chose to leave the "likely to warrant exceptionally low levels of the federal funds rate for an extended period" in their statement released at the end of the meeting. This suggests that the Fed will be reluctant to raise interest rates particularly if there is even a hint of the risk of a "double-dip" recession.

We believe that the Fed (having monetized about $1.25 Trillion worth of mortgage debt) is making a big mistake if they delay the inevitable. In our opinion, the Fed ought to be raising rates sometime this fall once it becomes abundantly clear that the economy is on a self-sustaining growth trajectory. A failure to do so, causes the risk of giving up on all the gains in inflation credibility that the Fed has managed to garner over the past two and a half decades!

Farther afield, the Japanese economy appears to be putting on a pleasantly surprising burst of speed – mainly after every Japan watcher had given up on it. While much of the gain in GDP might be just inventory re-stocking, it is nevertheless surprising to see such an outcome. In non-Japan Asia, the Chinese authorities appear to be trying desperately to prevent their economy from over-heating – particularly its residential real estate sector. The Reserve Bank of India has started to tighten monetary policy – a harbinger of things to come – and appears to be gaining some credibility with both economists and market watchers.

The European economy continues to struggle: The intransigent problems relating to Greece (where the powers that be were wishy-washy about the involvement of the IMF), Iceland, Portugal and Spain imply that the European economy is probably going to underperform. The UK also has political uncertainty thrown in for good measure (in addition to its myriad fiscal problems) as they face an election in early May. The conventional wisdom seems to be betting that the Tories will be returned to power given the hash that recent Labor governments have created.

Warnings by credit rating agencies that the UK is unlikely to maintain its AAA rating given the trajectory of its fiscal deficits need to heeded. It is going to be very hard for the newly elected UK government to tighten its fiscal belt in the middle of a sluggish recovery (if that) from a prolonged recession. Already, the Pound Sterling looks like a sick currency (despite a bounce in recent weeks) and its fortunes do not look that appealing for the months and quarters to come.

US corporate earnings releases for 1Q2010 are just around the corner. While comparisons with 1Q2009 are likely to be easy, we expect that a vast majority of companies in the S&P500 to have met or exceeded the reduced expectations for this quarter. Much of the good news on the earnings front is probably already priced in, given the sizable up-move we have seen in equity markets with few exceptions over the past year.

Fundamentally, valuations in the US are either reasonable or are quite high – given one's expectations for the economy and the path for Fed policy over the next twelve to eighteen months. We would place ourselves in the "reasonable" camp considering that prospective earnings do look quite good over the next two years for US markets. This does not mean that markets are likely to move in a single direction over that period – on the contrary, as far as we can tell the laws of supply and demand have yet to be repealed and the cyclicality of markets are therefore to be expected.

The US Dollar has continued to appreciate against the Euro over the past few weeks – primarily as a result of issues with Greece and other European countries and we suspect that such strength may continue over the rest of the summer. Indeed, the US Dollar looks like it will appreciate further – particularly if one were to take into account the relative growth differentials among the currencies.

The US Congress passed landmark healthcare legislation during March after much horse-trading. While extending coverage to many Americans that have remained without healthcare, the details on how some of these exchanges will operate and whether they will be able to bring costs down (without any such cost containment measures being included in the legislation) is still an open question. Nonetheless, given the heated nature of the debate, we suspect that the last chapter in this saga has not yet been written.

In summary, we would characterize our outlook as cautiously optimistic. Equity markets generally appear to have an upward bias and are likely to do so as long as much of the excess central bank liquidity remains in play. We are little concerned about the low levels of volatility in markets in general and also feel that over the longer term, interest rates might indeed be headed higher. Our abiding faith in a diversified portfolio as the best way to achieve favorable financial outcomes over the long haul continues unabated.

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