Outlook for December, 2010: "Tis the Season…"

With the weather turning colder, Thanksgiving now behind us and the Holidays fast approaching – this is the time of year to look back, reflect and, thank our blessings for family, friends and all the good things in life. Indeed, despite the disappointing non-farm payroll report for November, Europe's ongoing fiscal crisis and other uncertainties surrounding the outlook, financial markets appear to be generally buoyant – creating their own version of Holiday cheer. Tis the season indeed!

The November non-farm payroll report was in a word, disappointing. The US economy added a paltry 39,000 jobs during the month (while expectations were for an increase of 150k) and the politically sensitive unemployment rate rose by two-tenths to 9.8%. The broader measure of under-employment (called the U-6 measure) remained unchanged at 17.0%. In terms of sectors, professional and business services (+53k) and education and health (+30k) were the ones that displayed the most strength, while manufacturing (-13k) and trade, transportation and utilities (-13k) were the laggards.

The household survey (the second survey contained in the non-farm payroll report, which typically receives very little media attention) was the harbinger of dismal news. The ranks of the unemployed increased by 276k during the month of November while the civilian non-institutional population posted a gain of 185k leaving the overall participation rate at a decidedly unappetizing 64.5%. In addition, statistics relating to average hourly earnings (up barely 1.6% in the past year), average weekly hours (unchanged at 34.3 hours per week in November) and manufacturing work week (also unchanged in November at 40.3 hours) were all indicative of an economy that is growing like molasses headed uphill.

Among the unemployed, those that have been out of work for over six months is now over 40% of the total. This group tends to be most at risk of departing permanently from the labor force as they are marginally attached to the labor force to begin with and their skills tend to atrophy faster as a result. In addition, in many cases these are jobs that have been eliminated as a result of changing skills requirements or other factors making this group particularly vulnerable. The dithering within Congress with regard to extending their unemployment benefits (or otherwise) beyond 99 weeks has not helped either.

All in all, the non-farm payroll report seems to cast the Federal Reserve's actions in a new ("scarier") light. Indeed, Chairman Ben Bernanke took to the airwaves – granting an unusual interview to a news magazine program which aired on Sunday evening to defend his actions and attempted to provide further color on the FOMC's thinking with regard to the economy and markets. While the contents of the interview were of very limited value, Chairman Bernanke did make it a point to imply that the Fed was "prepared to do more" if the conditions warranted further actions to stimulate the economy.

Historically, the Federal Reserve has had a dual mandate of simultaneously achieving price stability and full employment. While previous Fed Chairmen have typically interpreted the full employment mandate in the context of price stability (i.e., they could best achieve full employment by maintaining stable prices), it appears that Bernanke and Company have brought a whole new interpretation to the dual mandate. They appear to suggest that full employment is perhaps a more primary goal with stable prices being a secondary goal – at least for now.

The whole concept of quantitative easing (or QE 2.0 as this version is now being called) is fraught with danger when it comes to both nomenclature as well as its effect on the economy and financial markets. The Fed's avowed aim in initiating QE 2.0 was primarily to bring the stubborn unemployment rate down to more "reasonable" levels. However, the more immediate effect of QE 2.0 is likely to be a boost to financial markets in general – equity and commodity prices in particular – through the transmission mechanism of excess liquidity in the system!

This notion of excess liquidity seems to partially explain the robust nature of US equity markets lately – where they seem to rally significantly on good news and seem to shrug off bad news with equanimity. During his television interview, Chairman Bernanke was quick to point out that the Federal Reserve did have significant tools at its disposal to raise interest rates as well as rein in excess liquidity as soon as they felt it was appropriate to do so.

The real question in our mind from a policy standpoint is what makes the Federal Reserve (and their army of economists) more apt to pinpoint when the appropriate time is to tighten monetary policy – particularly as the unusually accommodative stance of monetary policy has been in place for a while? Indeed, history is replete with policymakers who thought they knew better. In addition, such stimulative monetary policy episodes have typically ended painfully – making us wary of taking on too much risk in the portfolio on the mere faith of the FOMC's ability to steer monetary policy.

Ongoing negotiations ("down to the wire" so to speak) in Congress on extending the "Bush era tax cuts" point to the torturous nature of policymaking currently in vogue. While action by the current lame-duck Congress will alleviate any confusion in the near term, we fully expect cooler heads will prevail before we turn the page on the year – as a failure to act could prove quite damaging to prospects for economic growth going forward.

Farther afield, events in Europe continue to serve as a warning for people whose governments lead a profligate existence. It is quite clear that the bailout of Ireland (after Greece earlier this summer) is far from the final chapter in this sordid mess. With markets increasing the risk premiums on Portugal, Italy and Spain's debt instruments through a widening of spreads – it is quite obvious that there is more to come. However, speculation that the Euro was likely to break apart as a result of these developments is obviously an exaggeration. Nonetheless, countries in that region do need to find a creative solution to the fiscal mess.

China's central bank appears to be attempting to slow the economy down as fears of increasing inflation seem to be taking hold. The central bank has raised reserve requirement ratios in the banking system a couple of times in the last quarter. The translation mechanism for monetary policy may not work as efficiently in China, but the central bank certainly seems to be fighting the good fight.

Much newsprint has also been expended on developments in the Korean peninsula. North Korea's belligerent actions against its southern neighbor do point up the fragile nature of peace in that part of the world. Indeed, while a changing of the guard in North Korea might be partly responsible (Kim Jong-un – the youngest son of Kim Jong-il - has recently been nominated to a senior military post), it is nonetheless, very hard to impute reasonable motives to the actions of a totalitarian and otherwise opaque regime. While South Korea and its leaders might have visions of a German style reunion with the North, such an event could be both traumatic as well as prohibitively expensive.

The nature of better than expected corporate earnings results as well as improved consumer and investor confidence does bode well for further gains in financial markets in the near to medium term. We do think that markets appear to have an upward bias which could easily carry us into next spring. From a results perspective, 2010 has been a reasonable year for financial markets – while they are not up as much as they were in 2009 – we appear to be closing out the year in a moderately healthy fashion.

In summary, we remain cautiously optimistic on the outlook for financial markets: We do feel that the fundamentals are generally supportive of higher levels over the medium term. However, 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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