Outlook for November, 2011: "If it is Tuesday, this must be Belgium…"

With all eyes focused on Europe, the title of the tourist movie (from 1969) aptly summarizes the whirlwind diplomacy, ad-hoc policy making and the intense nature of negotiations with regard to the future of the Euro. Indeed, as events evolve, our worry is that market participants may not fully appreciate the real risk of a train wreck coming out of Europe.

Recently released economic data have been mixed: The U.S. economy added 80,000 jobs in October. Data for the months of September (103k to 158k) and August (57k to 104k) were revised upwards with a net gain of 102k. Private sector payrolls continued to lead the charge in October, posting a gain of 104,000 while the beleaguered government sector continued to lose jobs. Among the sectors, health care (12k), leisure and hospitality (22k), and professional and business services (32k), posted gains with manufacturing remaining relatively unchanged and construction (-20k) and government (-24k) shedding jobs.

The politically sensitive unemployment rate edged fractionally lower to 9.0% from 9.1% a month earlier. Further highlighting the bleak employment picture was the fact that 6 million people (a marginal decrease from 6.2 million last month), have been jobless for 6 months or more, representing 42.4% of those unemployed. What continues to be evident is that unemployment will likely remain stubbornly high for an extended period of time as job growth, although positive, is not large enough to substantially bring down the unemployment rate.

The U-6 measure, considered a broader measure of unemployment, edged lower from 16.5% to 16.2%. The employment situation remains a black eye for political leaders and the Federal Reserve. Ben Bernanke recently forecasted that unemployment will likely hover around 8.6% at the end of 2012. What this means for the 2012 elections remains to be seen.

The U.S. Department of Commerce released its "advance" Third Quarter real GDP estimate at 2.5% (Seasonally Adjusted Annual Rate), a healthy rise from second quarter's final estimate of 1.3%. Growth in the personal consumption expenditures component (0.7% to 2.4%), nonresidential fixed investment (10.3% to 16.3%), and exports (3.6% to 4.0%), largely contributed to the quarterly rise in GDP. In spite of all the "doom and gloom" perpetuated by the media, it is a positive sign that real GDP actually increased over last quarter.

The on-again off-again nature of torturous negotiations to keep the Euro in its current form has clearly taken on a tragedy of Greek proportions (pun intended!). Talks among European nations continued into the wee hours of the morning before all the bankers agreed to a "voluntary" haircut of 50% in the price of Greek debt. Most equity markets reacted with joy on the news and the euphoria clearly appeared to spill over into the US as well.

Subsequently, claims by Greek Prime Minister Papandreou that he would seek a referendum on the deal from the Greek population appeared to scupper much of the optimism. As it turns out, this was a mere ploy to get the opposition party to sign on to the deal as well. At the time of writing, it appears that Greece might be forming a "national unity" government – which then presumably avoids further embarrassment to the other Europeans who were part of the original negotiations.

While Greece might just be able to find its way out of the crisis – after these on-again off-again talks, the focus now shifts to Italy. Italy is in the middle of passing further fiscal austerity measures amidst higher yields for Government bonds and an unsustainable fiscal regime. It is quite obvious that Italy cannot merely grow its way out of the problem – given the intransigent nature of its economy. Also, at current yield levels it becomes increasingly difficult for Italy to continue to service its debt as well.

Furthermore, leaders in Ireland and Portugal are, we are sure, watching these developments with a wary eye – particularly as they have had to make some unrealistic promises relating to fiscal austerity for their respective nations. Obviously, the story with regard to Ireland, Portugal and even Spain is yet to be told and we feel that the populations of these countries would also want similar "benefits" like those accorded Greece or Italy – simply because every country would rather take the easy way out!

The fundamental problem with the Euro is that an exit of a member from the Euro was never contemplated at its creation. A removal of a country like Greece or Italy from the Euro is likely to be quite messy and is fraught with logistical issues relating to having currency available and ensuring an appropriate exchange rate between the new currency(s) and the older (now smaller) Euro. The saga is likely to continue for a while and we believe that increased volatility for equity, bond and currency markets around the world are likely to become the norm.

Many of the economic reports coming out of Europe have turned decidedly downwards suggesting that the relentless focus on the fiscal situation is also taking a toll on both business as well as consumer confidence. Industrial production in Germany fell 2.7% (m/m) in September, and retail sales for Europe as a whole decreased 1.5% (saar, y/y) to highlight just a couple of data points.

Meanwhile, the Federal Reserve concluded a two-day meeting of its policy setting Federal Open Market Committee last week. Chairman Bernanke in his press conference played his usual admirable role of a calm voice amidst a sea of tumult. He appeared to have significant command of facts and also displayed his adroit skills at dancing around some thorny political questions during the press conference. The "hawkish" members of the FOMC appeared to bend to the wishes of the majority at the meeting by not dissenting in their votes.

The FOMC did manage to inject a dose of reality into its growth forecasts as part of the FOMC Statement. Growth for 2011 is now projected to be closer to 1.6 to 1.7% from a previous forecast of 2.7 to 2.9% and that for 2012 is now forecast to be between 2.5% to 2.9% compared to a previous estimate of 3.3% to 3.7%. Also, the FOMC significantly raised its projections for the unemployment rate for this year (9.0 to 9.1%) and next (8.5 to 8.7%) compared to its previous estimate – again reflecting a forecast that is closer to reality.

The much vaunted Congressional Super Committee is due to report on its workings (and whether a deal has indeed been struck between the Democrats and Republicans in Congress) before the Thanksgiving Holiday in the US. With time rapidly running out, we do not hold much hope for a "grand bargain" as reported in some parts of the press. We do feel that the Super Committee will likely strike a reasonable compromise, without any fundamental changes to the fiscal reality in the US.

Corporate earnings reports for 3Q2011 have almost been completed, with about 87% (438 companies) of the S&P500 having reported earnings so far. The share weighted percent gain in earnings has been healthy (16.3%) and roughly 78% of those reporting (or 344/438) have either met or exceeded earnings expectations – again a reasonably healthy number. These figures show that US corporations continue to be good at modestly growing earnings as well as at managing expectations going forward.

In summary, we continue to position your portfolios cautiously – having a higher than usual allocation to cash equivalents. In addition, the ***beta*** (or systemic risk) of equity holdings in the portfolio are managed with an eye to dampening volatility in your portfolios as well. While we remain cautious in the near term, we do feel reasonably positive over the medium to 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.

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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