Outlook for June, 2011: "More uncertainty…"

Global financial markets continue to be strained by more worries regarding the outlook for policy – both in the US and outside - conspiring to keep equity markets under pressure in the near to medium term. While some of the uncertainty will likely resolve itself shortly (for example, what happens after QE 2.0 expires?), the economic malaise is likely to linger for at least a little while, making for a tough summer.

The U.S. economy added a paltry 54,000 jobs in May. The weakness was broad based with both private sector (83K) and public sector (-29K) job creation very weak. The private sector job slowdown is particularly troublesome as it was not driven by any particular sectors, with most sectors essentially unchanged for the month. The only stand-outs were professional and business services (44K), accounting and bookkeeping (18K), and health care(17K), with a notable drag from local and state government (-28K). The previous two months' jobs creation was also revised downward slightly by 27K and 12K, respectively.

Furthermore, despite slight net job creation, the unemployment rate edged slightly to 9.1% from 9.0%. The broader measure of un- and under-employment, the so-called U-6 measure, actually declined slightly from 15.9% to 15.8%. The discrepancy between these measures is likely statistical noise, but if it persists could indicate that formerly discouraged workers are reentering the workforce, which would artificially inflate the base unemployment rate.

This weakening is concerning in the context of the broader economic picture, as a number of other major indicators have deteriorated recently. The ISM manufacturing survey's headline purchasing managers' index declined sharply to 53.5 from 60.4. While a reading above 50 still indicates expansion, the report showed a significant slowing in overall demand, including new orders and order backlogs.

The Bureau of Economic Analysis released its first revision to 1st quarter GDP growth, which was unchanged from its advance estimate last month of 1.8%, disappointing expectations for an upward revision. Additionally, the Consumer Price Index has risen at an annualized rate of 5.1% over the past 6 months, with the less volatile core measure up an annualized 2.3% over the same period, and the trend continuing to be toward higher inflation in both measures. While it is too early to discuss the possibility of a 1970s-style stagflation, the continued growth in inflation in the context of continued weak economic growth is nonetheless troubling.

Many economists blame the triple disaster in Japan (the earthquake, Tsunami and the nuclear crisis) as partially responsible for the loss of momentum in the US economy given the global linkages in supply chains that stretch across national borders. Reports of parts shortages – particularly in automobiles – leading to total or partial plant shutdowns or slowdowns in North America does seem to support this notion.

However, we suspect that uncertainty with regard to policy outlook is also responsible: Business leaders are increasingly worried about the regulatory overhang engendered by such legislation as the Dodd-Frank financial regulation, the uncertainty surrounding Obamacare and the EPA's attempts to legislate change through its rule making powers.

The Dodd-Frank legislation while well intentioned, is a classic case of "be careful what you wish for"! Indeed, under the scope of the Dodd-Frank legislation, both the Federal Reserve and the SEC are being tasked with making thousands of rules and then to implement these changes – despite the fact that neither agency has received any additional funding as a result of these onerous changes to their remit.

In addition, the Federal Reserve's announced intention to end its QE 2.0 program on schedule at the end of June is also adding to the uncertainty. Market participants are flummoxed as to what could potentially replace QE 2.0 – given the unusual support that this program has provided US Treasury instruments.

While it is quite clear that the Fed is unlikely to be in a big hurry to shrink the size of its balance sheet (currently around $2.8 Trillion at last count!), the pace of the inevitable shrinkage and its attendant impact on interest rates and the yield curve are creating more uncertainty. Market participants continue to try to decipher clues as to the Fed's next moves from speeches as well as minutes of the FOMC meeting – and such clues have been hardly forthcoming. To coin a phrase, the "silence has been deafening"!

The ongoing debate (or lack thereof) with regard to the debt ceiling in the US has also caused much uncertainty. The Treasury has made it abundantly clear that its authority to borrow additional dollars will reach its limit (the proverbial debt ceiling) on August 2nd, 2011. The heightened rhetoric and posturing ahead of the debate to raise the debt ceiling is obviously causing justifiable angst among market participants.

The Administration has not helped its own cause in this debate by appearing to be quite partisan. While the extremes of the political spectrum have staked out their respective positions on this debate, it is ironic that the rhetoric in Washington has gotten as vituperative as it has in the recent past. The irony is that most of the "good" that Washington has been able to achieve typically emanates from the middle and the current atmosphere of polarization leaves little room for compromise.

Farther afield, the European fiscal crises rolls on: Reports of a new bailout package for Greece in exchange for additional austerity measures abound; there is no question in our mind that the first set of measures relating to Greece were both ill-conceived and badly executed. It is hard to visualize a way out for a country like Greece whose leaders appear to have created a fiscal mess over many decades. It is obvious that this is going to take some time to solve.

Jean Claude Trichet, the President of the European Central Bank has called for a Europe wide finance ministry that would have responsibility for ensuring adherence to fiscal targets by countries that receive assistance from the European Financial Stability Fund. Essentially, what Trichet was suggesting – a uber finance ministry - is a non-starter, as this would imply giving up on some of the sovereign rights that delineate a country's powers.

Equity markets have therefore struggled to make any headway recently given all the uncertainty. Indeed, even as corporate earnings continue to show healthy gains, equity markets have labored under the stress of all the uncertainty. Interest rates have declined sharply on worries that the loss of momentum in the economy might be more systemic and longer lasting. Given the low level of interest rates, we see little value in Treasury instruments over the medium to longer term.

Commodity markets continue to remain volatile: Crude oil prices have declined slightly on worries about declining demand, but political uncertainty premiums as a result of the risk of supply disruptions from the Middle East continue to keep prices higher. With the advent of June and the US Gulf Hurricane Season, we suspect that energy markets are likely to see further volatility during the summer.

In summary, financial markets appear to be driven by uncertainty with regard to the outlook for both monetary and fiscal policy. However, we remain cautiously optimistic on the longer term outlook. 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.

This report was prepared by
Suresh Raghavan, CFA & Bryce Eakin, CFA
Raghavan Financial, Inc.
4400 Post Oak Parkway, Suite 2210
Houston, TX 77027

www.raghavanfinancial.com

For further information please contact us at
Voice: 832.667.8787
Fax: 281.974.2108
Email: contactus@raghavanfinancial.com

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