Outlook for August, 2012: "Inspire A Generation! (London 2012's Theme)…"

While the globe's attention is riveted to watching superlative athletic performances in London, financial markets continue to deal with lots of uncertainty: Uncertainty with regard to policy and outcomes that are likely to have a significant impact on how investors view this decade. Attention will swiftly turn to the Presidential elections and the campaigns over the Fall once the quadrennial rite of passage called the Olympics are concluded later this month.

Economic indicators point to a continued slowing in growth: Last Friday's non-farm payroll employment release by the Department of Labor pegged job growth in the US at 163k jobs in July (consensus expectations: 150k), with private payrolls +172k and public payrolls -9k. Among industries, professional and business services (+49k), leisure and hospitality (+27K), and manufacturing (+25k) provided much of the boost, while government (-9k) and construction (-1k) were responsible for losses.

Although the economy added jobs in July, the unemployment rate ticked up slightly to 8.3%. The report also noted that 8.2 million people were employed part-time or had their hours cut back due to economic business concerns, unchanged from the prior month. Long-term unemployment (comprised of those jobless for 6 months or more) dropped slightly to 5.2 million people, representing 40.7% of the unemployed.

A broader measure of unemployment, that includes the marginally attached and part-time workers that want to work full time - called the U-6 measure, ticked up for the 3rd consecutive month to 15.0%. An alarming trend is the extent to which employment prospects in the 16-19 age bracket has contracted where the unemployment rate is a currently scandalous 23.8%. The unemployment rate for anyone possessing a college degree in the same age cohort is at a low 4.1% - implying that the best advice to young people has always been the same: Stay in school and get a college degree.

The Bureau of Economic Analysis of the Department of Commerce released their initial estimate of 2Q GDP at 1.5% (q/q, saar), a notable deceleration from 2.0% in 1Q2012 and 2.8% in 4Q2011. Positive contributions from business equipment spending, inventory investment, and exports were partially offset by weakening consumer spending, higher imports, and reduced growth in nonresidential structures.

The notable regional diffusion indices (Chicago, Empire State, and Philly Fed) that report on the manufacturing health of their market showed continued contraction in new orders, depleting inventory levels and a decrease in shipment activity. Supplementing this dour tone was the ISM's manufacturing report that came in below the 50 mark at 49.8, practically unchanged from June's 49.7. Additionally, the JP Morgan Global Manufacturing PMI dropped further to a new three year low of 48.4 (previously 48.9), indicating that contraction is not just occurring in the U.S.

A host of other data released all over the world suggests the growth slowdown is real: GDP in China was reported to have grown at 7.6% for 2Q2012 by that country's statistical agency (the slowest such growth since 4Q2001). Anecdotal evidence from companies trading with China as well as power generation and consumption figures imply China is experiencing a slowing in growth. An impending change in leadership at the apex of the Communist Party in China is also complicating matters to some extent.

GDP was reported to have declined in the U.K. (-0.7%; saar), Belgium (-0.4%) and Italy (-2.5%) to provide a snapshot of the difficult times that economies face in Europe. Industrial orders data out of Germany and industrial production figures published for Italy, the U.K and Netherlands all suggest a note of abundant caution. When compared to the mess that Europe's economies find themselves in the US economy appears to be doing reasonably.

Statements by Mario Draghi, the President of the European Central Bank (ECB) were viewed in a very positive light as he appeared to suggest that the ECB would "do whatever it takes" to save the Euro. While the existential threat to the common currency is real, we do believe that tight fiscal integration among its members is the key to achieving a sustainable currency over the longer term.

From a policy perspective, there were fears that perhaps Mr. Draghi had overplayed his hand, especially as the alphabet soup of institutions in Europe (ESM, EFSF, ECB, EBA etc) are still evolving and there appears to be a clear lack of leadership from politicians on the continent – each wanting to make sure that they do not suffer the fate that befell Nicholas Sarkozy in France (of appearing to solve Europe's problems, and yet losing one's job in the process!).

Nevertheless, Mr. Draghi appears to have established a framework for ensuring that the single currency survives – especially if it leads to more sustainable outcomes from a fiscal policy standpoint. Never mind however, that it took a Central Banker by trade to teach the politicians how to do fiscal policy! We do not want to imply that Europe's problems are a thing of the past, far from it. We do, nonetheless, believe that a United States of Europe (similar to the steps envisioned by the brilliant Alexander Hamilton in 1790 relating to US debt) represents the ultimate solution to Europe's intransigence.

Earnings reports for 2Q2012 have been mixed: Of the 426 companies of the S&P500 that have reported so far (=85% of the total), 283 (=66.4%) have reported positive gains in earnings per share, 135 (=31.7%) have reported declines and 8 (=1.9%) have seen unchanged earnings. The overall share-weighted % change in earnings – a measure of the overall profitability of companies in the S&P500 – has seen a ***decline*** of 0.4% for the quarter.

Clearly, the consensus appears to have dialed back on the optimism with regard to earnings expectations from a few months ago. Expectations for 2012 are now around $102.05 per share for the S&P500 in aggregate (an annual gain of 5.8%) compared to $107.27 (a gain of 11.2%) at the end of last year. Analysts on Wall Street have a dismal track record of identifying ***turning points*** in earnings over the years and we will continue to pay close attention to this factor over the upcoming months.

Attention will likely turn to the US Presidential and Congressional elections in earnest once the Olympics are over later this month. There is no question in our mind that this is a very pivotal election. The two candidates are starting to put out their pitches to the electorate: They both have starkly contrasting ideologies as well as differing paths to "life, liberty and the pursuit of happiness".

Our operating assumption is that President Obama wins re-election even though we would love to be wrong on this one! An analysis of the electoral college puts into sharp relief the difficulty that Governor Romney faces – he would have to win some combination of Florida, Pennsylvania, Ohio and Michigan – in order to unseat the incumbent. Daily tracking polls as well as surveys of voter intentions in these four states make for a difficult outcome for the challenger.

Much newsprint will be consumed and the airwaves will be thick with speculation regarding Governor Romney's pick for his running mate. Mr. Romney's thoughts on this subject have been a closely guarded secret as they well should be – since "thinking out loud" amongst members of the media is never a good strategy to vet potential vice presidential candidates. Nonetheless, the history of VP nominees has been checkered and we believe that in the end, the VP candidate is not likely to matter much to the ultimate outcome at the hustings.

Reports of a continued drought in the Mid-West have plagued agricultural prices recently: Prices for both corn and soybean have spiked higher as a result. Clearly, corn prices have also been impacted by the irresponsible politics of ethanol – talk about using a grain as an energy source – but this has the associated risk of raising prices for all kinds of processed foods that include corn derivatives like high fructose corn syrup. This sector too bears watching in the months to come.

In summary, we continue to position your portfolios with mild optimism about the medium to longer term. While our worries about politics and policy uncertainty remain in the forefront, (we can add declining earnings momentum to this list), we do feel reasonably positive about the longer term prospects 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 steadfast.

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