Outlook for July, 2011: "A Mid-Summer Night's…"

Ongoing policy uncertainties as well as the cumulative effect of "kicking the can down the road" have continued to pressure global financial markets. Indeed, since markets abhor uncertainty more than anything else, we might very well be in for a Mid-Summer Night's Nightmare instead of halcyon days at the beach (with our tongue in cheek apologies to Shakespeare, the Bard of Avon!).

Economic data in the US has been quite negative of late: Only 18,000 jobs were created in June, according to the most recent Bureau of Labor Statistics survey, a deceleration from the past few months' already weak pace. Private firms added 57,000 jobs, but this was offset almost completely by net job cuts of 39,000 by government. The only two subsectors of the survey to indicate any significant net job creation were Leisure and Hospitality (34K) and Health Care (17.4K).

The headline unemployment rate stayed essentially the same, ticking up slightly from 9.1% in May to 9.2% in June. However the broader U-6 measure of labor un- and under-employment jumped 0.4% to 16.2%, from 15.8% in May. Furthermore, both average weekly hours worked, and average hourly earnings declined slightly, a possible harbinger of more labor market weakness to come.

The ISM Manufacturing Purchasing Managers' Index increased notably, from 53.5 to 55.3, an increase welcomed by the markets (recall that values above 50 indicate improving conditions in a diffusion index). However, a more careful look at the components of the index paints a somewhat more cautious picture. The backlog of orders has begun to decline (a value of 49.0, down from strong positive readings in January through April), New Orders are essentially flat, and Customer's inventories appear to have stabilized from their prior "too low" reading. All of this indicates that manufacturing is unlikely to be a major driver of growth over the next few months.

The National Federation of Independent Business's Small Business Optimism Index has declined for the fourth consecutive month. Small businesses continue to report weak consumer demand with 1 in 4 small business owners reporting weak sales as their top business problem, and very little net intention to expand employment (on a seasonally adjusted basis). As small businesses typically account for a lion's share of job creation – particularly during recovery from a recession – this trend suggests further weakness in both the economy and the job market over the near-term.

The European fiscal crisis drags on: The Greek government barely survived a vote of confidence in its own parliament. Many of the violent images from Athens and elsewhere that were beamed to televisions all over the world are a grim reminder of some of the struggles yet to come in other parts of Europe. It remains to be seen whether there is sufficient appetite to follow through with all the tough medicine that needs to be administered in order for Greece to survive as a viable fiscal entity.

As yield spreads have widened significantly, the market now appears to be focused on Italy's fiscal woes. While every country with a fiscal crisis in Europe has its own unique nuance, it all comes down to the same common theme: These governments have simply promised too much to their populace without having the wherewithal to deliver on these promises over time and have built up a debt load that they are unable to service given their meager revenues.

The advent of the Euro (and the agglomeration of Germany and better quality credits as a result) fudged reality for a few years. In all honesty, the Maastricht Treaty itself was more honored in its breach even by some of the stalwarts of the Euro like France. Indeed, as some of the peripheral countries in the EU have discovered much to their chagrin, Germany and other "quality" credits provide very little cover when the game is up.

The ability of politicians to "kick the can down the road" to use an oft repeated cliché, never ceases to amaze us. It is abundantly clear that the first rescue package of Greece (begun in May, 2010) was a non-starter. The torturous nature of negotiations this time around, points up the fickle nature of politicians' desire to please their constituencies and yet keep the system afloat at the same time.

Italy's debt to GDP (as a ratio) exceeds 120 percent and a severe widening of yield spreads relative to a Euro benchmark will likely put further pressure on Italy as it goes to the public debt markets for refinancing the maturing debt. Reports that two of the major credit rating agencies (Standard and Poors and Moodys) are reviewing Italy's ratings have not been well received.

Unlike Greece, much of Italian debt is held domestically, but this provides little comfort to a government that is in the throes of cutting spending. Ironically, the Italian economy has grown at an anemic pace of 0.2% per year over the past decade making it very difficult for the economy to service its debt over time. Time will tell whether the contagion spreads to other countries in Europe, but we are wary of betting that it is unlikely to do so.

The US Government is also in the midst of budget and spending negotiations, with Congress and the Administration at loggerheads on this issue. While the two political parties offer radically different visions of the future, their ability to dither till the eleventh hour obviously does not sit well with market participants. We fully believe that despite all the poisoned rhetoric, a "budget deal" along with an increase in the debt ceiling will be eventually forthcoming.

For after all, none of the actors in this political game of "brinkmanship" want to be seen as the person responsible for sending the US into a default. In the shifting sands of Washington DC's political calculus, most politicians are looking at their prospects in the next election. The reality is that failure to raise the debt ceiling does not necessarily lead directly to default – it just means that the Treasury has to live within its means (what a radical concept!).

US debt markets have remained volatile – initially selling off as market participants took on more risk in their portfolios, but also rallying in the face of weaker than expected economic data. It is also interesting to note that the Treasury Inflation protected ten year instrument currently yields 0.57% (compared to the nominal ten year at 2.90%) – suggesting that market participants peg the average inflation rate in the US at around 2.3% over the next ten years – a level of complacency that is quite startling.

Equity markets have remained volatile reacting significantly to swings in sentiment. Sentiment measures do indicate outsized moves from the depths of despair to the heights of ecstasy (all in the space of a couple weeks).While many technical analysts continue to watch specific moving averages (and sometimes these levels have a way of becoming self-fulfilling prophesies) for clues as to market direction, we suspect that the unsettled nature of trading is likely to continue through the rest of the Summer – at least until some of the uncertainties are resolved.

In summary, financial markets continue to react to ongoing uncertainty. We are hopeful that the Mid Summer's Nightmare is just that – a bad dream and not likely to come to fruition. While we remain cautious about the near term outlook, we are reasonably optimistic over the 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.

Regular readers should note that the next edition of the Outlook will be published in September, 2011 – with no Outlook for the month of August, 2011 as a result of the timing of travel and vacations. We look forward to continuing the conversation in September.

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