Outlook for July, 2010: "Worries about a double-dip…"

Financial markets continued to face some tough sledding this past month as worries about a double-dip recession in the US came to the fore. Indeed, many market participants have been forced to re-assess the inherent risk in their portfolios in the wake of the recent sell-off in equity markets. While the risk of a double-dip still appears to be modest, uncertainties surrounding fiscal policy, financial and other regulations and the outlook for prices (inflation or deflation) conspire to reduce the optimism going forward.

The US economy posted a net decline in jobs of -125,000 during the month of June – primarily as a result of temporary census workers being laid-off (-225k). The private sector added a paltry 83,000 jobs during the month, clearly suggesting that employers are loath to add full-time employees. Manufacturing gained (+9k), construction lost (-22k), while mining and logging held its own (+5k). Within the service sector, leisure and hospitality posted a gain (+28k), healthcare edged up slightly (+9k) while financial activities continued to lose steam (-15k).

The employment report also implied that the economy appears to be losing momentum – as witnessed by the reduction in the hours worked (from 34.2 to 34.1) and in the average hourly and weekly earnings as well. The politically sensitive unemployment rate improved by two-tenths (from 9.7% to 9.5%) – but this was primarily as a result of the number of people now deemed as not being part of the labor force – these are persons that had simply stopped looking for work! Our own preferred measure of unemployment – the U6 measure – also declined slightly, but to a still dismal 16.5% for June. All in all, there were not too many bright spots in the employment report released last week.

In other data, the PMI of the Institute of Supply Management posted a decline during June of 3.5 points to a still respectable 56.2. However, many of the components of the ISM report also suggest some loss of momentum in the manufacturing sector – production declined from 66.6 to 61.4, new orders declined from 65.7 to 58.5 and prices posted a steep drop from 77.5 to 57.0. The housing sector seems to be in the throes of another stunning decline – pending home sales posted a 30.0% drop for the month of May – due mainly to the expiration of new home purchase incentives at the end of April.

Consumer confidence also saw sharp declines (52.9 in June versus 62.7 in May) with the expectations index (71.2 in May versus 84.6 in April) accounting for most of the fall. The present situation index also suffered, declining to 25.5 in June versus 29.8 in May. All of these data do suggest that the chances of a double-dip recession appear to be increasing. Our own view is that while the risk of a double-dip is now higher than earlier this spring, it is still a modest 30% chance or so. Indeed, with much of the stimulus spending (over 50% outstanding) still to come during the 2H10, it is quite difficult to see such an economic outcome.

In addition, the US economy is more like an aircraft carrier rather than a cigarette boat. In other words, despite the downshift in economic growth expectations (1Q GDP was finally pegged at a 2.7% seasonally adjusted annual rate compared to an original release of 3.3%), we do not expect the economy to enter into a broad-based decline in industrial production, retail sales or employment – a real recession. However, the odds of such a recession – the second one in three years – are now higher than they were earlier this spring.

Interest rates have declined during the past month – with the ten year easily dropping below the 3.0% threshold during the latter part of June. The yield curve is in "bull flattening mode" which is probably symptom of worries about a double-dip recession as well as the risk of deflation in the US. Many market participants do worry that the US could experience a Japanese style deflationary period – and undergo many years – indeed decades, of no growth and no improvement in financial markets.

It would be hard to imagine a Japanese style deflationary period in the US for a number of reasons: First, the Federal Reserve could easily monetize debt (as they have done successfully so far in the past year and a half), thus putting plenty of liquidity in the system to prevent the recurrence of deflation. Second, and perhaps more important, the national psyche of the US would very much agitate against going through a prolonged period of no or very slow growth. Our nation is simply not one where a restive population would accept economic under-performance for very long.

The Federal Reserve for its part maintained the Fed Funds Target at the 0.0 to 0.25% level. In a statement released at the end of the FOMC meeting the committee did pay homage to tightening financial conditions and decided to leave the "extended period" language in their communiqué as an indication that the FOMC was very far from thinking about tightening monetary policy. The Fed did also indicate that ongoing troubles in Europe were partly responsible for the deteriorating financial conditions in US markets.

The Euro appears to have stabilized relative to the USD. The Euro currency's apparent strength relative to the USD is quite illusory – particularly if it is placed in the context of the EUR/CHF exchange rate and the fact that the Swiss Franc continues to strengthen against both the currency pairs. Indeed, we suspect the Euro's apparent improvement is more as a result of continued worries about the US Dollar and its fundamentals rather than that of the Euro alone.

European leaders – particularly Chancellor Merkel of Germany and President Sarkozy of France – appear to be pushing for fiscal rectitude not only among other European states, but also within the G-20. Clearly, local election results in Germany have been partly responsible for this bout of religion. In addition, there continues to be very little appetite in continental Europe to help their profligate brethren along the Mediterranean. We suspect that some of the plans for austerity in Europe are unlikely to come to fruition – given that most governments do not have the political will to follow through on some of the tough decisions that need to be taken if they were to truly pursue fiscal restraint and austerity.

The US political scene is also likely to get real interesting real soon: With mid-term elections fast approaching, the political pundits are far apart in their forecasts of what is likely to occur at the hustings in early November. While it is still too early to call, we suspect that the time honored tradition of the ruling party losing ground during mid-term elections is likely to hold this time as well. The American populace has also obviously liked divided government – as another way to ensure the checks and balances that were put in place by the founding fathers of this nation do operate normally.

With earnings season for 2Q10 almost upon us, we expect much will be known about the health or otherwise of US corporations. Going into the earnings season, we do expect that a large majority of companies will likely either beat or meet their earnings expectations this quarter. Despite the lack of top-line growth, many companies have quite aggressively cut costs, thus enabling them to improve their margins. It is the subsequent quarters – particularly later this year – that they could potentially have trouble given elevated expectations.

In summary, we suspect that the ongoing correction in US equity markets is likely to remain with us at least for a few more weeks. Indeed, as volatility continues to spike, we do feel that this is a time to remain cautious about the outlook for economic growth and financial markets. Given the very nature of sustained cross-currents – this does not appear to be a time to take on additional risk in portfolios. If anything, we feel this is a very opportune time to re-assess the risks inherent in portfolios.

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.

This report was prepared by

Suresh Raghavan, CFA
Raghavan Financial, Inc.
4400 Post Oak Parkway, Suite 2210
Houston, TX 77027

For further information please contact us at
Work: 832.667.8787
Cell: 281.804.4444
Email: suresh@raghavanfinancial.com

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