Outlook for June, 2010: "Increased Volatility…"

As the weather in the northern hemisphere has turned warmer, so has market volatility. This Brownian motion like financial market turbidity (named after the eponymous British scientist who first discovered the property of seemingly random movements of particles suspended in fluid, as far back as 1827) – suggests that volatility might indeed be a regular feature for the rest of the summer and fall.

The US economy added 431,000 jobs during May. While the number looked quite robust, the fact that 390,000 of those jobs related to temporary hiring by the Census Bureau put a damper on any celebrations. Goods producing sectors were responsible for a mere 4,000 jobs during the month, with manufacturing posting a reasonable gain of 29k while construction posted a loss of -35k jobs. Within the service sector, professional and business services (+22k) and educational and health (+17k) were the main gainers, while financial activities lost -12k jobs during the period.

The politically sensitive unemployment rate declined two-tenths to 9.7% while the broader measure of unemployment – the U6 measure – posted a decline of five-tenths to a still high 16.6%. Average weekly hours posted a gain of 0.1 hour (to 34.2 hours) while average hourly earnings gained ten cents to $22.57 for the month. All in all, the payroll report was symptomatic of a two-steps forward one step back type of recovery rather than a robust kind that market participants have been craving.

In other US economic data, survey indicators point to an ongoing recovery in manufacturing, despite a slight decline in many of the ISM Manufacturing Survey components. The service sector Non-Manufacturing ISM survey posted smallish declines in many components, but continues to suggest further expansion in this sector as well. Industrial production posted a solid gain of 0.8% (m/m; y/y: 5.2%) for the month of April, while retail sales also indicated fairly hearty gains of 0.4% (m/m; y/y: 8.8%).

The major characteristic of the foreign currency bourses has been the surprising strength in the US Dollar and the concomitant weakness in the Euro. Fears with regard to the sustainability of sovereign debt issuance and the ability of governments (or lack thereof) in Europe to tighten their fiscal belt at a time of anemic economic growth continue to roil the Euro.

While much has been made of the "rescue" of Greece (with a €110 Billion package) by the rest of Europe and the "all-in" bet on propping up the Euro – significant doubts remain. It clearly does not help that the perception of the "man in the street" in many developed European countries remains skeptical – particularly on the viability of the process of fiscal austerity and the significant economic pain that this would engender.

Anecdotal evidence also suggests that many leveraged market participants are apparently using the Euro as the funding currency for their carry trades. This probably has two market implications: First, the Euro is likely to weaken far beyond what many analysts would consider reasonable. Indeed, already the Euro appears to be below its purchasing power parity relative to the Greenback by more than 10 cents. Second, and perhaps more important – such an accumulation of one-way positions could easily lead to a virulent reaction in the currency markets in the opposite direction – particularly as leveraged players are forced to liquidate positions.

The significant change in the Euro relative to the US Dollar, makes European exporters more competitive relative to their US counterparts for international trade. It also has the perverse effect of reducing the foreign profits that were previously enjoyed by American based multinational corporations. In other words, a stronger US Dollar will likely lead to lower profits for those companies that derive a significant proportion of their profits from abroad.

The consensus earnings estimate for the S&P500 companies appears to be around $75/- per share for 2010. An ongoing decline in the Euro would probably result in a lower consensus earnings estimate to around $68/- per share (a haircut of approximately 10%) for the S&P500. Applying a reasonable valuation multiple of 14 times results in a fair value estimate of 952 for the index. Much of the math behind both the consensus earnings estimate and the valuation multiple is both subjective and is clearly in the eye of the beholder!

We believe that market participants are currently struggling with the uncertainties associated with precisely this kind of arithmetic. From a top-down perspective, the range of outcomes – particularly as they relate to earnings and valuations – appear to have widened significantly. Normally, the range of outcomes is within a quantifiable cone of reason. Now, however, the range of outcomes appears to be much wider given the experience of the past few years. Financial market participants have to therefore deal with much higher volatility in prices and outcomes.

Farther afield, Japan has witnessed a change in leadership at the top of the government. Our assessment is that this is unlikely to lead to a significant change in fiscal policy in the near to medium term. Many analysts are also warily watching the United Kingdom – as a coalition government attempts to restore some semblance of fiscal order to their profligate ways.

Meetings held by the finance ministers (and their S*herpas*) of the G-20 nations in Busan, Korea resulted in a communiqué that was long on platitudes, but light on measures to improve fiscal deficits around the world. We do not hold much hope for anything substantive to come out of the G-20 summit meeting to be held later this month in Toronto, Ontario, Canada either.

Fiscal conditions appear to be deteriorating all over the developed world – with some minor exceptions. As a rule, governments are running up deficits at a pace that appears to be unsustainable. Many of these governments have also been aided and abetted by pliable central banks that have the belief that a deteriorating fiscal situation is a far better result than an outright depression.

Given the accumulation of deficits and the challenge in dealing with burgeoning debts, the temptation to inflate their way out of the deep fiscal morass must be quite attractive to many policymakers. Throw in the short horizon for many of these elected officials – and you have a potent cocktail for deliberate policy miss-steps. In other words, it could become real convenient if a little inflation were to make its presence felt – particularly as it eases the fiscal burden over time. It will be more than just idle curiosity to see how the developed world deals with this issue over the medium to long term.

While inflation is the longer term worry – particularly two to three years into the future – published inflation readings in the US (at both the consumer and producer levels) suggest that inflation is quiescent. We would not be surprised to witness another deflation scare in the near term - as economic growth downshifts in the US – as a result of the waning effects of fiscal stimulus.

Meanwhile, the Bank of Canada and the Reserve Bank of Australia have started the process of removing the extraordinary monetary accommodation that they had put in place during the credit crises a few quarters ago. However, fears that a contagion from the fiscal crises in Europe could make its way across the Atlantic are likely to stay the hand of the Federal Open Market Committee of the Federal Reserve.

In summary, we would characterize our outlook as less positive than the one from last month. The increased volatility in financial markets does inject a note of caution over the medium term outlook. Our belief in a diversified portfolio as the most suitable way to help achieve favorable financial outcomes over the long haul remains steadfast.

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