Outlook for September, 2010: "A Two-handed Economist…"

Equity markets appear to be stuck in a well-defined trading range for now – with significant cross-currents visible on both sides of the water. With apologies to Harry Truman's ghost (who only wanted to hire one-handed economists), we are resigned to sound like a two-handed version of the same species: Those with a bearish bias, point to the slowing in economic growth and the "unusual uncertainty" attending the outlook for markets over the near to medium term. On the other hand, those with a bullish axe to grind, point to the robust nature of corporate earnings, an increase in merger and acquisition activity and low interest rates as their main proof.

The US economy lost a seasonally adjusted -54,000 jobs during the month of August. While private employment witnessed a small gain (+67k), the goods producing sector was unchanged for the month. Education and health services (+45k), professional and business services (+20k) and construction (+19k) were the mainstays for employment during the month. Manufacturing (-27k), government (-121k) and financial activities (-4k) were the laggards for the month.

Revisions to June and July's employment statistics (lowering the net number of jobs lost by 125,000) for the previous two months was heartening, but a one-tenths increase in the politically sensitive unemployment rate to 9.6% and a two-tenths of a percent increase in the U-6 measure of unemployment to 17.6% were not. Measures relating to earnings and hours worked appear to suggest a recovery in the labor market – but a very fragile one at that.

Other survey data including the Institute of Supply Management's Purchasing Manager's Index (which rose from 55.5 in July to 56.3 in August) and the Non-Manufacturing Index (which posted a decline from 54.3 in July to 51.5 in August) also seem to reiterate the "two-steps forward, one-step back" nature of the economic recovery. Indeed, given the deep hole that the economy fell into in 2008/2009 and all the uncertainties surrounding business decision making it is no real surprise that growth is coming in fits and starts.

Fears of a prolonged period of sub-par growth are also partly to blame for the economic malaise. Many analysts have suggested that the US could be in the middle of a decade long period of sub-par growth – much like that experienced by Japan since their real estate and equity bubble burst in late 1989. Indeed, economic growth in Japan has continued to suffer from the combined effects of a bursting of the bubble as well as ill-advised policy moves – resulting in two decades of lackluster economic performance.

It is hard to argue that the United States is following the Japanese path for economic growth: We are of the firm opinion that our national psyche will not allow for an extended period of sub-par economic performance. To wit, policy makers – in Washington as well as at the Federal Reserve – will likely lose their credibility (and perhaps their jobs as well) before the populace accepts such a prolonged period of economic malaise.

There is no question that uncertainty surrounding taxation and regulatory burdens are partly responsible for the lack of job growth among small and medium businesses. While the healthcare legislation passed a few months ago, many of the operating rules regarding healthcare and other Administration initiatives have yet to see the light of day. Further, it does not help that Congress has failed to address the vexing question of tax rates for dividends and capital gains as well.

We have for long maintained that markets abhor uncertainty. They do know how to deal with "risk" – they price it every day, but uncertainty – particularly with regard to outcomes – is a very different cup of tea! While risk is often mis-priced (as happened before the technology bubble burst in 2000 and the housing bubble burst in 2008), markets have a way of finding their own equilibrium in the face of virulent moves. Uncertainty on the other hand is a different ball game.

Investor sentiment has become more bi-polar recently than we can ever remember: Sentiment has swung violently from deep despair to verging on the euphoric to despair again. The wide arc of market outcomes that are possible – given the uncertainty – tends to exacerbate these swings in sentiment. Further at times like these, slightly better than expected data (or slightly worse than expected data) also seem to have a larger than life impact on markets. In other words, it appears that the volatility could stay with us until many of the uncertainties are resolved.

Fixed income markets continue to be volatile – primarily as fears of deflation have come to the fore. The yield curve appears to have a flattening bias recently amidst the volatility. With many investors "reaching for yield" in this environment, we are wary of doing the same – as such episodes never end well.

Emerging markets debt continues to be the "flavor of the month" as many investors believe that they are getting paid for the inherent risk in these securities. However, on a relative value basis, an investor gets paid almost twice that of emerging markets (in terms of a yield "spread") by buying high yield corporate debt. Further, credit issues with emerging markets countries tend to impact the entire sector – with no selectivity whatsoever. Credit issues among high yield borrowers does, on the other hand (there is that expression again!), display some selectivity among market participants.

Overseas, it looks like the German economy is starting to hit its stride a little bit – primarily as a result of a more competitive currency. The rest of Europe is still patchy – with many of the black sheep – continuing to remain so – growth in Portugal, Ireland, Spain, and Greece remains challenging. Japan seems to be back-sliding again. The move by the Bank of Japan to increase its lending program from ¥20 Trillion to ¥30 Trillion is being viewed by markets as too little too late. The Japanese economy continues to suffer from the ravages of deflation, but now the appreciating Yen seems to be increasing the pain felt by exporters from that country.

Chinese economic growth remains quite robust. However, an impending change in leadership at the top of the Chinese hierarchy along with a restive and itinerant labor force could conspire to make the Chinese stance more hard-line particularly when it comes to international trade and currency issues. We suspect that the Chinese are loath to allow Yuan to appreciate much more given that such an increase in the value of the currency can only come at the expense of export competitiveness. They are therefore more than likely to find other excuses to continue their mercantilist currency policies for as long as the world will allow them to get away with it.

Closer to home, politics is increasingly a factor in financial markets: Recent polls appear to suggest that the Administration and the Democrats are in danger of having an electoral setback in the mid-term elections in November. While many analysts believe that gridlock in Washington DC is a good thing for markets in general, we are not so sure of this axiom anymore. If the Republicans were to win the House of Representatives in November and act from a purely ideological standpoint, we are concerned that the economy might sputter as a result of shutdowns of the government or even a freeze in spending. Stay tuned.

In summary, we view the outlook for financial markets like a two-handed economist: There are sufficient uncertainties that need to be resolved, and yet there are also enough positives that provide comfort from a longer term perspective. 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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