Outlook for April, 2011: "Climbing a wall of worry!…"

Global financial markets are climbing a proverbial "wall of worry" as events in Japan, Europe and North Africa dominate the headlines. While economic data has on balance, been positive, policy uncertainty - as the end of QE2.0 in June approaches - raises the specter of further volatility in markets. All in all, we remain - to coin a phrase - cautiously optimistic.

The US economy added a slightly better than expected 216,000 non-farm jobs during March, 2011. The private sector continues to out-perform the public one, being responsible for 230k additional jobs during the month. Among the sectors, professional and business services (+78k) and education and health (+45k) were the bright spots, but local governments (-15k) and information (-4k) were the laggards.

Other labor market measures including average hours worked, average hourly earnings and average weekly earnings were all unchanged, thus suggesting some degree of stagnation in the labor market. The politically sensitive unemployment rate posted a decline of one-tenths to 8.8%, and the broader U-6 measure also witnessed a healthy decline of two-tenths to 15.7% for the month of March.

The household survey of the labor market also depicted some strength with the number of unemployed dropping by 131k, the number employed increasing by 291k and both the civilian labor force (+160k) and the civilian non-institutionalized population (+149k) showing reasonable increases. While the labor market might slowly be finding its sea legs, the process of creating jobs to re-employ the many millions that had lost their jobs as a result of the financial crisis appears stuck in a low gear. We suspect it might indeed take many more quarters before one can sound the "all-clear" when it comes to the labor market.

Survey data – particularly the ISM manufacturing survey (PMI for March: 61.2) - and other indicators like the National Federation of Independent Businesses' small business survey (Feb: 94.5) seem to suggest that the manufacturing sector and indeed the entire economy might finally be coming into its own. Data on factory orders and manufacturers' shipments also seems to corroborate this theme.

The Bureau of Economic Analysis of the Department of Commerce managed to revise upwards the estimate of GDP growth for 4Q2010 to a fairly robust 3.1% (seasonally adjusted annual rate). Personal consumption expenditures rose 4.0%, gross private domestic investment declined -18.7%, exports rose 8.6%, while imports declined -12.6% and government expenditures and investment also declined -1.7% (all at seasonally adjusted annual rates) for 4Q2010.

Despite the upward revision to GDP data for 4Q2010, the prognosis for 2011 remains murky: With crude oil prices rising significantly, the impact on GDP growth of such an increase is hard to measure with any degree of precision. The current increase in the prices of crude, if sustained, does have the potential to dampen economic growth by as much as a full percentage point. Indeed, many economists appear to be lowering their forecasts for this year to a still reasonable 2.5 to 3.0%.

Meanwhile, the Federal Reserve at its FOMC meeting in mid-March held the Fed Funds Target unchanged at 0-0.25%. The FOMC statement released at the end of the meeting contained this particular gem: "Recent increases in the prices of energy are currently putting upward pressure on inflation. The Committee expects these effects to be ***transitory***…" (emphasis ours and added).

Surely, the FOMC's forecast of crude and energy prices must strain credulity as absent peace breaking out all over the Middle East or a sudden and unanticipated decline in global energy demand, it is hard to see how one can witness a decline in energy prices over the medium term. As that wise old baseball sage Yogi Bera once opined "It is hard to make predictions, especially about the future"!

The extent of the natural disaster in Japan is only now coming into full view – with thousands of people dead or still missing. While the scale of the disaster is mind-boggling, it is a real testament to that nation's fortitude and their culture that there have been no reports of looting or unruly behavior by the populace. The population seems to accept the tragedy with a stoic calm which we have often marveled at over these many weeks.

The partial meltdown at the Fukushima Dai-ichi nuclear plant has brought into sharp relief how little we know about the dangers of such technologies – despite the fact that mankind was able to split the atom more than 60 years ago. While the age of the plant, an earthquake and a tsunami were all contributory factors, one still wonders about the safety of such plants all over the world. Nonetheless, it appears that the nuclear energy industry has been setback by years (if not decades) as a result of this crisis.

Libya appears to be rapidly heading into an unmitigated civil war. While the UN resolution to help the people of Libya was well intentioned, the execution of the no-fly zone and subsequent reports suggest that the conflict between the rebels and Government forces is likely to remain an intractable one. The US (or any other NATO nation for that matter) has very little appetite to put boots on the ground and it is fairly clear that the Administration must now look for a graceful exit from the entire situation.

The Portuguese government lost a vote of confidence causing the President to dissolve Parliament and call for snap elections to be held on June 5th. The ongoing crisis further underlines the fiscal mess that exists in Europe. Downgrades of Portugal's debt rating by multiple credit rating agencies has also exacerbated the problem – leading to speculation that Portugal might be the latest country to seek a bailout from the European Union after Iceland, Greece and Ireland did so earlier.

The one bright spot for US equity markets has been the better than expected earnings releases from American companies. A full 75.7% of the S&P 500 constituents either exceeded (338; 67.7%) or met (40; 8.0%) earnings expectations for 4Q2010. When all is said and done, we expect a similar number for upcoming 1Q2011 earning releases as well.

Doubtless, some of it has to do with managements' ability to "manage" expectations. However, the improvement in margins appears to be genuine and we believe that analysts might be under-estimating the operating leverage that American companies possess. We will continue to track this statistic (among many others) particularly closely as earnings season gets into full swing next week.

Interest rates continue to tread water after posting sharp rallies in the aftermath of the Japanese disaster last month. Indeed, while markets are still flush with cash and interest rates remain low, we are of the opinion that the cycle of low administered interest rates could well be coming to an end – particularly if the European Central Bank raises rates next week as is widely expected.

The USD has come under some pressure as the perceived interest rate differential between Europe and the US moves decisively in the former's favor. Already, expectations that the ECB will likely raise its rates in a series of moves to counter rising inflation worries are causing a nice bid to the Euro. Exporters out of the region are already beginning to clamor about a high currency, but we suspect that such whining by exporters is unlikely to sway the ECB as it is in the midst of a "credibility rebuilding" exercise.

In summary, financial markets are climbing the proverbial wall of worry as many market participants fear much of the uncertainty. Despite the many known unknowns and unknown unknowns, we do believe that excess global liquidity is likely to remain positive for financial markets. Indeed, our abiding faith in a fully diversified portfolio - that has a balanced approach to both risk and return - as the main way to attain favorable investment outcomes over the long haul remains resolute.

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