Outlook for September, 2011: "More worries…"

Worries about an impending recession in the US and ongoing fiscal crises in Europe and the lack of any fiscal policy response out of the US Congress have all conspired to keep equity markets under pressure. Indeed, while we do not see much scope for the situation in Europe to resolve itself in the near term, the global policy environment rapidly appears to be approaching a critical juncture.

Recently released economic data have been quite negative for equity markets: The U.S. economy added no new jobs and a meager 17,000 jobs to private non-farm payrolls in August. In addition, July and June figures were revised downwards by 58,000 jobs further suggesting a weakening labor market. The politically sensitive unemployment rate remained unchanged at 9.1%, although the preferred broader measure of unemployment (the U-6 measure) ticked up slightly to 16.2%.

Many of the other labor market indicators that we traditionally set store by, including average hourly earnings, weekly hours, overtime hours and weekly average earnings - all appear to be headed in the wrong direction. Indeed, with this sort of loss of momentum, it is hard to visualize how the labor market might improve over the medium to longer term – particularly as business confidence continues to be impacted by ongoing uncertainty with regard to regulation and economic demand.

The US Commerce department lowered its GDP estimate from 1.3% to 1.0% (Seasonally Adjusted Annual Rate) for the Second Quarter. While the personal consumption expenditures component saw a small upward revision (0.1% to 0.4%), gross private domestic investment (from 7.1% to 6.4%) and exports (from 6.0% to 3.1%) saw significant downward revisions. The downward revision to the GDP figures further bolstered the case of those that feel that the US is either already in or on the verge of another recession.

The Conference Board's consumer confidence index plunged a sizable 14.7 points (from 59.2 in June to a reading of 44.5 in July), to easily the lowest level witnessed in over two years (April 2009). Furthermore, regional diffusion indices like those compiled by the Philadelphia Fed on business outlook (+3.2 in July to -30.7 in August) as well as the New York Fed suggest further problems for the economy.

We still think that the US economy - as a base case - is likely to avoid a recession; although the pace of growth is unlikely to be anything to write home about. While many of the ingredients for an acceleration in growth already exist in the current environment, much of the malaise is as a result of uncertainty – uncertainty with regard to policy, as well as uncertainty with regard to economic and market outcomes.

The Federal Reserve at the conclusion of its FOMC meeting in early August seemed to make an unusual move by suggesting that they were going to leave interest rates unchanged at least until mid-2013. While market participants had gotten used to the "extended period" language in previous FOMC Statements, to see a specific time period attached to such a phrase made this policy move an unprecedented one.

In addition, three of the members of the FOMC had voted in dissent – implying that the vote to attach a specific time period to define "extended period" did not sit well with all members of the FOMC. The Fed could seriously risk its hard earned credibility with markets by establishing such a specific date particularly if circumstances changed in the future causing the FOMC to want to raise interest rates in the face of deteriorating inflation fundamentals.

The unorthodox move by the FOMC is another hallmark of Chairman Bernanke's term – where he has used any number of policy options to either prevent a deflationary spiral from taking hold or to propel stock markets (although the Fed would be loathe to admit to such a policy objective). Indeed, as the Fed and the FOMC operate in an increasingly inter-connected and globalized world, it appears to us that they are pushing the envelope on credibility.

Elsewhere, the Swiss National Bank (SNB) cut interest rates and also intervened in foreign exchange markets in a bid to weaken the Franc primarily against the Euro. To fix the value of a freely traded currency (presumably) like the Swiss Franc relative to another currency really amounts to competitive devaluation. We do not quite like the policy implications of such a move by the SNB and are afraid of the consequences if other central banks also resort to similar such moves.

The European Sovereign debt crisis continues to roll on, but does appear to have implications for global financial markets. As we have often commented before, the appetite among the German populace for continuing to write checks to the weaker members of the Euro must fast be approaching a point of no return. Indeed, recent local election results in the Northeastern state of Mecklenburg-Western Pomerania (Merkel's home state) suggest that the opposition might be gaining in stature, thus throwing a spanner in the works.

Further, comments by senior German bankers that the current situation was reminiscent of 2008 have not helped matters. Many policy makers in Europe are still in denial: While the second package for Greece was agreed upon in late July of this year, bond markets appear to have concluded that this too is unlikely to suffice. Earlier this week, Greek two-year yields have risen ***above*** the price of the same instrument – an inglorious outcome indeed!

Meanwhile, the political wrangling among policy makers in the US continues: President Obama is likely to announce a package of measures billed as "creating jobs" after Congress returns from their summer recess. In addition, the Super Committee – put in place as part of the debt and deficit deal struck earlier in August – is populated by members whose positions have perhaps hardened as they have heard from their various constituents.

It is hard for us to imagine how the Congressional Super Committee can come up with spending cuts in sufficient size to change the outcome from a fiscal perspective. The Super Committee's remit does not authorize it to change the trajectory of spending patterns for Medicare, Medicaid or for Social Security – three of the critical programs that need to be dealt with if we are to secure this nation's long term fiscal health.

Another important feature of markets lately has been volatility: Some of this volatility is a natural outcome of the change in expectations and outlooks for different markets – for after all, we do live in interesting times. However, the sinusoidal wave shape of rising and falling sentiment is also partially to blame. It is not often that sentiment goes from the heights of euphoria to the depths of despair in the space of a few weeks!

In this vein, we have further reduced risk in client portfolios by raising additional cash as a result of eliminating the position in natural resources as well as one of our small capitalization holdings. We continue to feel that in times like these, it pays to be cautious and often return ***of*** capital is more important than return ***on*** capital.

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 wish a hearty good luck to our Portfolio Strategist, Bryce Eakin, CFA – who is embarking to Oxford, England for his MBA. His contributions have been salutary and his counsel and camaraderie will be missed.

In this vein, Clark Blackman III has joined us as Portfolio Analyst. Clark has a BBA and a Masters in Finance, both from Texas A&M. He is also a CPA and is currently a Level II candidate for the CFA Exam. We look forward to his many contributions.

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