Outlook for December, 2012: "Short-Termism…"

CNBC's second-by-second countdown clock to the fiscal cliff is a symptom of the "short-termism" that appears to pervade financial markets. While the ridiculous countdown clock does tell a story, we are afraid that market participants are fed a daily diet of "trading" rather than "investing" and "making a quick buck" rather than thinking about the long haul.

The Department of Labor's employment report for November showed modest improvement in the labor market: Nonfarm payrolls increased by 146,000, handily beating market expectations, with the private sector accounting for basically all of the increase. On a year-to-date basis, the economy has added an average of 151k jobs per month, slightly less than the 153k average experienced in 2011.

Among sectors, November's report showed gains in professional and business services (+43k), health care (+20k), wholesale trade (+13k), leisure and hospitality (+23k) and retail trade (+53k) partially offset by construction (-20k) and government (-1k). Revisions for prior months produced a net loss of 49k: October (from 171k to 138k) and September (from 148k to 132k).

As the saying goes, the truth is in the details: 12.0 million people are still unemployed, with 4.8 million labeled as "long-term" unemployed. Labor participation rates are at multi-decades lows as the civilian labor force participation rate is 63.6% (previously 63.8%) and the employment-population ratio is at 58.7% (previously 58.8%). Those employed part-time due to economic reasons dropped slightly to 8.2 million from 8.3 million previously.

The unemployment rate moved lower to 7.7% from 7.9% primarily because of a decrease in the labor force, by about 350k workers. Keep in mind that the BLS survey excluded 2.5 million people because they had not looked for work in the 4 weeks preceding the survey period. A broader measure of unemployment that includes the "marginally" attached and discouraged/part-time workers, known as the "U-6" measure, moved down slightly to 14.4% (previously 14.6% and below 15.0% a year ago).

The Bureau of Economic Analysis of the Department of Commerce released their "second" estimate of 3rd quarter GDP at 2.7% (q/q, saar), higher than the initial estimate of 2.0%, and above 2nd quarter's 1.3% pace of growth. The higher growth rate came from upward revisions to private inventories, personal consumption, foreign trade, and nonresidential construction. The capital expenditures component showed that private companies continue to hold back investment in light of fiscal and regulatory uncertainties.

The ISM survey of manufacturing activity, dipped below 50, signaling monthly contraction for that sector. The decline (51.7 to 49.5) reflected weak readings in the employment component, with businesses operating at lean levels of employment. In the non-manufacturing index, the positive upward trend continued (54.7, previously 53.6), with positive readings from new orders and business activity.

Consumer confidence in the US remains robust: The Conference Board's index of consumer confidence rose to a cyclical high of 73.7 in November. Anecdotal evidence of internet shopping and credit card trends seem to reiterate the idea that the American consumer is in a spending mood. However, corporate confidence on the other hand, appears to be in a deep malaise – primarily as a result of continued uncertainties with regard to the fiscal cliff and other regulatory burdens.

Speaking of the fiscal cliff, despite the mud being slung around in Washington DC, we still believe that a deal will take place – perhaps at the eleventh hour – but like anything else, the devil will be in the details. We feel that the chances of a comprehensive package of fiscal reforms that place the US on a path to sustainable long term growth are "slim to none" and in true Texas fashion, slim just got on a horse to ride out of town!

We do believe that a deal to avert the fiscal cliff will likely contain parts with which neither party's faithful will be happy with, and yet, it will be a compromise that both sides can live with. Such is the way of politics and the torturous nature of "short-termism" in policy making which has its own impact on longer term growth expectations.

Our worries about the underlying deterioration in corporate earnings in the US and the risk of further multiple ("valuation") compression have not been assuaged by what we have seen in 3Q numbers. Indeed, while the overall weighted results of all companies in the S&P500 rose 4.6% for the quarter (on a year-on-year basis), non-financial corporations posted a ***negative*** (-1.7%) earnings growth figure for the quarter. This is the first such negative quarter since 1Q 2009 and bears further careful watching and ongoing analysis of forward expectations of earnings.

Farther afield, the Cabinet Office in Japan indicated in its second estimate of Gross Domestic Product for the third quarter that GDP shrank -0.9% for the quarter; this pegs the year-on-year change in GDP at -3.5% leading to Japan's third recession in the past five years. Rebuilding from the ravages of the triple threat Earthquake, Tsunami and Nuclear disaster has petered out and the economy has begun to languish again. With elections in Japan around the corner, here too, it appears that the "short-term" nature of politics is playing havoc with economics.

Data coming out of Europe also suggests that economic activity in that continent is perilously close to a recession: Industrial production in Germany shrank 3.7% (year-on-year) in November, while that in the UK shrank 3.0 (year-on-year) in October. The unemployment rates in Greece (26.0% in September) and Spain (25.0% in September) do tell a sordid tale of what happens when governments make promises they are ill-equipped to keep.

In aggregate, the data shows marginal improvement in the global economy a month on month basis. However, what we are not seeing is significant improvement in data sets that would portend a long-term robust economic recovery. Growth prospects will likely remain subdued and below potential until elected leaders provide long-term certainty in tax and regulatory policy, and provide a path to financial stability.

Investing is a disciplined, long term activity (we ought to know!). The internet age has helped level the playing field in asymmetric information – especially when it comes to the ability to gather and analyze data – whether on the economy, company fundamentals or price discovery. However, the relentless focus on the "short term" to the detriment of the "long term" has also propelled a coterie of individuals into an activity where "short-termism" remains a prescription for disaster.

It is therefore our opinion that knee-jerk reactions to news headlines ("sell the rumor, buy the fact", "buy the rumor, sell the fact" and a plethora of other such cute but useless sayings) often end in unfavorable investment outcomes. In our almost three decades of (still, ongoing) learning about economies and markets, we are convinced that this trend to "short-termism" does not augur well for the future for those "short-termers".

In summary, "short-termism" will likely lead to unfavorable investment outcomes. 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 steadfast.

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 2013 brings good tidings to all!

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