Outlook for August, 2011 – A Special Edition: "The more things change…"

"Plus ca change, plus c'est la meme chose" opined Jean-Baptiste Alphonse Karr, the famous editor of Le Figaro in his native French almost a century and a half ago. This phrase loosely translated to mean "the more things change, the more they stay the same", uniquely symbolizes the malaise that global capital markets appear to be dealing with currently. Fears of another global recession and a consequent 2008 style sell-off in equities have roiled markets recently.

Recently released economic data have been negative for equity markets: The US economy added 117,000 jobs during the month of July, with the private sector gaining 154k jobs. The politically sensitive unemployment rate fell 0.1% to 9.1% from the prior month, with the more robust U-6 measure also falling a similar 0.1% to 16.1%. The major contributors to job growth were health care (37k), professional and business services (34k) and retail (26k), with the only noteworthy net job losses coming from the government (-37k) and financial activities (-4k) sectors.

The Bureau of Economic Analysis pegged US GDP growth at a soggy 1.3% (seasonally adjusted annual rate) for 2Q2011. Indeed, personal consumptions expenditures rose a paltry 0.1% during the period, gross private domestic investment rose 7.1%, while government expenditures fell 1.1% for the quarter. The BEA also revised down the growth rate for 1Q2011 from an original release of 1.8% to a final enumeration of 0.4%.

The GDP release also contained sizable benchmark revisions: Most of the revisions to GDP went in the wrong direction, suggesting that the economy had been weaker than previously reported. The peak to trough decline in GDP is now pegged at -5.1% (from a previous decline of -4.1%) and GDP growth was revised downwards by approximately 0.3% per year for the entire decade.

The benchmark revisions also made it clear that the US economy was still in recovery mode and not yet in an expansion. While this is a subtle but esoteric point (an expansion is thought to commence only after the total dollar GDP figure has risen above the high water mark established at the previous expansion's peak), it is nonetheless important to understand the tepid nature of the rebound in economic growth. The severe deleveraging currently underway in consumer balance sheets also places further speed bumps on the path forward.

We have been a little disappointed at the serious loss of momentum in the economy – mainly in the labor market and the lack of follow through demand from exports or capital investment. Economy wide inventory levels are too low even given lower levels of expected future sales. This implies a need for restocking (which ought to lead to additional demand). Further, the expiration of investment tax credits in calendar year 2011 also ought to boost growth later this year.

The realization that neither fiscal nor monetary policy has the potential to reverse the economic downturn is also causing significant angst. Many market participants handicapping the chances of further assistance by the Federal Reserve (a la Quantitative Easing 3.0) seem to discount such a possibility. We do believe that the Federal Reserve is unlikely to resort to QE3.0 considering the limited success experienced by the two previous versions of QE, unless the Fed really believed that a recession was very likely within their forecast horizon.

The wrenching budget and debt battle in Washington DC was quite a spectacle in political theatre! While politicians' ability to "kick the proverbial can down the road" never ceases to amaze us, even we were surprised at the torturous nature of talks and the "on again-off again" nature of negotiations. A deal did indeed get done at the eleventh hour.

With neither party entirely happy with the outcome of the debt ceiling talks, it does feel appropriate from a political compromise standpoint. The fact that the deal did not increase taxes is probably a victory for the Republicans, and the fact that the debt ceiling was raised beyond the Presidential elections next year is a personal victory for President Obama.

It is also quite important to point out that the US Government does not have a revenue problem – what we have is a pure and simple spending problem. It is high time that the powers that be in Washington DC (from across the entire political spectrum) learn to live within their means – something that American households have learnt to do as a matter of course!

Despite some of the serious numbers being thrown around (in terms of spending cuts) it is important to note that the deal really does not address the vexing issue of entitlement spending. To be sure, while it is politically unpalatable to talk about cutting entitlement spending, we do not see much scope for a structural reduction in the budget deficit without serious reform of Medicare, Medicaid and Social Security.

Elsewhere, both the Bank of Japan and the Swiss National Bank cut interest rates and also intervened in foreign exchange markets in a bid to weaken the Yen and the Franc respectively, which had strengthened substantially over the past few months. The actions by these two central banks could lead to further interventions by other central banks if they believed that their own currencies were unusually strong – thus leading to a competitive devaluation scenario.

The European Sovereign debt crisis now appears to have morphed further into Italy and Spain along with those in Greece, Portugal, Ireland and Iceland. While Germany led the way for a new package for Greece last month, it is increasingly becoming clear that the appetite for ongoing spending from richer countries in the EU might be fading. Certainly, European leaders can be faulted for moving at a glacial pace and not quite fixing the problem in successive attempts, thus allowing uncertainty to fester.

The one bright spot in all this has been corporate earnings: Earnings grew an outsized 19.6% in aggregate for the 430 S&P500 companies that have reported earnings so far for 2Q2011. The proportion of companies that have met or exceeded expectations is a very healthy 79.3% (of the 430 companies), thus implying very little in the way of an anticipated recession. In addition, earnings expectations for 2012 have seen the normal skeptical downward revision which is also quite healthy.

Technical charts for US equity indices do not paint a pretty picture. As equity indices have crossed below the vaunted 200 day moving averages, many of the declines have accelerated thus often making these levels self-fulfilling prophecies. In addition, many chartists are also gazing at a "head and shoulders" pattern which could lead to further declines in equity markets. However, given the oversold nature of the sell-off, from a purely technical standpoint alone, we would not at all be surprised to see a rebound in the market.

Another feature of market action lately has been the wild swings in sentiment that we have witnessed over the past few months. Since late July, sentiment has gone from the heights of euphoria to the depths of despair – all in the space of about six weeks suggesting that sentiment remains notoriously fragile. Market movements and volatility tend to be exacerbated by these swings in sentiment, thus implying that the higher volatility is likely to remain a feature of market action for at least the near term.

In summary, financial markets continue to react virulently to fears of a double-dip recession. While we remain cautious in the near term, we do feel reasonably positive over the medium to longer term. 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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