Outlook for January, 2012: "The Sands of Time…"

With a turn in the calendar, one would hope that markets might start to experience some much needed calm as well. While 2011 will go into the record books as an unusually volatile year, we do not see much hope for the volatility to recede given that many of the fundamental uncertainties (from a policy perspective) continue. And oh, by the way, welcome to the end of the Mayan calendar!

Economic data for December were primarily upbeat: The U.S. Labor Department reported that the economy added a greater than expected 200,000 jobs in December. Revisions to the previous two months witnessed a net loss of 8k jobs. Job gains were widespread, with transportation/warehousing (50k), retail trade (28k), and leisure and hospitality (24k) leading the way. Over the past 12 months, private payrolls have added 1.92 million jobs while the public sector has lost 280k.

The politically sensitive unemployment rate, as part of the larger household survey, edged fractionally lower to 8.5% from a revised 8.7% a month earlier, the lowest rate since February of 2009. Long-term unemployment (comprised of those jobless for 6 months or more) remained relatively unchanged at 5.6 million, representing 42.5% of the unemployed. The U-6 measure, considered a broader measure of unemployment, edged lower from 15.6% to 15.2%. Additional labor market indicators, such as weekly hours and hourly earnings ticked up slightly although wages are only up 2.1% over the last 12 months, failing to keep pace with the rate of consumer price inflation.

The Bureau of Economic Analysis of the Department of Commerce revised their enumeration of 3QGDP downwards to 1.8% (q/q, saar) from a previous estimate of 2.0%. While the headline suggests some decline in economic momentum, the reverse is actually true: A lower GDP figure for 3Q2010 implies expectations of higher GDP for 4Q2011. In addition, with the expiration of accelerated depreciation provisions in the tax code at the end of 2011, we anticipate that corporate investment spending had been pulled forward into 4Q2011 from later in 2012.

The hand-off to 2012 appears to have been quite robust given the upside surprises seen in retail sales at the end of the year: Consumers seemed to have gladly opened up their wallets for the Christmas retailing season. Much of this appears to have been at the expense of the savings rate. The savings rate posted a decline during the final months of last year (from north of 5.0% to around 3.5% as a percent of disposable income) implying that the increase in spending was likely to be unsustainable going into 2012.

The Federal Reserve left the Fed Funds Target unchanged at 0.00% to 0.25% at its Federal Open Market Committee meeting in mid-December and reiterated its intention to keep interest rates at that level at least until mid-2013. Subsequently released minutes of the meeting make clear that the Federal Reserve is upping the ante on "transparency" and will likely provide additional color with regard to its forecasts.

The Fed Funds Target – which is an economic variable that the Fed has considerable control over – will be part of this updated longer term forecast over time. Policy makers at the Fed obviously believe that by providing advance notice of changes in economic variables like the Fed Funds Target, it provides for greater transparency in the conduct of monetary policy. In addition, speeches and interviews by some Fed officials also suggest that the Fed might resort to inflation targeting both on the upper bound as well as lower bound.

While openness in policy making and transparency are laudable goals, we are of the opinion that the Fed might steadily be painting itself into a corner with each additional step. Providing forecasts of common economic variables is one thing, but providing forecasts of the Fed Funds Target (as part of their usual briefing) is fraught with danger as it could signify policy moves that market participants are ill-prepared for.

Inflation targeting – a favorite policy objective of Chairman Bernanke – is another praiseworthy goal. While the Fed's anticipated policy actions in the face of worsening inflation are well known, the rest is not as clear. How does the Fed react when inflation falls below the lower bound and the Fed Funds Target is already at zero? In an attempt to become clearer, the Fed appears to be revealing too much of the secrets of the temple and the sands of time will tell whether this was an appropriate policy action.

Farther afield, late January brings with it yet another EU summit. A meeting between French President Nicholas Sarkozy and German Chancellor Angela Merkel appears to have decided to impose a financial transactions tax in Europe to partially defray the cost of bailing out profligate governments. Prime Minister Cameron of the UK was quick to squelch this idea as it would lead to a flight of financial businesses away from the UK into other regions that do not have this tax.

The European Central Bank seems to have chosen a back door way to provide liquidity to European financial institutions in need of funding. The ECB's auction of three year collateralized loans at 1.0% of 489 billion Euros ($621 billion) to European banks provides much needed breathing room. The ECB will offer a second three-year loan in late February (probably also at 1.0%), further providing relief to those institutions that need it badly.

While the ECB has been dragged into the fiscal mess kicking and screaming, its response has been seen as temporary by market participants. It is quite obvious that in order to "clear the decks" the fiscal policy response has to come from the governments themselves as opposed to from the ECB. We are not yet convinced that the current generation of leaders in Europe has the intestinal fortitude to impose severe austerity on their populace for fiscal decisions made by their profligate European brethren.

2012 is also a year in which the leaders in France, Germany, Russia and the US face a general election. Recent poll numbers for President Sarkozy and Chancellor Merkel are flashing warning signs for their re-election bids throwing another spanner in the works – particularly if the opposition gets elected in France or Germany. In both of these countries, the population appears to be quite restive and unlikely to view their current leaders with equanimity.

In the US, the slow and torturous route to winning the Presidential nomination in the Republican Party appears to be finally coming to a conclusion: For all intents and purposes, Mitt Romney the former Governor of Massachusetts, seems to be emerging as the inevitable candidate. While Governor Romney has his work cut out for him (President Obama is a consummate campaigner), the real work of distinguishing himself from the policies of the President will likely begin in earnest soon.

The political atmosphere in Washington DC (never quite cordial at the best of times) appears to have been poisoned even more recently by recess appointments made by the President during a time when the Senate was not technically in recess. Such blatantly political moves make for good theatre, but clearly throw cold water over the idea that Washington could actually pass reasonable laws and function as our founding fathers once intended.

A word about earnings: Earnings expectations for 4Q2011 have seen significant downward revisions recently. Currently, the bottoms-up consensus is expecting a mere increase of 6.0% in 4Q2011 earnings relative to 4Q2010; this is a substantial decline from the 14.7% increase that analysts had been expecting during the summer and late fall of last year. Lowering the bar is a classic way for corporations to look more successful than they truly are, especially in an environment where earnings misses are penalized heavily.

Commodity markets have seen some volatility as a result of sanctions imposed on Iran by the US and the EU. Iran's threat to close the Strait of Hormuz (the narrow strip of water through which 35 percent of the world's seaborne oil transits through) is legitimate. The threat has caused oil prices – for both Brent as well as West Texas Intermediate – to spike higher on fears of a supply disruption. Prices of precious metals have also remained well bid as policy uncertainties abound.

The USD - despite its oft repeated problems of a high current account deficit and a high budget deficit – continues to appreciate against the Euro primarily as a result of the latter currency's ongoing fundamental questions. We continue to feel that the US Dollar will likely remain the currency of choice from a "safety" standpoint until many of the policy issues around the world are resolved.

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.

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