Outlook for October, 2010: "Paradigm shift in policy…"

A paradigm shift appears to be underway on the conduct of monetary policy by the Federal Reserve. Indeed, in plenty of public speeches and appearances, Federal Reserve Bank Governors, Presidents, and members of the FOMC have made it clear that they see the current situation as "unacceptable" and as offering a real opportunity to shape the outlook for the economy.

Our own classical economic training agitates against this "fiscalization" of monetary policy and engenders worries about comparisons with other periods in history when clever central bankers thought they could repeal the law of unintended consequences. The Fed has clearly stepped beyond the pale of monetary policy and has managed to add to the policy uncertainty (as if we did not have enough of that already!).

The US economy appears to be muddling along just above stall speed (to use an aviation term): The economy lost a disappointing 95,000 jobs in September, with leisure and hospitality (+38k), and education and health services (+17k) sectors posting the most gains, while government (-159k) and construction (-22k) sectors accounted for the most losses. The politically sensitive unemployment rate remained unchanged at 9.6%, while the broader measure of under-employment (known as the U-6) rose by four tenths to 17.1%.

Data on hours worked, average hourly earnings and the index of aggregate weekly hours all suggest that the labor market is not in great shape – with many businesses continuing to be reticent about hiring. Indeed, the economy has muddled along since the start of the year with the famous adage "three-steps forward, two-steps back" aptly describing the state of affairs. Also, governments at the state and local level continue to cut back leading to more furloughs adding further pressure on labor markets.

The sluggish labor market continues to confound many policy makers. The labor market's inability to add jobs above the rate of labor force growth – in order for the unemployment rate to fall noticeably – has been an ongoing concern. Further, as the economy grows slowly (but surely), it is also entirely possible that the unemployment rate could actually rise as more previously discouraged workers enter the labor force looking for work.

Many market participants now seem to ardently believe – especially after well publicized speeches and public appearances by Fed Chairman Bernanke, New York Fed President Dudley and Chicago Fed President Evans – that the Fed is well on course to implement further measures to ease monetary policy. With interest rates bounded by positive unity, the Fed will likely resort to Quantitative Easing (QE) in order to get the job done.

This version of QE will probably involve the Fed buying more than just coupons. Also, the number being bandied about (around $100 Billion per month) is large enough to suggest that the Fed runs a real risk of disappointing the market if their implementation of QE is not viewed as sufficient to make an impact – or even if it is regarded as not broad enough. In addition, the Fed already has a fairly bloated balance sheet that is now larger than $2.0 Trillion – on the domestic side alone!

It is interesting (in a macabre sort of way) to hear the President of the New York Fed articulating the view that the Fed would rather see inflation above its current level and how the Fed's actions in the bond market could actually have a salutary effect on the equity market. In our almost three decades of analyzing Fed speak – we do not recall another instance of a central banker actually wishing for inflation! This is like hoping that one can let the genie partially out of the bottle – and then somehow control what it does once it is out of the bottle.

Furthermore, the Fed can ill afford to play the game of goosing asset markets – especially ones where they do not even have the illusion of control like equities – and then hope to calm things down once the party gets going. We worry that the Fed might be scripting plays from the Bank of Japan's playbook – which recently has also adopted a more expansive version of QE by even buying commercial real estate instruments – let alone mere government obligations.

US interest rates have been on a "swan dive" recently as more and more market participants believe in the efficacy of QE2.0. Indeed, the US two-year is now at all time lows in yield terms and despite a "flattening" of the yield curve, the difference in yield between the longer end and the front end remains substantial thus allowing for those investors who are traditionally net long (banks, insurance companies and other financials) to continue to print money taking advantage of the yield curve.

Much newsprint has been expended on discussing the recent trade spat between China and the United States. While politically expedient to blame a trading partner (and thus blame China for the loss of jobs in the good old US of A), the rhetoric has recently been ratcheted up to an uncomfortable temperature. There is no question in our mind that China has for long pursued a mercantilist currency policy and used it to build an export driven powerhouse.

China is well aware of the challenges it faces: The wide chasm in growth rates between the coast and the hinterland is a real policy issue. In addition, domestic consumer demand represents less than 37% of total GDP (unlike the US where it is around 67%) in China. The most sane way to ensure that the hand-off to domestic demand does happen is to encourage domestic spending by the Chinese consumer – which we suspect – will occur only a few years down the road rather than a few quarters down the road. Be that as it may, the proper way to get China to change its mercantilist policies is not by asking it to do so in the court of public opinion and the media – as some of our policymakers are want to do recently. However, a stable US$/Yuan exchange rate is unlikely to resolve the issue anytime soon.

A spat between China and Japan on fishing rights amidst disputed islands is perhaps a harbinger of things to come: As Japan placed a Chinese fishing boat captain under custody, China stopped the export of some rare-earth minerals to Japan causing all sorts of confusion and delay in shipping electronic components. This saber rattling by China has not been viewed kindly by many in the international community. However, the quick climb-down by the Japanese might even manage to embolden the Chinese in future disputes.

We await with interest earnings reports for 3Q2010. While consensus expectations for next year have started to come down slightly (a positive sign), we expect that this quarter's earnings reports will reflect US corporations as having had a very good quarter - particularly relative to expectations. Time will alone tell whether the multiples one is paying today for the cash flows as an equity investor are reasonable.

With a mere three weeks to go before the much anticipated Mid-term elections in the US, the consensus view now seems to have evolved to the idea of a Republican take-over of the House, but with the Democrats maintaining control of that other august body, the Senate. There appears to be real angst with incumbents in Congress and much will depend on the direction of policy in the future.

In summary, we view the outlook for financial markets as reasonable – cautiously optimistic to coin a phrase. While the economy will likely continue to muddle through, there are still plenty of opportunities to add value to portfolios. 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.

Please be on the lookout for an invitation to our Investment Forum which takes place later this month featuring Edward Guay on "The American tipping point? Why America is at a Critical Crossroads." We look forward to seeing you there!

This report was prepared by

Suresh Raghavan, CFA
Raghavan Financial, Inc.
4400 Post Oak Parkway, Suite 2210
Houston, TX 77027

For further information please contact us at
Work: 832.667.8787
Cell: 281.804.4444
Fax: 281.974.2108
Email: suresh@raghavanfinancial.com

Important Disclosures

Securities and investment advisory services offered through FSC Securities Corporation, a registered broker Member FINRA/SIPC, a registered investment adviser. The views expressed are not necessarily the opinion of FSC Securities Corporation. Raghavan Financial, Inc. is not affiliated with FSC Securities Corpraton or registered as a broker-dealer or investment advisor.

Investing involves risk including the potential loss of principal. There is no guarantee that a diversified portfolio will outperform a non-diversified portfolio in any given market environment. No investment strategy, such as asset allocation, can guarantee a profit or protect against loss in periods of declining values.

Indices are unmanaged and investors are not able to invest directly into any index. Sector investing may involve a greaer degree of risk than investments with broader diversification. Past performance is no guarantee of future results. Please note that individual situations can vary. Therefore, the information presented here should only be relied upon when contained with individual professional advice.

International investing involves special risks including greater economic and political instability, as well as, currency fluctuations which may be even greater in emerging markets. An investor should also note that vehicles that invest in lower-rated debt securities (commonly referred to as junk bonds) involve additional risks because of the lower credit quality of the securities in the portfolio. An investor should be aware of the higher level of volatility and increased risk of default.

This memorandum is based upon information generally available to the public from sources believed to be reliable. No representation is made that it is accurate or complete. Certain assumptions may have been made in this analysis, which have resulted in any returns detailed herein. No representation is made that any returns indicated have been or will be achieved. Changes to the assumptions may have a material impact on any returns detailed. Past performance is not necessarily indicative of future returns.

The foregoing has been prepared solely for informational purposes, and is not an offer to provide investment research, consultation, or advisory services. The author and his affiliates may have positions in, and may effect transactions in securities and instruments relating to the securities mentioned herein and may also provide significant advice or investment services to clients who trade in such securities and instruments.

The investments discussed and/or recommended in this report may be unsuitable for investors depending on their specific individual investment objectives and financial position. The price or value of the investments to which this report relates, either directly or indirectly, may fall or rise against the interest of investors.