Outlook for March, 2011: "Exogenous Events…"

The term "exogenous" comes from two Greek words "exo" and "genis" meaning "outside" and "generated" referring primarily to actions coming from outside a system. In this context, the phrase further underlines our long held belief that events outside our sphere of influence are likely to have a larger than life impact on outcomes – particularly in an increasingly globalized world! Clearly, events in the Middle East fall under this purview and continue to bear (pun intended!) watching.

The US economy added 192,000 jobs in February, largely in line with expectations, and a pleasant increase from the paltry 63,000 jobs created in January. Additionally, the figures for December and January were both revised upwards, by 31,000 and 27,000 jobs respectively suggesting that the labor market was gaining significant momentum. Professional and business services (+47k) and education and health services (+40k) were the main beneficiaries, with the government sector (-30k) and information (0k) being the main laggards.

The widely watched unemployment rate declined slightly to 8.9% in February, the first reading below 9% since April of 2009. The wider measure of unemployment and underemployment (called the U-6 measure) posted a decline of two tenths to 15.9%. Despite this month's decline, we suspect that the unemployment rate is likely to remain stuck at a stubbornly high level for many months to come – as more discouraged and marginally attached workers start looking for work again, thus biasing the rate upwards and masking the steady but gradual improvement in the employment picture.

In other economic data, the Institute of Supply Management's manufacturing and services reports continue to indicate a healthy recovery is underway for businesses. However, the prices component of these indices indicates that significant inflation pressures may be beginning to build below the surface. Though final goods inflation seems quiescent for now, we will be keeping a close eye on the inflation picture over the coming months for any signs that inflation may unexpectedly pick up leading to further dislocations in financial markets.

Events in the Middle East continue to bear watching: We would characterize the changes in Tunisia and Egypt as changes in leadership, rather than a change in the underlying regimes, and therefore unlikely to create any policy surprises that could have noteworthy economic or market implications. Libya on the other hand, appears to be rapidly devolving into a state of civil war thus putting upward pressure on crude oil prices.

From a purely economic perspective Libya is a fairly isolated and marginal player, and produces only about 1.8 million barrels per day of crude, which is mostly exported to Italy. That level of production could probably be made up for by increased production in Saudi Arabia and elsewhere, and so even if Libya's production went completely offline, the effect on markets should be fairly muted – despite the fact that Libyan Crude tends to be low in sulphur and the "sweet" variety as opposed to the "sour" variety.

In our opinion, similar protests in places like Oman and Bahrain have larger implications for global markets than the events in Libya. Indeed, if the Sunni regimes in Oman and Bahrain have to compromise with their larger Shia dominated populations, this could clearly embolden restive populations in other countries in the region - like Kuwait, Saudi Arabia and even Iran – having a real destabilizing influence in the region as a whole.

The global crude oil market is worried about the prospect of supply disruptions from the Middle East. In addition, a wider than usual gap between the prices of two benchmark crude price indices - Brent and West Texas Intermediate – makes for difficult market analysis. West Texas Intermediate prices are being affected by excess storage at Cushing, OK, which biases prices downwards. Further, the mix of crude oil used by refineries in the US tends to be driven more by the price of Brent, thus making prices at the gasoline pump all the more volatile.

Higher crude oil (and therefore gasoline) prices act very much like a tax on consumers of energy. Estimates on the impact of higher crude prices differ widely - from reducing GDP by 0.2% to 0.3% for every $10 per barrel of increase in crude oil prices. Nonetheless, the price elasticity of both crude and gasoline are not fixed (nor are they linear) and this makes for some very interesting econometric modeling.

Recent events in the Middle East and North Africa have taken the focus off of Europe's fiscal troubles for the moment, giving it much needed breathing room. Numerous central banks around the world have begun the cycle of raising interest rates, with the European Central Bank most recently indicating that it may be on the verge of its first rate hike. Significant rate hikes by the ECB could put paid to some of the calm that the European periphery has witnessed recently.

Expectations that the ECB will be the first among the big three to tighten monetary policy has certainly put downward pressure on the US Dollar - particularly against the Euro. While the latter's fiscal problems are well known, we suspect that the USD might come under further selling pressure until such time as market participants feel that the Federal Reserve is going to tighten monetary policy in earnest.

Minutes of recently held Federal Open Market Committee meetings of the Federal Reserve as well as recent speeches by bank Presidents and Governors suggest that the Fed continues to focus on the risks of deflation and "unacceptable" labor market outcomes. It appears to us that the Fed has painted itself into a corner and they have no choice but to finish the entire dose of the so called QE 2.0 of $600 Billion which is set to be completed in June, 2011.

Prices of precious metals – primarily Gold and Silver – continue to be driven higher by excess global liquidity as well as ongoing worries about events in the Middle East. While it is hard to determine "fair value" for commodities when prices are driven by considerations other than mere supply and demand, we continue to be amazed by statements from the Fed that their actions have not led to the recent increases in prices of precious metals.

Equity markets have witnessed increased volatility despite better than expected earnings results for 4Q2010. The previously worrisome bullish sentiment appears to have corrected itself fairly quickly on weekly sentiment readings thus pointing up the bipolar nature of sentiment among market participants, further underlining the various cross currents in vogue. Regardless, we would characterize valuations as "relatively moderate" using an expression made famous by none other than the former Chairman of the Federal Reserve Alan Greenspan.

Interest rates have also seen increased volatility – rising as better expectations for growth brought on inflation worries only to fall as a "flight to quality" bid appeared following the events in the Middle East. We continue to cast a wary eye toward implied inflation differentials between nominal interest rates and inflation protected securities with a view to discerning any deterioration in inflation expectations going forward.

In summary, despite the recent volatility we remain cautiously optimistic on the outlook for financial markets: Exogenous events outside our sphere of influence are likely to have a larger than life impact on expected asset and portfolio returns over the medium as well as 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.

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