***Outlook for May, 2012: "All politics is local!…"***

With equity markets taking a pause as they focus on politics (and elections), we couldn't resist the urge to quote the former Speaker of the US House of Representatives Tip O'Neill who is reputed to have quipped "All politics is local". Indeed, as elections are held in many countries (France, Greece, Germany and the US later this year), voters appear to be casting their ballot based on their local preferences rather than for the larger common good leading to interesting implications for markets around the world.

Economic data of late appears to be signaling caution ahead: The U.S. Department of Labor's monthly employment report showed an increase of 115k jobs in April (private payrolls +130k and public payrolls -15k). The outcome disappointed consensus estimates of 165k and recorded the smallest increase since October of last year. Sector analysis showed professional and business services (+62k), education and healthcare (+23k) and trade, transportation and utilities (+22k) as the main gainers. Government (-15k), construction (-2k) and other services (-2k) were the laggards. Figures for February (240k to 259k) and March (120k to 154k) were revised upwards for a net gain of 53k.

The politically sensitive unemployment rate, as part of the larger household survey, dipped 0.1% to 8.1%. While it is encouraging to see this statistic trend down, it is important to look at the cause. Market pundits and Street analysts emphasize that the unemployment rate fell primarily because of a 342k reduction in the labor force. Also consider that 2.4 million people were left out of the household survey because they had not searched for work in the 4 weeks preceding the survey (those considered "marginally attached"). The labor force participation rate is now at 63.6%, from 64.2% a year ago – not a good trend from an overall labor market standpoint.

Long-term unemployment (comprised of those jobless for 6 months or more) was mostly flat at 5.1 million, representing 41.3% of the unemployed (previously 42.5% in March). The U-6 measure, which we view as a more realistic picture of unemployment, was flat m/m at 14.5% - a marked improvement from 15.9% a year ago. What all these numbers tell us is that we are in a period of slow growth. The duration and speed of this recovery is unique in that it has contrasted from more recent cycles. Unfortunately, in today's world, there are forces at play that have created significant "fault lines" in the fabric of our globalized domestic economy.

The Bureau of Economic Analysis of the Department of Commerce released their initial estimate of 1Q GDP at 2.2% (q/q, saar), with year/year GDP up 2.1%. While the number disappointed expectations of a 2.5% rise, positive growth in inventories, final sales, and personal consumption expenditures (durables and housing) provided a boost to sentiment. Weak readings on business investment, nonresidential construction, and government spending provided some talking points for those expecting an anemic recovery.

The ISM manufacturing report came in notably positive, a contradiction to recent regional reports that the manufacturing sector was slowing down. Destocking of inventories suggest further growth in the sector in subsequent periods as inventory will need to be replaced. The ISM report on the non-manufacturing side was a little less upbeat, although continued growth in the sector appeared to be the outlook from this survey as well. Indeed, an unseasonably warm winter in the US along with expiring depreciation tax credits in 2011 has conspired to pull forward demand from future months. A payback for this - resulting in slower than expected growth - certainly seems due in the second and third quarter of this year.

Events in Europe have dominated headlines lately: The French electorate voted to oust Nicolas Sarkozy from the Élysée palace in favor of Francois Hollande from the Socialist party, thus throwing a spanner in the works when it comes to the future of the European fiscal compact agreed to last October. Francois Hollande campaigned on a platform of favoring a "growth component" to the austerity plans in France (whatever that means!). It is hard to ignore the fact that government austerity typically begets ***less*** growth and it is quite impossible to boost growth in a country without structural reform – especially one that has an outsized fiscal deficit.

Greece also went to the polls this past weekend and it is quite obvious that here too the results indicate a general fatigue with austerity and a preference for local governance rather than a pan-European legislated fiscal policy! This is classic: Populations have for too long gotten used to largesse from governments and are now finding it difficult to give up their goodies – especially since the selfsame government has no way to pay for the goodies given its already bloated deficit and debt load. We do think this trend bears watching as the fiscal outcomes from lack of austerity in Greece, Spain and Italy are too hard to even contemplate without also talking about the fate of the single currency in the region.

German voters in the northern state of Schleswig-Holstein also voted to turf out Chancellor Angela Merkel's Christian Democratic Union (CDU) party along with their coalition partner the Free Democrats (30.6% of the total votes). However, the opposition Social Democrats and the Green party coalition could only muster 29.9% of the vote, thus leaving the state with no coalition able to declare victory.

Despite talk of a "grand coalition", in Schleswig-Holstein, markets are likely to watch the elections next week in North-Rhine Westphalia (May 13th), Germany's most populous state. A loss there, would certainly put paid to Ms. Merkel's chances of hanging on to power and by implication also call into question the future of the fiscal compact for the entire European continent as well as that of the Euro. Amidst all this, the European Central Bank appears to be suggesting that it has done all it can from a monetary policy perspective.

The election battles in the US appear to be well and truly joined with speeches by President Obama in battle ground states of Ohio and Virginia – both of which he won in 2008 – trying to define Romney's policies (as well as his personality) for the electorate. It is quite obvious that the President would rather not talk about his economic achievements – since there are more entries in the debit column than in the credit column here. Regardless, it is too early to focus on opinion polls at this early a stage in the cycle.

We are in for a long and arduous Presidential campaign (the Democratic Convention concludes well after Labor Day), one that is likely to turn nasty with lots of mud being slung by both the contestants as well as their surrogates. Indeed, 2012 is likely to end up being one of the most expensive election campaigns in recorded history. At this point it certainly looks like it is Obama's to lose, although outcomes from the Congressional elections – for both the House of Representatives and the Senate – are also likely to determine the nature of policy over the next few years.

A word on earnings: With 428 companies in the S&P500 (=85.6%) having reported earnings so far for 1Q2012, earnings have climbed 6.8% compared to 1Q2011 on a share-weighted basis. Of these, 273 (=63.8%) of the companies had positive earnings growth, 14 (=3.3%) had unchanged earnings and the balance 141 (=32.9%) had negative earnings growth. Relative to expectations, 285 (=66.6%) companies beat expectations, 42 (=9.8%) met expectations and 101 (=23.6%) failed to live up to expectations. Overall, the S&P 500 companies posted a per share earnings of $25.52 which is an impressive run rate of $102.08 for the entire year.

In other words, despite all the uncertainties (tax policy, elections, monetary policy activism, slowing in China, Europe's fiscal mess, the list goes on and on), US corporations appear to be in good shape and performing well. It goes without saying that if US companies kept up their recent performance, equity markets could certainly surprise investors on the upside. We do worry about the risk of peak margins – that corporate margins are at a peak and to therefore assume peak margins for the entire cycle is foolhardy – but do feel that margins are unlikely to be pressured by rising wage demands or other such internal causes.

The ongoing dichotomy between prices of crude oil and natural gas continue: While crude oil appears to be responding to worries about a supply disruption from the Middle East, natural gas continues to plumb new lows in price. New drilling techniques, an abundance of shale gas as well as a host of other factors have contributed to the relentless decline in natural gas prices. Longer term, we continue to feel that cleaner burning natural gas has to represent part of the solution for the US' energy independence issues. Switching to natural gas for a variety of uses – including power generation as well as transportation – is, in our mind, likely to be a natural (pun intended!) outcome of the realities of energy infrastructure.

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, we do feel reasonably positive over the medium to 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.

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