Outlook for May, 2010: "Continued Cross-currents…"

The outlook for financial markets remains clouded by widespread cross-currents: Economic growth and earnings fundamentals remain supportive of higher equity prices, but dramatic shifts in sovereign debt outcomes continue to cloud the outlook. The campaign by Europe to stabilize the beleaguered Euro raises the issue of whether it is a sufficient and necessary condition for economic recovery. Time will tell whether the "all-in" bet made by the European authorities will indeed be a paradigm shift or whether this too could lead to heightened expectations only to be dashed by a case of cold, hard reality.

The US economy added a greater than expected 290,000 jobs during the month of April with most sectors witnessing widespread gains. Leading the pack were professional and business services (+80k), government (+59k) and leisure and hospitality (+45k). The only two sectors that reported job losses were trade, transportation and utilities (-3k) and information (-3k). The politically sensitive unemployment rate (U3) rose by two-tenths to 9.9% as did the measure of under-employment (U6) to 17.1%.

Professional and business services have now posted job gains for the past twelve months as a whole – a significant turnaround from previous readings of this sector. Many of the other statistics found in the payroll report including those on earnings and hours worked appear to suggest that the labor market is slowly but surely working its way back to "normality". While we continue to expect the unemployment rate to remain stubbornly high – given discouraged workers and the long term unemployed – we do feel that this report contains some kernels of strength that bear watching.

The US economy also posted a GDP growth rate of 3.2% (seasonally adjusted annual rate) during 1Q2010 – slightly below our expectations. While housing remains challenging (-11.0% saar), consumer spending witnessed a nice rebound (3.6%, saar) as did the investment in producers' durable equipment (+13.4%, saar). Government spending contracted (-1.8%, saar) mostly as a result of sizable cutbacks in state and local government spending (-3.8%, saar). All in all, we would not at all be surprised to see an upward revision to the GDP figures during the coming weeks.

Plenty of other readings on the economy including the Institute of Supply Management's manufacturing as well as the more recent series (the non-manufacturing index), appear to suggest that order books are looking better and the "Great Recession" is clearly behind us. Indeed, in looking at the monthly data it appears to us that the nadir in economic activity might well have occurred sometime during last summer. The business cycle dating committee of the National Bureau of Economic Research (NBER) the ultimate arbiter of such things did meet but could not come to a consensus on whether the recession had ended. We do expect that the pronouncement (regarding the end of the recession), when it does occur, will clearly be the worst kept economic secret in recent memory!

Meanwhile, US corporate earnings continue to surprise on the upside: For 1Q2010, of the 447 companies in the S&P500 that have reported earnings so far (89% of the total), 344 (=77% of those that have released earnings) have exceeded expectations, and 36 (=8.0%) have met expectations. In other words, a full 85% of the companies that have released quarterly earnings figures have either met or exceeded expectations. Also, the reported earnings so far imply a gain for the S&P500 of $19.74 per share during 1Q2010 – putting the consensus expectation for 2010 of $75.00 per share easily within reach. These figures do appear to be supportive of higher equity prices over the medium to longer term.

The Federal Reserve for its part maintained the target range for the federal funds rate between 0 to ¼ percent at the FOMC meeting held in late April. The Federal Reserve chose to leave the "extended period" language in the statement released after the meeting – seeking to assure (and re-assure) market participants about their conduct of monetary policy. We believe that the Federal Reserve will, in all likelihood, de-emphasize the federal funds target as an instrument of monetary policy as it tries to remove the accommodative stance of monetary policy in the distant future. The Federal Reserve might also start paying interest on reserve balances kept at the Fed as a first step to doing so later this year or even early next year.

Interest rates have remained volatile: US rates fell significantly in the wake of the Greek debt crises – as market participants rushed to the safety of fixed income instruments - but then backed-up as risk aversion took a back-seat in response to the Euro rescue package. While we expect rates to remain low in the near term, our operating assumption is that considerably higher interest rates are likely to be a feature over the medium to longer term.

Farther afield, the deterioration in the outlook for sovereign debt – particularly in peripheral Europe – with Greece leading the way has been startling for many investors. While the crises in Greece have been brewing for many years, it all appears to have come to a head with a spectacular widening in yield spreads of Greek debt across the entire yield spectrum relative to those of Germany. In addition, with Greece needing to issue sizable debt in the capital markets, it has become abundantly clear to many market participants that Greece needed external support as well as a commitment to fiscal reform – primarily through austerity measures promulgated by the Greek Government.

A downgrading of Greek debt appears to have set-off the proverbial powder keg – necessitating a rescue package of €110 billion from the other European governments. While speculation abounds as to who could be next to need a rescue the Euro currency has seen a significant decline in value particularly against the US Dollar and the Japanese Yen. The Euro’s swoon on the currency bourses – while acting in part as a translation mechanism for the deteriorating credit quality of sovereign borrowers within the Euro zone – has been deemed as questioning its very existence from a longer term perspective.

Indeed, Greece and many of the beleaguered nations have opted instead to shore up their currency by a substantial show of force – through an impressive package of €750 Billion (about $960 Billion) voted on this past weekend. While impressive by its size alone, such an “all-in” move certainly manages to raise the overall stakes. We are not at all clear that such a package will do much to provide longer term stability to a currency whose fundamentals raise important questions about political will and trust amongst the nations that make up the currency.

The dramatic events witnessed in the US equity market last week also underscore the fragile nature of multiple order fulfillment systems. As widely reported, the Dow Industrials appeared to be in free-fall last Thursday (May 6th) losing almost 1,000 points during a mere half hour in the afternoon only to recover a majority of the declines within the next hour. While the sizable rise in volatility is quite alarming, what is even more disconcerting is that there does not appear to be a coherent explanation for this move in the markets even as of this writing.

It appears that while the New York Stock Exchange went into a self-imposed “slow” mode as a result of the dramatic price swings, many of the electronic crossing networks (ECNs) that are now a common feature of trading did not do so leading to a big disparity in prices. The political uncertainty because of the Greek debt crises and the UK elections did not help matters either. Regardless, we expect that much will be written about and debated on these price swings and we would not even be surprised to see legislative changes emanating from the Congress as a result of this episode.

In summary, we would characterize our outlook as cautiously optimistic: Equity markets appear to have an upward bias. Financial market volatility has returned with a vengeance and is likely to stay. Our abiding faith 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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