Outlook for December, 2011: "To the Brink…"

The relentless ebb and flow of news from Europe leaves us worried about politicians' proclivity to drive at break-neck speed up to the brink without worrying about the long term consequences of such behavior. Since we continue to be disappointed by the lack of leadership in Europe and the US, we do not feel that this is a time to take on additional risk in portfolios.

Recent economic data have had a slightly better tone: The U.S. economy added 120,000 jobs in November according to the Bureau of Labor Statistics. Data for the months of October (80k to 100k) and September (158k to 210k) were revised upwards for a net gain of 72k. Private sector payrolls continued to lead the charge in November, posting a gain of 140,000 while the beleaguered government sector continued to lose jobs (-20k). Among the sectors, trade, transportation and utilities (58k), professional and business services (33k), and education and health services (27K) posted gains with government (-20k), construction (-12k) and information (-4k) shedding jobs.

The politically sensitive unemployment rate edged sharply lower to 8.6% from 9.0% a month earlier. While this is welcome news, much of the improvement was attributed to a decline in the labor force. The expiration of unemployment benefits after 99 weeks for many unemployed persons was the main reason for the decline. While the household survey appears to contain better news than the more popular establishment survey, much of the improvement is likely to be ephemeral!

The U-6 measure, considered a broader measure of unemployment, also edged sharply lower from 16.2% to 15.6%. Many of the other labor market indicators like weekly hours worked (unchanged) and average hourly earnings (a decline of 2cents) suggest that the labor market is far from being out of the woods. If anything, the progress is quite real, but slow and halting.

The U.S. Bureau of Economic Analysis of the Department of Commerce downgraded its computation of Third Quarter real GDP to 2.0% (Seasonally Adjusted Annual Rate), from a previous release of 2.5%. Perversely, the downward revisions to Third Quarter imply additional strength for the Fourth Quarter and could therefore lead to further upgrading of economic growth expectations over the coming quarters. Indeed, many market participants now believe that the chances of seeing a US recession next year are now considerably lower than earlier this summer.

The number of Americans receiving food stamps rose to 46.3 Million in September according to data released by the US Department of Agriculture. This represents a gain of 0.9% (m/m; y/y: 7.8%) for September. The press release also noted that the number of Americans receiving food stamps under the Supplemental Nutrition Assistance Program has set records every month but one since December 2008 – dismal news indeed.

Markets appeared to rejoice with joy as reports coming out of Black Friday implied that the American consumer might be opening up his wallet again. Typically, most retail outlets do see the bulk of their sales during the short period between the Thanksgiving Holiday and Christmas (which is why the day after Thanksgiving is called "Black Friday" – the day that retail shops finally get into the black!).

However, the US consumer has gotten used to larger than usual discounts as well as continuously lower prices for technology. In addition, the savings rate has dipped down to 4.0% again – a danger sign, suggesting that much of the binge buying might have occurred on credit. Time will tell whether the Christmas retailing season is going to be a great one, but we are not waiting with bated breath to find out if the consumer will lead us yet again out of the spending malaise!

Farther afield, the trend in Europe appears to be to replace existing political leaders with technocratic led governments. These technocrats then have the unenviable job of imposing austerity on an unwilling populace. While the technocrat himself might become unpopular as a result, he is not beholden to any special interests and is also unlikely to seek a popular mandate at the hustings after his work is complete. In theory, this should work: However, given a number of imponderables, we remain wary of the world embracing such overly simplistic solutions to intransigent problems.

The Federal Reserve in co-ordination with the European Central Bank, the Swiss National Bank, the Bank of England, the Bank of Canada and the Bank of Japan, agreed to provide additional US Dollar liquidity to wholesale funding markets across the globe. The extent of co-operation and co-ordination it took to achieve such a move is in and of itself quite impressive. The move lowers the cost of US Dollar liquidity significantly but in one fell swoop also establishes the Fed as a lender of last resort for the world – a corollary of the reserve currency status of the Greenback.

While the provision of additional liquidity is creditable, it does not obviate the need to address the issue of solvency as well as the extent of debt load for many of the European countries. In addition, it simply comes down to a matter of governments making too many promises to their population (witness the profligate spending by Greece amidst a very low retirement age) which they are unlikely to be able to meet over the longer term.

In previous episodes it would have been relatively easy for a Greece or an Italy to simply devalue their currency and pay back their creditors with cheaper domestic currency. With the advent of the Euro this is not an option anymore. The irony in this whole situation is that Germany and France, the presumed stalwarts within the Euro, were the first ones to fudge the numbers with regard to deficits as a percentage of GDP enshrined in the Maastricht Treaty.

Regardless of the outcome of the tortured negotiations in Europe, we remain convinced that there are no magic bullets for the problem. Further, amending the treaty or putting in place a new fiscal compact like the one demanded by Mario Draghi, the head of the ECB, is fraught with danger as markets may not necessarily have the patience to wait for such a legislative outcome which could take much longer. Further, Europe looks uncomfortably close to falling into a recession – an outcome which would not be positive for equity assets worldwide.

The People's Bank of China lowered its reserve requirement ratio by 50bp last week in a signal that it was now focusing on continued economic growth rather than merely fighting inflation. While this move was lost in the shuffle last week, we think this is fairly important from an outlook standpoint over the medium term. Many leading indicators including those relating to land sales to developers imply some note of caution with regard to growth expectations for the middle kingdom.

Opinion regarding the prognosis for the Chinese economy is quite divided: There is a significant dichotomy among analysts as to whether China is merely going through a soft patch or the moves by the PBOC are a harbinger of further bad news. We do feel that China has a restive population and any faltering in the growth rate could lead to significant internal social pressures – much like those that led to Tiananmen Square in 1989. Time alone will tell whether China will become a peaceful citizen of this world despite its stresses or something more nefarious will occur. Stay tuned.

In summary, we continue to position your portfolios cautiously – having a higher than usual allocation to cash and money markets. 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.

We would like to wish our regular readers the best that the Holiday Season has to offer. Here's to you and your family and hope 2012 brings good tidings to all!

This report was prepared by

Suresh Raghavan, CFA and Clark Blackman III
MBR Financial, Inc.
2000 West Loop South, Suite 1510
Houston, TX 77027

www.mbrfinancial.com

For further information please contact us at
Voice: 832.667.8787
Fax: 281.974.2108
Email: contactus@mbrfinancial.com

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