Outlook for September, 2012: "Activist Central Banking…"

September witnessed another chapter being written in the annals of activist central banking: Both the Federal Reserve and the European Central Bank launched aggressive campaigns to boost economic growth in their respective jurisdictions. While the efficacy of these moves are in doubt, there is however no doubt in our mind that this change in policy has damaging longer term effects. The financial repression imposed on savers as a result of such policies is very real and needs to be dealt with if these economies are to return to their "normal" growth path longer term.

The US economy added a meager 96k jobs for the month of August, falling below consensus estimates of 125k; downward revisions for July (163k to 141k) and June (64k to 45k) produced a net negative of 41k. Private payrolls added 103k while the public sector contracted by 7k. Among the various segments, food services (+28k), professional and technical services (+27k), and health care (+17k) were the main gainers, while manufacturing (-15k) and other services (-7k) were the negative offsets. Over the past twelve months the economy has added a mere 1.8 million new jobs – at a rate of roughly 150k jobs per month – an anemic pace barely sufficient to keep up with population growth.

The unemployment rate moved lower to 8.1% from 8.3%, representing a total of 12.5 million unemployed people. A lower rate should have been good news for the market; further analysis shows that the rate fell as result of an estimated 368,000 people dropping out of the labor force. Over 5.0 million people have been unemployed for 6 months or more, the labor participation rate and employment-population ratio hover around disturbing lows, and 8.0 million people are employed part-time for purely economic reasons. A broader measure of unemployment that includes the marginally attached and workers employed part-time for economic reasons (called the U-6 measure), fell to 14.7% from 15.0%.

Concerns of meager, anemic growth in the past several months are showing up in economic indicators we follow. This story has been repeating for some time as the past year has seen little in the way of marked improvement in labor and productivity. "Muddling along" seems to be the phrase du jour as market pundits and analysts question whether this is the "new normal." Following the employment release, media outlets were abuzz with prospects that the Federal Reserve will likely provide further assistance through additional monetary measures.

The Bureau of Economic Analysis of the Department of Commerce released their second estimate of 2Q GDP at 1.7% (q/q, saar), following an initial estimate of 1.5%. The report indicated a healthier economy with positive contributions from personal consumption, exports, and nonresidential structures which were partially offset by weaker estimates in equipment/software, residential investment, and inventories. The regional diffusion indices we follow (Chicago, Empire State, and Philly Fed), show business activity continuing to contract, albeit at a slower pace than the previous month.

The ISM survey of non-manufacturing activity was notably positive, at a reading of 53.7 (up from 52.6 the prior month). However, the manufacturing ISM survey declined again in early September (to 49.6 from 49.8, the third such reading below 50.0) and the lowest rate since April of 2009. Inflation however, remains quiescent: The Consumer Price Index posted a benign gain of 1.7% (y/y) for the twelve months ended August, 2012.

From a global perspective, the JP Morgan Global Manufacturing PMI continued its decline as it fell from 48.4 to 48.1; the lowest level since June, 2009. In the euro zone, the economy contracted 0.2% in the second quarter, with the latest purchasing managers' index falling into contraction territory for the 13th month in a row. Even powerhouse countries like Germany (where new orders suffered a steep decline in August), and China (PMI dropped to 47.8, a nine-month low) do not appear to be immune to the global slowdown.

Global trade data is also telegraphing a real slowdown in both container as well as bulk shipping. Exports from the US slowed to a crawl gaining 2.8% (y/y) while imports into the US slowed even more to a paltry gain of 0.6% (y/y) for the twelve months ended July, 2012. Similarly, exports out of China slowed to a 2.7% (y/y) pace in July, compared to double-digit growth rates that the country was routinely posting earlier this year. The Baltic Dry Index – a composite index of bulk shipping is also mired, hitting 52 week lows, suggesting very little impetus for increased activity in this sector.

The Federal Reserve at its FOMC meeting on Sep 12th and 13th decided to implement the so called Quantitative Easing Version 3.0. Essentially, the FOMC decided to purchase to the tune of $40 Billion additional mortgage backed securities ***per month*** in an attempt to boost economic growth through further lowering of interest rates. While it is plain for most of us to see that the level of interest rates has not been a problem for some time now, the FOMC played the only real card it held.

The Statement accompanying the decision by the FOMC makes it clear that the Fed will monitor job growth and continue to purchase mortgage backed securities as well as extending the maturity of its Treasury portfolio until such time as job growth becomes "sustainable". In other words, this is a very ***open-ended commitment*** by the Fed on quantitative easing. The Fed's move certainly calls into question the efficacy of the previous two episodes of quantitative easing – whose impact remained ephemeral as far as the economy is concerned.

While the Bernanke Fed ought to be lauded for its liberal use of non-traditional techniques to ease monetary policy, our issue with the Fed's move is a difference on philosophy. Indeed, the Bernanke Fed is a far cry from Volcker's Fed which appeared to have a singular focus on fighting inflation and price stability. Such interventionist action in our mind is fraught with danger – especially as the Fed continues to expand the size of its balance sheet with impunity.

The focus of the Bernanke Fed on full employment and by its implication on economic growth is essentially fiscal in nature and not merely monetary. The short term nature of the policies as well as discretionary nature of the same will in essence make for greater policy uncertainty. Such uncertainty – fiscal, monetary as well as regulatory is what ails the US economy and is unlikely to be solved by further bouts of intervention. If the only tool one has is a hammer, the whole world looks like a nail!

Farther afield, the European Central Bank has also resorted to its version of non-traditional methods by offering to purchase ***unlimited amounts*** of short term (under three year maturity) debt issued by member countries that have trouble refinancing their debt in the open markets (primarily Greece, Italy and Spain) – as long as such a country has asked for help. The European ***crises*** roll on, but here too it appears to us that the ECB is not doing their citizens any favors by intervening aggressively in markets.

The net effect of all of this intervention is, in our mind, like a ***sugar high***. While the sugar high feels good as a result of the short term boost in energy (which might be good on an athletic field), we do realize that there will also be a crash as a result of the high – not in market terms but in epidemiological terms. In other words, such a boost in economic growth (and the stock and commodity markets as a consequence) is transitory and unlikely to be sustainable.

The US political elections are clearly upon us with both parties having had "successful" conventions – where the party faithful were treated to a spectacle of "red meat" and anointing their man as the candidate for President. This time around, the wives of the candidates took on starring roles – a clear departure from conventions of yester year where the spouses did not have much of a role to play. With opinion polls still divided across the country, we suspect that it will come down to the four pivotal states of Florida, Ohio, Pennsylvania and Michigan.

The violence in the Middle East especially against American consulates and embassies appears to be conducted by terrorist elements. The killing of the US ambassador to Libya is another instance of pre-planned acts of terrorism and such violence does not augur well for longer term peace in the region. Further, increasing tensions between Israel and Iran are also worrying; particularly if such tensions cause the former to attack the latter's nuclear facilities. We are convinced that we have not yet heard the end of this saga.

In summary, we continue to position your portfolios with some near term caution, but optimism about the medium to longer term. While our worries about policy uncertainties remain over the near term, we do feel reasonably positive about the longer term prospects for financial markets. 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 steadfast.

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