Outlook for February, 2012: "Excess Global Liquidity…"

Now that January 2012 is in the books, financial markets appear to be experiencing some calm. There is no question in our mind that excess global liquidity being pushed into the system by central banks from around the world is partly responsible for the better tone in markets. While we continue to worry about event driven risk and the "fat tails" around such events, there appear to be plenty of reasons to be optimistic for the period just ahead.

Economic data released recently have, on balance, been positive: The U.S. Department of Labor pegged January growth in jobs at an increase of 243,000, handily surpassing consensus estimates around 140k. The previous two months were revised upwards (+3k for December and +57k for November) for a net gain of 60k jobs. Professional and business services (+70k), leisure and hospitality (+44k), and manufacturing (+50k) were the leading sectors. Not surprisingly, the public sector maintained its position as a laggard, cutting 14k in January and 276k in the past year.

The politically sensitive unemployment rate, as part of the larger household survey, continued its improvement as it settled in at 8.3% from a revised 8.5% a month earlier. Long-term unemployment (comprised of those jobless for 6 months or more) remained marginally unchanged at 5.5 million, representing 42.9% of the unemployed. The U-6 measure, considered a broader measure of unemployment, edged fractionally lower from 15.2% to 15.1%. Income measures such as average hourly earnings, personal income, and wages trended upwards in January, albeit at a marginal pace.

The Bureau of Economic Analysis of the Department of Commerce released their advance estimate of 4Q GDP at 2.8% (q/q, saar) from 1.8% in the 3rd quarter. We had anticipated businesses would increase capital investment in the 4th quarter to take advantage of expiring tax credits – which came through in the 4Q11 GDP release. As such, the GDP report showed sizeable increases in inventory and residential fixed investment, but disappointing gains in final sales. Also driving the increase was a resurgent manufacturing sector, as confirmed by the Institute for Supply Management report, which showed new orders, exports, and production posting gains during the period.

An improving jobs picture may complicate recent communications by the Fed regarding policy projections in the medium term. The Fed expressed the need to maintain low interest rates until late 2014 (a change from the previous Mid-2013 language) as unemployment remains stubbornly high and economic growth remains weak. However, if economic data continues to surprise to the upside, we wonder what the Fed would do then. Talk about painting yourself into a corner!

The Fed also provided additional color around forecasts made by members of the Federal Open Market Committee. Ironically, two members of the FOMC thought that the Fed Funds Target would remain at zero well into 2016, implying economic growth was likely to remain anemic and inflation would not be a problem well into the future. However, this same set of prognosticators believes that the "longer run" projection for the Fed Funds Target should be well north of 4.0% under "normal" circumstances.

The European Central Bank (ECB) for its part has also continued to push additional liquidity in the system through its Long Term Refinancing Operations (LTRO). This allows European banks to essentially borrow unlimited amounts of Euros – for up to three years – at a fixed rate of 1.0%. The first such auction of funds in December was obviously a big success, with another one scheduled for later this month. In turn, European banks and financial institutions appear to be turning around and investing the LTRO funds in sovereign debt instruments issued by European Governments.

The ECB appears to be taking a page from the Fed's play book and is in essence helping the monetization of debt. Indeed, this is a dangerous game – especially if inflation rears its ugly head – as it surely will at some point even if this is only in the distant future. Most central bankers feel that they are smart enough to recognize when they need to drain liquidity from markets in the face of deteriorating inflation fundamentals. Decades of history however, suggest precisely the opposite: Central bankers are only human and do not appear to have any supernatural ability to divine when to pull back on liquidity.

Negotiations between the Greek government and its creditor representatives continue apace – although not a day or week goes by without additional revelations on the "haircut" that would be needed. It is also quite interesting that the ECB has an axe to grind on this topic. The ECB would prefer that its holdings of Greek debt be left out of the negotiated settlement, simply because taking such a large reduction in the value of its holdings of Greek debt would do serious damage to its paid-up capital on the balance sheet!

As a result of all the excess liquidity, financial markets appear to be rejoicing in 2012: January has seen one of the best starts to a year in almost 25 years and February seems to be continuing the gains from January. Doubtless, an improvement in the tone of economic data has been partially responsible for the "risk on" nature of markets recently. From a technical perspective, markets might be in danger of getting ahead of themselves in the very near term, but the longer term outlook remains quite reasonable.

Earnings results for 4Q2011 have come in better than expected: Of the 307 companies in the S&P 500 that have reported earnings so far (61% of the index), the share weighted earnings gain has been 3.6%. Of these 307 companies, 187 (or 61%) have reported positive surprises (relative to expectations), 31 (or 10%) have met expectations and the remaining 89 (or 29%) have missed consensus expectations. While the proportion of companies missing estimates is slightly higher (29%) compared to the previous 4Q2010 (24%), these numbers do look quite good.

Earnings expectations for the entire year 2012 have seen significant downward revisions over time – a healthy sign. While earnings were expected to grow at 15% for 2012 around the middle of last year, they now stand around 8.0% growth – which is eminently achievable – absent any exogenous events that could upset the apple cart. Further, valuation mutiples remain quite reasonable as well – around 14 times earnings, with the median mutiple at around 18 times earnings over the past three decades.

Given the improved outlook over the medium term, we have reduced cash holdings in your portfolios in favor of an investment in domestic REIT securities. REIT fundamentals are attractive – especially as economic growth remains positive with ongoing demand for commercial space. This sector also benefits from limited new construction, thus keeping a lid on supply in this space. Valuation mutiples for a number of REIT sectors remain reasonable in our opinion. It also helps that these securities have an income component – especially in an environment where yield in general remains hard to come by.

From a political standpoint, it certainly looks like the Presidential contest will likely take place between President Obama of the Democratic party and Mitt Romney, a Republican former governor of Massachusetts. The long road to the Republican nomination has indeed been torturous (with the candidates all slinging sufficient mud at each other) and it appears that this will be the most expensive campaign on record for the land's most powerful office.

Fiscal policy uncertainty looks set to continue: If ever any of us needed a reminder about the dysfunctional nature of Washington DC politics, we are about to get a reminder soon when the payroll tax cuts – which were extended for two months in December – are about to expire at the end of this month. Talk about short term: The irony is not that "inside the beltway politics" is partisan, it is that positions on both sides are so polarized that nothing good is likely to come out of either the Administration or the Congress until at least the deadlock is resolved at the hustings in November.

Commodity prices – especially those relating to crude oil – continue to be impacted by fears of supply disruptions from the Persian Gulf. Indeed, additional saber rattling by Israel and Iran suggest increasing tensions in the region. While the Strait of Hormuz remains an important choke point in the gulf, it is quite clear to us that the US is in serious need of an energy policy. Such a policy needs to take into account our abundant supplies of natural gas rather than one that is dependent merely on increasing the share of alternative sources of energy.

In summary, we continue to position your portfolios with slight optimism for the future – reducing cash balances on hand in favor of an income orientation in equity holdings. While we still worry about 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.

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