Outlook for October, 2011: "May you live in interesting times…"

The famous Chinese saying certainly appears to be coming true given the volatility being witnessed in financial markets. What is however not clear is whether the saying was originally meant as a blessing or as a curse? Given the number of imponderables attendant the outlook for markets, the ongoing volatility is likely to remain a feature for some time to come. Interesting times, indeed!

Recently released economic data have been mixed: The U.S. economy added a better than expected 103,000 new jobs in September, along with upward revisions of 57,000 in August and 42,000 in July. Private sector payrolls reported a more robust gain of 137,000 jobs also beating expectations. Among the sectors, health care (44k), construction (26k), and professional and business services (48k), posted healthy gains with manufacturing falling slightly (-13k) and government shedding jobs (-34k).

The politically sensitive unemployment rate remained unchanged at 9.1% for the third month in a row. Further highlighting the bleak employment picture was the report's statement that 6.2 million people, representing 44.6% of the unemployed, have been jobless for 6 months or more. The U-6 measure, considered a broader measure of unemployment, ticked up sharply from 16.2% to 16.5%.

Several of the labor market indicators we watch, including average hourly earnings, weekly hours, overtime hours and weekly average earnings – edged fractionally higher, gaining back some of the decline experienced in August. However, it goes without saying that despite the job gains in September, the economy continues to gain payroll jobs at a pace that is unlikely to lower the unemployment rate in any sustainable fashion.

The US Commerce department raised its Second Quarter real GDP estimate from 1.0% to 1.3% (Seasonally Adjusted Annual Rate). While the personal consumption expenditures component (0.4% to 0.7%) and exports (3.1% to 3.6%) saw small upward revisions, gross private domestic investment remained at previous levels (6.4%). Although the upward revision was an overall positive for the markets, investors took little notice as economic data remains mixed, and mostly to the downside.

Less than ideal economic data readings in September did not come as much of a surprise given the deep negative sentiment and market volatility in August. Certainly not helping the situation is an aggressive effort by the media to focus primarily on the negatives, seemingly instigating a self fulfilling prophecy. Keep in mind that some bright spots do exist in the economy – corporate profits are at a record high and cash flow remains healthy.

Stepping back from the relentless day to day drumbeat of economic data, our working hypothesis is that the US economy will likely escape falling into a recession, absent any exogenous events. We would place the odds of an oncoming recession in the US at about one in three – not above 50%, but still at an uncomfortably high enough number to worry about the prospects of financial markets. Our lack of faith in politicians of all stripes to "do something" to pull the economy out of its current spiral is, we suspect, widely held!

Markets appear to be waiting with bated breath earnings releases for 3Q2011 – which start in earnest this upcoming week. While much has been made of reduced expectations for this quarter, our own research suggests otherwise: The consensus bottoms-up earnings expectations for the S&P500 for next year are at $111.37 per share – signifying a gain of 13.7% over this year's elevated figure.

Given the slow and anemic growth prospects in the US for the next year as well as the threat of a credit crises fueled implosion in Europe (more on this later), it is hard to visualize how earnings can grow at a mid-double digits number for next year. We do suspect that these expectations are likely to face disappointment, thus leading to further selling pressure on equities. We would characterize earnings multiples for the S&P500 as quite rational – placing valuations in a "reasonable" zone – as being neither "cheap" nor "expensive".

The Federal Reserve at its FOMC meeting in September chose to promulgate "Operation Twist" – a new policy measure that lengthens the maturities of Treasuries being held by the Federal Reserve – causing it to sell shorter term Treasury notes to buy longer term Treasury bonds to the tune of $400 Billion over the next few quarters. Chairman Bernanke himself placed the benefits of Operation Twist at likely to lower the longer term interest rates by about 20bp, thus having a salutary effect on long term borrowing costs.

The fact that what ails the economy is policy uncertainty and a lack of confidence among businesses and not the level of interest rates somehow appears to have gotten lost in translation from Fed speak to plain American! Layer on the fact that the beleaguered consumer continues to be focused on balance sheet repair (deleveraging) and one begins to see the futility of policy moves like Operation Twist.

Interest rates have declined significantly, as the yield curve flattens – with longer maturity Treasury instruments declining more in yield than those of shorter maturity. Another feature of debt markets recently has been the sharp widening in credit spreads of all kinds – especially those of companies that are rated below investment grade. We see such a widening as presenting an opportunity to add to positions – simply because the fundamentals do not appear to justify the sharp widening in yield spreads.

Farther afield, worries about Europe's fiscal crises continue: Greece appears to be the epicenter of the crisis where it is quickly running out of money to finance its profligate ways. While the single currency experiment that is the Euro places a straight jacket on Greece from a trade and monetary policy perspective, for too long Greece has depended on the largesse of pliable debt markets to make ends meet.

A Greek default and its ejection from the Euro seem likely. Having said that, one wonders how such a move can be made without it being disruptive to global financial markets. A risk of contagion to other countries like Portugal, Ireland, Spain and Italy from such a Greek default is another worry. While Germany (and its purse strings) holds the key to the outcome, if policy makers were to forgive the debts of Greece, it is more than likely that such terms would need to be extended to all the other nations.

There is no question in our mind that the German population has a limited appetite for continuing to write blank checks to the likes of Portugal, Ireland, Greece and Spain. Yet again, politicians in Europe appear to be either in complete denial or feel that merely "kicking the can down the road" will suffice – as all they have to do is survive the next election. The capacity of elected officials to have a myopic view of the road ahead never ceases to amaze even us skeptical analysts.

Commodity prices – primarily crude oil and copper – have continued to slide on fears of a global slowdown. The declines in copper prices are quite worrying especially as it is rumored that Dr. Copper has a P.hd. in economics and often appears to telegraph economic conditions months and quarters ahead of turns in the fortune of the global economy.

In summary, financial markets continue to react violently to ongoing fears in the US and Europe. 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.

We would like to remind our regular readers about the upcoming Investment Forum to be held on Tuesday, October 18, 2011 at the Briar Club where Edward Guay of Wintonbury Risk Management (no stranger to this audience, we might add) will deliver the keynote address. We look forward to seeing you there!

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