Outlook for June, 2012: "Approaching a tipping point?…"

The European fiscal crisis appears to be approaching a dangerous phase: With elections slated for next weekend in Greece, and Spain garnering headlines every day, the sense that we might be approaching a tipping point for the fiscal crisis in Europe is palpable. And yet, despite all the uncertainty surrounding the outlook, the fundamentals for investing remain reasonably positive over the medium to longer term (for after all, the laws of supply and demand have yet to be repealed!).

Economic data released recently suggest strong headwinds still remain: The monthly non-farm payroll report from the U.S. Department of Labor showed an increase of 69k jobs in May (private payrolls +82k and public payrolls -13k), falling well behind the first quarter monthly average of 226k. Markets reacted negatively to the news as the number came in well below consensus expectations around 150k. Job growth among sectors showed transportation and warehousing (+36k), health care (+33K), wholesale trade (+16k), and manufacturing (+12k) in positive territory, while construction (-28k) has seen little growth since hitting bottom in 2009. If that wasn't enough, March (154k to 143k) and April (115k to 77k) were also revised downwards for a net loss of 49k.

The household survey showed a marginal rise in the unemployment rate to 8.2% from 8.1% a month earlier. The rate excludes 2.4 million people that did not search for work in the 4 weeks preceding the survey; the labor participation rate is at a fairly low 63.8%. Long-term unemployment (comprised of those jobless for 6 months or more) rose to 5.4 million, representing 42.8% of the unemployed (previously 41.3% in April). The U-6 measure, which we view as a more realistic picture of unemployment, was up to 14.8%in May from 14.5% in April, and is down a mere 1% over the past year.

The Bureau of Economic Analysis of the Department of Commerce released their second estimate of 1Q GDP at 1.9% (q/q, saar), a downward revision from an initial estimate of 2.2%. The 1Q GDP certainly appears to imply a slowing in growth momentum relative to the 3.0% GDP growth for 4Q2011. Declines in inventory investment and state and local government spending contributed to the downward revision.

On a more positive note, the ISM Purchasing Managers Index continued to remain in expansion territory. We are encouraged to see a robust monthly growth rate in the new orders index of the ISM report. Inventories have become quite lean as sales gains have led inventory purchases, suggesting that a restocking could well be in the works. After-tax corporate profits edged higher in the first quarter of 2012 to settle at $1.669 trillion annualized. This represents an increase of 14.7% on a year/year basis – a healthy gain by any calculus.

Data out of Europe suggests that growth might be slipping there as well: Euro-Zone GDP for 1Q2012 was pegged by EuroStat at 0.0% (q/q; y/y: -0.1%). Indeed, given the forced austerity being imposed on some of the countries in Europe (Greece, Italy and Spain to name a few), it is a surprise that we have not seen more negative growth numbers. German Industrial production slipped in April to -2.2% (m/m; y/y: -0.7%) and factory orders in Germany retreated -1.9% (m/m; y/y: -3.8%) in April.

Since early 2009, we have seen markets exhibit a "risk-on, risk-off" pattern with several mild corrections interspersed with reasonable up moves. What remains a feature is how sharply the market appears to react to the smallest bit of negative news coming out of Europe or elsewhere. If you consider that yields on ten year US Government securities and German Bunds have hit historical lows, it becomes apparent that at its core, this is a crisis of confidence.

German government two year notes are currently trading at a ***negative*** yield to maturity: This suggests that some market participants are clearly in panic mode – willing to accept negative returns at the outset in order to be assured of return ***of*** capital rather than return ***on*** capital. While this might appear to be strange from a normal investment standpoint, we do believe that all the uncertainty coupled with the singular lack of safe-havens is responsible for this state of affairs.

Markets have also reacted to polls coming out of Greece on the impending elections on June 17th. While the Syriza party led by Alexis Tsipras (who is in favor of abrogating the European funded bail-out) was in the lead earlier, it now appears that the New Democracy party led by Antonis Samaras (who is more Euro centric in his approach and views) might be leading. Voter fatigue might indeed be setting in as well, since this is the second election to the Greek Parliament in about six weeks. The failure of a single party to garner a majority (or even its inability to form a coalition government) could reset the clock for another election – a dreadful outcome – as it would lead to further uncertainty.

The leaders in Spain also managed to botch the cleaning up of some of the bad loans at the Cajas – the housing mortgage lenders. In essence, the Spanish government created a "bad bank" called Bankia – which would then acquire all the troubled loans from the various lenders and "work-out" the loans over time. However, instead of funding Bankia directly, the Government of Spain tried to use a back-door way to access funding from the European Central Bank (by pledging Government debt which was essentially given to Bankia by the Government).

The ECB put paid to this scheme leading to Bankia filing for bankruptcy and significantly raising the size of the bail-out needed to recapitalize mortgage lenders. Indeed, with yields on Spanish government bonds climbing above 6.6%, the capital markets window might now be starting to close for Spain. In addition, it is obvious that Spain is not Greece; Spain is the fourth largest economy within the European Union and the entire region could ill afford further crises in Spain.

Many commentators have suggested that some form of Pan-European deposit guarantee system for bank deposits along with recapitalizing the banks in Europe would solve the fiscal crisis. In turn, individual countries would then surrender their fiscal sovereignty to a higher authority in Brussels for issuance of common Euro-bonds. We are of the opinion that Europe's labor rigidities along with the structural issue of governments promising benefits to their populations that they could ill afford to meet are fundamental to the crisis and unless this is resolved, we do not see much light at the end of the tunnel.

Closer to home, Governor Scott Walker of Wisconsin created history of sorts by becoming the first ever Governor to win a recall election: The vituperative nature of the recall campaign and the outsized influence of money from outside of the Badger state was nothing but a harbinger of the Presidential campaign this fall. Indeed, Governor Romney of Massachusetts won the Republican primary in Texas, thus securing his party's nomination for the Presidency this fall.

We do expect much mud to be slung as part of the campaign and several undisguised attempts at obfuscating the truth: For after all, this is politics we are talking about, where the players all hew to the line of "Don't let the truth get in the way" to paraphrase the song by Gaellic Storm! Looking at a state by state breakdown of Electoral College votes, it really comes down to four pivotal states: Florida (29 votes), Pennsylvania (20), Ohio (18) and Michigan (16). Much will be made of the choice of Vice President on the Republican side as well as the negative advertising put out by each candidate (and his surrogates), but at the end of the day, this is likely to be the most expensive political campaign ever waged.

US interest rates have plumbed new lows across the yield curve as money flows into perceived "safe-haven" assets. While inflation remains quiescent (for now), we still believe it is quite foolhardy to lend money to anybody (including uncle Sam) at 1.50% per year for any length of time (let alone for ten years!) given the other potential opportunities for higher returns in other asset classes.

The reality is that no matter the market environment, there will always be something to worry about. We will always be "entertained" by the news media and their ability to create fear in the minds of many. But let's not forget that America is the land of opportunity and the world's greatest innovator. Innovation and technology combined with the spirit of American entrepreneurship will bring us out of this rut; stronger leadership and a little less government intervention in the private sector would no doubt speed up the process as well.

In summary, we continue to position your portfolios with some optimism about the medium to longer term. While our worries about politics and policy uncertainty remain in the forefront, we do feel reasonably positive about the longer term prospects for financial markets. 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 steadfast.

This report was prepared by

Suresh Raghavan, CFA and Clark Blackman III
MBR Financial, Inc.
2000 West Loop South, Suite 1510
Houston, TX 77027

www.mbrfinancial.com

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

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