## ***Outlook for January, 2011: "The more things change…"***

"The more things change, the more they remain the same" opined Jean-Baptiste Alphonse Karr, the famous editor of Le Figaro! This expression aptly describes the current state of global financial markets and economies. Indeed, with the advent of the New Year, as commentators and strategists offer their opinions on the top ten surprises for 2011 or the top ten investment ideas for 2011, we often view these pronouncements with a mixture of mild amusement and disdain!

Despite expectations that the US labor market was improving, the recently released non-farm payroll report for December was decidedly disappointing. The economy added a paltry 103,000 jobs during the month of December. While the job numbers for November and October (+32k and +38k respectively) were revised upwards, the pace of job growth remains lackluster. The economy has managed to add 1.12 million jobs in the past twelve months (which implies an average addition of 93,000 jobs per month) – far below the level at which the unemployment rate will decline significantly.

In the December employment report, leisure and hospitality (+47k), education and health (+44k) and trade, transportation and utilities (+31k) were the leading sectors while, local government (-20k), construction (-16k) and information (-4k) were the laggards. The average weekly hours (unchanged at 34.3 hours) also appears to be telegraphing that the labor market is not improving much – as this indicator is likely to witness a sizable gain before employers take on new (additional) workers.

Meanwhile, the politically sensitive unemployment rate declined a surprising four-tenths to 9.4% in December. The wider measure of unemployment and underemployment (called the U-6 measure) also posted a decline of three tenths to 16.7%. Despite this month's decline, we suspect that the unemployment rate is likely to remain stuck at a stubbornly high level for many months to come. Even if the labor market does improve, the unemployment rate will likely be impacted by discouraged workers returning to the labor force – thus having a perverse impact on the rate masking any fundamental improvement in the labor market.

The much ballyhooed Christmas retailing season appeared to finish with better than expected results despite the advent of a snow storm that socked in much of the Northeast on the day after Christmas. Indeed, with equity markets performing better last year, the American consumer seemed to enjoy some good holiday cheer by opening up his wallet. Electronics and toys (two perennial best sellers) led the way forward this past season – buttressed by newer technology both in mobile computing and video gaming.

The US economy does however look like it is in decent shape – the typical three steps forward, two steps back pattern we have seen since the end of the recession continues. While it is certainly possible that a single quarter of GDP growth over the next two or three could provide upside surprises (we would not at all be surprised if we saw a 4.0% plus GDP quarter), the pace of growth over the next year or two is however likely to remain fairly anemic.

Worries regarding housing remain paramount. The future prognosis for housing is inextricably linked to the labor market, but with roughly one in five homes' mortgages underwater (the homeowner owes more on the mortgage than the house will fetch on the market), the vaunted mobility of the labor force has also been severely reduced. New home construction is currently well below the demand for new homes, but this hardly makes a dent in the surface – since housing suffers from the overhang of the deleveraging mess.

Furthermore, demographics – one of the fundamental drivers of housing – are also on the wane from a household formation standpoint. We suspect that consumer confidence and job growth will need to return to higher levels than prevails currently before housing demand becomes truly sustainable. Nonetheless, it is quite clear that the beleaguered housing sector is unlikely to remain the engine of growth like it hitherto used to be in previous recoveries.

The extension of the Bush Era tax cuts by a lame duck session of the 111th Congress (which was then duly signed into law by President Obama) does remove (at least temporarily for the next two years) much of the uncertainty around tax policy. The accelerated depreciation right-off for equipment for small businesses is a positive. The increasing of estate tax allowances for 2011 and 2012 to $5.0 Million is also a positive – as it also manages to reduce the uncertainty with regard to estate taxes.

Congress also reduced payroll taxes paid by employees by 2.1% for 2011. While this move does provide some relief, it nonetheless manages to continue to propagate the international trade problem that the US has. In other words, the relief that the payroll tax reduction provides will probably be used by consumers to purchase more goods that are made in China – thus not increasing US jobs, but perversely widening the already burgeoning trade deficit that the US has with China and the rest of Asia.

The deleveraging of the public sector has only just begun. We expect state and local governments to remain under fiscal pressure for two main reasons: One, their spending – particularly on discretionary items – is quite unsustainable. Indeed, spending levels have not adjusted downwards to the new reality unlike corporations – which had been much quicker to reduce their payroll. Second, states and local governments are also likely to see further declines in revenues given the state of affairs in housing (property taxes representing a significant portion of their revenues) and previous cut backs in consumer spending (with sales taxes being the other big source of revenue).

US interest rates have remained quite volatile with the yield curve (the difference in yield between longer term maturities and shorter term ones) steepening. Some of this is as a result of the Fed continuing to anchor the front end of the curve near zero, but increasing inflation expectations are also without a doubt part of the story. While plenty of slack remains in the economy (thus providing some cushion on the inflation front), sizable increases in commodity prices particularly precious metals, agricultural and industrial commodities bear watching.

US equity markets have enjoyed a nice bounce during the fourth quarter of 2010 and appear to be headed higher – if the first week of 2011 is any indication. While the fundamentals of better corporate earnings and reasonable valuations are generally supportive of higher prices, we worry that in the very near term sentiment might have gotten a little ahead of itself. Surveys of individual investors suggest that many investors expect markets to do well – thus sounding a note of caution for the near term.

Farther afield, the European fiscal crisis continues to roll on: Sovereign yield spreads particularly for Greece and Ireland have now approached all time highs (since the creation of the Euro in 1999) with no end in sight. While the size of the European Stability Fund had some promise, the execution leaves much to be desired. Policymakers in Europe have been muddled in their response to the crisis with a cacophony of voices that does not augur well for a quick resolution.

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. The more things change, indeed!

***We want to take this opportunity to wish all our clients a Happy New Year! Here is hoping that you and your families had a wonderful and safe Holiday Season.***

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