Outlook for February, 2011: " A Grind Higher…"

Equity markets continue to grind higher propelled by better than expected earnings reports and the excess global liquidity engendered by central banks. Recently released data suggest an upswing in economic growth might well be underway in the US. While events in the Middle East and bullish investor sentiment are troublesome in the near term, we remain cautiously optimistic about the outlook for financial markets.

The US economy added a paltry 36,000 jobs in January despite expectations that were closer to an increase of 150,000 jobs for the month. Manufacturing (+49,000 jobs), construction (+32k) and professional and business services (+31k) were the sectors that saw the most additions, while government (-14k), financial activities (-10k) and trade, transportation and utilities (-3k) were the laggards for the month of January.

The politically sensitive unemployment rate declined a larger than expected four tenths to 9.0% - thus posting a decline of 0.8% in two months. The broader measure of unemployment and underemployment – also called the U-6 measure – posted a sizable decline to 16.1%. Average weekly hours declined one-tenth to 34.2, while both average hourly earnings (+$0.08 to $22.86) and average weekly earnings (+$0.46 to $781.81) reported small but meaningful increases.

The household survey (different from the more popular establishment survey) – both of which form the bedrock of the Bureau of Labor Statistics' monthly non-farm payroll report – pegged declines in the civilian labor force (-504k) and the unemployment rolls (-622k) making it much harder to decipher the true labor situation. Since the BLS typically uses this month (January) to also compute benchmark revisions and disruptions related to winter storms in large parts of the nation - it is all the more difficult to discern the true nature of the labor market.

Despite the big declines in the unemployment rate seen recently, we remain of the opinion that the labor market improvement is likely to come in fits and starts – following the well worn three steps forward, two steps back pattern. In addition, with almost one in five homes now under some sort of foreclosure proceeding or with a mortgage that is worth more than the value of equity in the home – the vaunted mobility of the American labor force is now quite constrained.

In other economic data, the Institute of Supply Management's manufacturing report on business and the services index imply that business activity along with new orders, production and prices are picking up. Further, data on durable goods orders show healthy double-digit gains for the past year – reiterating the argument that the economy might be witnessing a resurgence – at least in the manufacturing sector.

A few words on earnings: So far, 311 out of the 500 companies (62.2%) in the S&P500 have reported earnings for 4Q2010 (as of the close of business on Feb 4th, 2011). Of these 311, 253 (or 81%) have shown better earnings than those reported in 4Q2009; 54 companies (or 17%) have reported worse than the same period last year and the balance 4 (or slightly over 1%) have reported unchanged earnings relative to the previous comparable period.

However, it is relative to expectations that the earnings picture becomes crystal clear: 71.4% (or 222 companies) have exceeded expectations, 7.1% (or 22 companies) have met expectations and the balance 21.5% (or 67 companies) have disappointed. Thus, 78.5% of the companies that have reported earnings so far have either met or exceeded expectations for 4Q2010 – a spectacular result any way you slice the earnings figures.

Furthermore, the earnings per share figure for the S&P500 stands at $22.93 for 4Q2010 – which implies a run rate for the entire year at $91.72 per share – putting the bottoms-up consensus estimate in earnings of $94.00 for 2011 within easy reach! In other words, if corporate earnings were to stay at their current pace, earnings might potentially outpace expectations. At a rate of $94.00 for the S&P500 this implies a valuation multiple of just under 14 times earnings (using the close of the S&P500 last week at 1310).

It is quite obvious that a multiple in the low to mid teens is reasonable – given history and valuation metrics. Clearly, the valuation multiple is not as cheap as it was in March 2009 (when the world was staring Armageddon in the face). It is nonetheless foolhardy to argue that current levels are expensive. We prefer to couch valuations as "reasonable" – hoping that if earnings were to come through as expected, one could even see an expansion of the multiples going forward. Equity markets continue to grind higher – climbing the proverbial wall of worry.

There is a lot of chatter among analysts about the sustainability of these earnings and it is quite fashionable in some circles to talk about the "peaking" of corporate margins thus throwing a wet towel on expectations of better corporate results. In our opinion, corporate margins are quite high and could see some downward pressure (or compression) especially if commodity prices were to rise sharply and corporations did not have pricing power or the ability to pass on these cost increases to their consumers.

The Federal Open Market Committee (FOMC) of the Federal Reserve left the Fed Funds target unchanged at its meeting in late January – with minor changes in language in the statement issued. Subsequent speeches by Chairman Bernanke and other Fed officials imply that while the economy might indeed be accelerating, the FOMC remains committed to seeing its program of quantitative easing (QE2.0) completed and they do not see any reason to now stop stimulating markets at this juncture.

Interest rates have ticked up recently – along the entire yield curve - primarily driven by expectations of accelerating growth, but also perhaps as a result of higher commodity prices. Indeed, the yield curve – or the difference between longer dated maturities and shorter dated ones has continued to steepen (or increase) suggesting that the fixed income market might also be believing that growth is likely to be better than expected and the risk of accelerating inflation might now be more real than before.

Events in Egypt have garnered much attention in the media over the past fortnight. While Egypt as a nation is not a big contributor to international trade (it is not a major exporter of oil or other commodities) it sits astride the Suez Canal and does have significant strategic importance to the world. It remains a lynchpin for the Arab world and events in Cairo have clearly demonstrated the pent-up frustration felt by many citizens of that country. Egypt also has a population that is relatively young, educated and restive. It remains one of the more secular countries in the region.

In addition, it has been a real friend to the west as well as to Israel – clearly providing a calm and reasoned voice in a region that has often seen much volatility. While the US Administration's avowed desire for regime change in Egypt might be an intellectually satisfying goal, we worry that similar sentiments existed around the time of the overthrow of the Shah of Iran in 1979. Egypt is no Iran, but the risk of getting a fundamentalist regime in that country is, in our opinion, not worth taking. Time will tell whether this is a change for the better.

In summary, despite the apparent elevated bullish sentiment in the near term, we remain cautiously optimistic on the outlook for financial markets: We do feel that the fundamentals of better than expected corporate earnings and "reasonable" multiples are generally supportive of a grind higher by equity 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 resolute.

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