Outlook for August, 2010: "The Dog Days of Summer…"

With much of the country under a heat wave (as temperatures soar and air-conditioning continues to be an engineering marvel) financial markets appear to be dealing with their own version of the dog days of summer. Indeed, while earnings reports for the Second quarter appear to be quite robust and positive, many of the macro-economic indicators suggest that the economy might be in the midst of a significant slowdown coupled with rising fears of deflation – whether real or perceived among market participants.

The US economy lost 131,000 jobs during the month of July – paced primarily as a result of accelerating layoffs of census workers by the Federal government. The private sector added an abysmal 71,000 jobs in July: Manufacturing rose 36,000, trade, transportation and utilities also gained 25,000, while financial activities lost -17,000 and professional and business services lost -13,000. Measures of earnings and hours ticked up slightly – suggesting a marginal improvement in both those fundamentals.

The innards of the payroll report did however paint a mixed picture with regard to prospects for the labor market: The unemployment rate remained unchanged at 9.5% and the U-6 measure of unemployment also remained unchanged at 16.5%. The employment to population ratio declined one-tenth of a percentage point to 58.4%. The number of the long term unemployed was largely unchanged at 6.6 million, but this represents 44.9% of the total unemployed. In many ways, the labor force appears to be suffering from the ravages of policy uncertainty as well as structural unemployment issues.

Businesses are loath to take on new employees as a result of the uncertainties surrounding healthcare (despite the new healthcare law), energy policy and the outlook for business in general. Our computations imply that the US economy needs to add about 250,000 jobs every month in order to reduce the unemployment rate over time. As we do not see this happening in the medium term, we suspect that the unemployment rate is likely to stay stubbornly high.

The Commerce Department pegged GDP growth for the US economy at a seasonally adjusted annual rate of 2.4% for 2Q2010. While personal consumption expenditures rose a paltry 1.5% (saar), gross private domestic investment was a bright spot rising 28.8% (saar). Exports rose 10.3% for the quarter, while imports surged 28.8% for the same period. Government consumption expenditures posted a gain of 4.4% for the quarter. Final sales of domestic product rose a minimal 1.3% for the period.

No question about it, the US economy appears to have entered a slowdown in economic activity. While we would peg the risk of a double-dip recession at a still smallish 25 to 30%, such a double-dip recession does not yet appear to be in the cards. First of all, a double-dip recession is quite rare – it has occurred only once since World War II (in 1980 and 1982), but such pauses or slowdowns in economic activity do seem to occur with surprising regularity – we just called them "soft landings" previously!

Fears of deflation also appear to be a little pre-mature: As we wrote in last month's outlook, while inflation is a central banker's enemy, deflation is their biggest nightmare! In a period of deflation, consumers simply stop spending money (other than on essentials like food) as they realize that as prices drop, they can buy those goods cheaper in the future. As a result, a central bank (being the lender of last resort) cannot simply compel an economic agent to borrow money to cause economic activity. Thus interest rates become ineffective as a tool of monetary policy.

Federal Reserve Chairman Ben Bernanke - an ardent student of the 1930s US depression, has also spent significant time studying and understanding the Japanese experience from the 1990s. Among all the policy makers he is probably best positioned to wage the battle against deflation – if it ever came to such a situation. We do believe that the threat of deflation is remote and much will be known in the coming months and quarters regarding the outlook for prices.

The Federal Reserve is expected to maintain the Fed Funds target at the previously announced 0.0% to 0.25% and also leave the "extended period" language in place. During testimony before Congress, Chairman Bernanke did allude to the cloudy nature of the outlook for growth and prices using the term "unusually uncertain". We suspect that yet again, much newsprint will be expended dissecting every word and nuance of the FOMC Statement, only to realize that the Fed is unlikely to tighten monetary policy in the near to medium term.

Corporate earnings releases have been quite robust: Of the 446 companies that have released earnings so far for 2Q2010 (almost 90% of the S&P 500), 341 (or 77% of the total) have exceeded expectations; 37 (or 8%) met expectations and 68 (or 15%) disappointed relative to expectations. Indeed, with a share-weighted gain in earnings of 51.9% (y/y) for the entire S&P 500, this quarter looks very much like the previous two – corporate America is doing very well, thank you very much!

Considering the slim top line growth that companies exhibited in the previous two or three quarters (with most of the earnings gains coming as a result of cost cutting rather than top line growth), the conventional wisdom appeared to suggest that there would be a limit to such gains over time and margins would eventually deteriorate. The most recent quarter's results exhibit some (marginal) increases in top line growth, but clearly companies continue see increases in margins as well. If nothing else, corporate America has gotten quite adept at managing expectations – particularly those on Wall Street.

US interest rates have remained under downward pressure – with the yield curve actually flattening further this past month amidst downbeat economic growth expectations and further fears of deflation. Indeed, the US two year rates are now hitting its lowest yield levels and corporate spreads for both high grade and high yield issuers have continued their narrowing over time. The "roll-down" on the yield curve continues to provide significant incentive for bond managers to seek out longer dated paper as they take advantage of a "positive carry" as well.

Commodity prices have risen again this past month - particularly the energy complex - as a result of renewed interest in the Chinese miracle and that country's insatiable appetite for raw-materials. While near term inventory re-stocking might be partly responsible for the recent surge in commodity demand, longer term China watchers discern some unfavorable trends among the tea leaves.

Urban China – with its 650 odd cities – appears to be in the middle of a classic real estate boom. Many measures of real estate valuation including land price as a proportion of total value, price per square foot as well as the change in values on a year-on-year basis suggest that the trend is unlikely to end well for many urban Chinese. The policy struggle regarding home values might be wrapped up in larger issues within a change in Chinese leadership. It is hard to forecast how all this will play out, but this is enough of a red flag for us to continue to pay attention to developments in the Middle Kingdom.

Back in the good old US of A, politics will likely become a front and center issue once market participants return from the beach after the Labor Day holiday. Politics is a difficult factor to assess and it is even more difficult to hedge portfolios against unfavorable outcomes. Nonetheless, it is our opinion that this will likely be an important factor to consider in September and October – particularly in the run-up to the Congressional Mid-Term elections in November.

In summary, we view the outlook for financial markets as cautiously optimistic: There are sufficient imponderables out there to worry about, but there are also enough positives that provide comfort from a longer term perspective. 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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