Outlook for May, 2011: "Ongoing Cross-Currents…"

Global financial markets continue to be buffeted by various cross-currents of higher energy prices, rising inflation in the emerging world, loss of momentum in the US economy but stellar corporate earnings, as well as a counter-terrorism triumph for the "good guys" this past month. Indeed, the various cross-currents make for an unusually uncertain outlook in the near to medium term.

Non-farm payroll employment in the U.S. rose by a healthy 244,000 in April. The private sector added 268k new jobs, led by retail (+57k), leisure and hospitality (+46k) and health care (+37k), while state and local governments were the biggest drag on job creation with a combined loss of -22k. In addition, the total jobs added for February and March were revised upwards, by 41k and 5k respectively.

Other measures of labor market strength, such as hours worked, hourly earnings, and weekly earnings, were either unchanged or slightly positive. The widely followed unemployment rate increased slightly from 8.8% in March to 9.0% in April. The U-6 measure, a broader measure of labor un- and under-employment, also increased by two-tenths to 15.9%.

Despite this slight weakening, it is important to remember that these measures both indicate notable improvement from a year ago, when the unemployment rate stood at 9.8%, and the U-6 rate was 17.0%. All considered, the labor market continues to heal slowly, albeit not at a pace that is likely to return the economy to full employment any time soon.

The Bureau of Economic Analysis released its advance estimate of GDP growth for the first quarter at 1.8% (seasonally adjusted annual rate). Though somewhat weaker than the previous quarter (3.1%), private sector growth was broad based; personal consumption expenditures grew 2.7%, private non-residential investment increased 1.8%, exports increased 4.9%, though largely offset by imports which grew 4.4%.

The major detractor to growth in the first quarter was government, with the federal government decreasing 7.9%, and state and local declining 3.3%. Given that this is an advance estimate, these numbers are subject to substantial revision (an average of 1.3% historically), and we expect that first quarter GDP will be revised upward modestly as more data becomes available.

Survey data in April were somewhat more mixed; the ISM manufacturing and non-manufacturing surveys continue to indicate expansion, though both point to some loss of momentum. The NFIB's small business survey fell slightly, driven by a decline in the percent of owners expecting higher sales in six months as compared to March. In general, business optimism seems to have receded somewhat, likely driven by rapidly rising input costs and continued policy uncertainty.

Inflation pressures, in aggregate, remain contained for the time being with core CPI rising only 1.2% over the past year. Stubbornly high unemployment has limited the ability of workers to bid up wages in the face of an increase in the cost of gasoline of 27.5% over the past year, and rapidly accelerating food prices (3-month annualized increase of 7.5%). These cost increases have clouded the outlook for economic growth, and we will certainly continue to keep a close eye on inflation going forward.

Meanwhile, the Federal Reserve at its FOMC meeting in late April, held the Fed Funds Target unchanged at 0-0.25%. The FOMC released their Statement earlier in the afternoon to much fanfare as it was followed by an epoch making press conference by Fed Chairman Bernanke. Gone are the days when "Fed Watchers" had to decipher the Fed's actions by looking at arcane moves in the securities repurchase markets.

The FOMC essentially took a page out of the ECB's playbook with the Chairman of the Fed holding a press conference to further clarify their current stance on monetary policy. Chairman Bernanke bobbed and weaved successfully as he parried questions put to him by a live audience of journalists. Indeed, while sometimes being blunt, Chairman Bernanke took pains to explain the uncertainty in the outlook and implied that the path of monetary policy would depend very much on the evolution of economic data.

The Chairman also set about explaining the FOMC's central tendency forecasts for the medium to long term, where members lowered their growth expectations slightly (by about 0.3% for 2011) and also upped their forecasts for headline inflation (by 0.8%), while also slightly raising their "core" PCE inflation forecasts. All in all, the changes to the forecasts in April suggest that the Fed is unlikely to be in a hurry to tighten monetary policy anytime soon.

As expected, the Fed will likely end the so called QE 2.0 program next month once they have completed their purchases of $600 million of additional Treasury securities. While the Fed is unlikely to add to that cache after June, Chairman Bernanke made it quite clear that the Fed would be actively redeploying funds that accrue as a result of maturing Treasury issues.

Elsewhere, the Greek tragedy (pun intended) continues: Standard and Poor's announced a cut of two notches in Greece's sovereign debt rating to a "B", from an earlier "BB-" rating – thus validating what the markets had already been pricing in. Greek two-year instruments currently yield an outsized 25.0% with the ten-year yield rising as high as 15.6% providing a spread of 1,250bp (a basis point is one hundredth of a percentage point) to the benchmark German Bund.

These events make it abundantly clear that the fiscal situation in Europe is unlikely to go away – no matter the size of the European Financial Stability Fund (EFSF). Many of the fiscal problems in peripheral Europe are intractable and do not therefore lend themselves to an easy solution. We suspect that the appetite for continuing to write checks among the German populace is now declining at a rapid pace – as earlier attempts to simply throw Euros at the problem have come to naught.

Commodity prices continue to witness much volatility – perhaps as a result of forced hedge fund liquidation. While moves in crude and industrial metals have been significant (on the order of 10% last week), Silver certainly takes the cake – posting a decline of over 25% in a single week alone. We suspect we will learn more about these price moves as time goes on.

A successful incursion by a SEAL team into Pakistan resulted in the killing of the notorious Osama Bin Laden. While the psychological boost from gaining such a scalp alone is important, it does place into sharp relief some of the ongoing issues in counter-terrorism. This does not mean that the "good guys" have been able to completely uproot terrorism – nor does it mean that the scourge of state sponsorship of terrorism is likely to meet a premature demise.

Clearly, the Pakistani Government has some "explaining to do". Claims that the Pakistani authorities were unaware of Bin Laden being present in Abbottabad, ring hollow – as he was found to be living within stone's throw of that country's military college. In addition, it is well nigh impossible for a foreign national to acquire land and then build a fortress like compound without the authorities knowing about it. Any way you slice it, Bin Laden appears to have had some "friends in high places".

In summary, financial markets appear to be in the throes of many cross currents, but 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.

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