Lassus Wherley ...a view from the top
Building Better Futures
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Here We Go Again………..

Another Summer Swoon

As we go to press this morning, we are happy to see a better-than-expected jobs report for July. Payroll jobs were up 117,000. May and June were revised upward by 56,000. The 117,000 new jobs added compares to the latest consensus expectation of 75,000. Private sector jobs grew 154,000 in July, following a 80,000 increase in June and a 99,000 increase in May. Markets are opening up (green arrows) on this news.

Everyone is so focused on the bad news we have forgotten that corporate profits have stayed strong and exports have exceeded expectations. But for now, everyone is more focused on the market action and the current headlines. The action on Thursday was more rapid and certainly created much more stress for anyone who has dollars in the financial markets, including the professionals. Much of the selling was driven by market reactions to concerns about events in Europe and to the slowdown in global economic growth.

Many investors were so caught up in the recent budget debate that they missed the fact that the global economy had been giving off hints that growth was slowing. Once the deal was signed to raise the debt limit, everyone began to focus once again on the economy.

The debt limit deal which was concluded in Washington earlier this week has faded into the background now as investors realize that while the focus has been on the US debt and deficits, the global economy has continued to lose momentum. They also began to realize that the spending cuts which were enacted as part of the deal will act to constrain growth at a time when it is already slowing.

The US and European economies are facing the same issues, i.e., accumulated debt which is too high and no easy way to reduce it without inflicting pain. European nations on the periphery such as Greece, Ireland and Portugal have been forced to embrace austerity in order to satisfy bond investors, but this austerity is coming at a difficult time.

Economists had been expecting that growth would resume in the second half of this year as the supply chains which had been disrupted by the Japanese earthquake came back on line, as oil prices declined and as cash-rich corporations continued to spend on capital equipment.

Stock prices have been reacting to the uncertainty brought about by the debt-ceiling drama in Washington for the past few weeks, but now they are reacting to slowing economic growth. Global markets are now in correction territory, having declined by 10% since their peak in May.

We know that the recent market action is unsettling. Markets are moving down as investors price in a slower economy. We are enduring the pain of this process now, but the quicker it happens, the shorter this correction should be. At some point, stocks will have been sold down to the level at which they "discount" the news that growth in the global economy is slowing.

This shouldn't be a big surprise given how deep the 2008-2009 recession was (output lost was -5.1% as of last week's revision) and given that growth since the recession ended has been slower than normal. Mid-cycle downturns are common when the economy is recovering from a recession as deep as the recent one. Investors who are selling stocks are saying that they don't want to wait for the economy to right itself. Many of the folks involved in this selling are traders who are very short-term return focused and focus on technical analysis to drive their decisions for trading.

We do not believe that we are witnessing another financial crisis such as we saw in 2008. Banks have built up huge surpluses on their balance sheets. S&P 500 companies held 28% of current assets in cash as of June, 2011. Households have also markedly reduced their debt levels in recent years. As of March, 2011, household debt payments were 11.5% of disposable personal income, down from 14% in September, 2007.

In recent days, Japan and the European Central Bank have announced that they are resuming bond purchases. There is a good chance that we will see a similar announcement by the Federal Reserve in the days and weeks to come. The Swiss National Bank cut interest rates effectively to zero and added significant cash to the system. The important point is that Central Banks are ready to be proactive in order to support their banks and economies. The moves that they make to make money easier and more available will go a long way towards building confidence and help ease concerns on the part of investors.

Food for Thought

There are several measures that we track to gauge the health of the banking system and the perceived risk in the markets. Among these are the TED spread, which is the difference between the 3-month LIBOR (London Interbank Offered Rate) and the 3-month T-Bill rate. The TED spread is currently at 26.16 basis points (hundredths of a percent). In 2007, the TED spread was as low as 20 basis points, before there were worries about the financial system. In contrast, this measure was as high as 330 basis points in early October, 2008, when we were in the midst of the 2008 Financial Crisis. This measure was also as high as 50 basis points in June, 2010 when the European debt crisis also dominated the news.

Sentiment indicators are another statistic that we have been tracking. Sentiment indicators are used in technical analysis to measure the levels of optimism or pessimism in various markets. When levels in such indexes as the Consensus Stock Index or the Market Vane Index are very high, this indicates that investors on the whole are too bullish and there are fewer dollars left to flow into the market. Recently, these indexes have been around 50% and 59%, respectively. In other words, they were indicating that levels of bullishness were far from extreme. After this week, however, we should see a marked deterioration in the levels of bullishness shown by these indexes. In a contrarian view, this would be a positive for stocks.

The market is being hit this week with the reality that the spending cuts that are included as part of the recent budget deal, while helping to bring the deficit in line, will also have the effect of slowing the economy. We anticipate, however, that in addition to monetary stimulus, there may well be some increased spending by the private sector which will serve to offset the shrinking of government spending.

Continuing Concerns

Even with today's good news, unemployment is unlikely to go down meaningfully for at least another year. Unemployment will continue to be a major issue in the US economy for some time to come, and the downsizing of government will add to this challenge.

Given all of the uncertainty surrounding the economy in the US and the debt situation in Europe, investors are choosing to increase the amount of cash or bonds that they hold in portfolios. We understand this but caution that having too much in either one of these asset classes could provide a sense of safety at the expense of long-term returns.

We believe that the best approach is to maintain a well-diversified portfolio with exposure to cash, fixed income and equities. Based on this, we will continue to slowly move excess cash into the markets to take advantage of the current low prices. The key to successful investing is to sell high and buy low. We accomplish this by rebalancing based on targets established for individual portfolios.

At this point, with investors earning nothing on cash and the 10-year US Treasury yielding 2.45%, stocks represent better value for long-term investors. Stocks are becoming very cheap at a price/earnings ratio of about 11.4 times next year's earnings compared to a long-term average forward p/e of 16.4 times.

As we mentioned in earlier issues, we have increased cash levels in accounts that have regular cash needs for distributions to avoid having to raise significant amounts of cash over the next few months based on the possibility of continued volatility. Once again, we ask that you keep us informed as soon as possible of any special cash needs, and we will make sure that we have the cash on hand.

Remembering the Past

We have spoken before about how this summer seems eerily similar to last summer. We remind you that last year we were focused on a possible double dip in the economy and the European debt situation. This year, it is a soft patch, the budget debate and the European debt situation.

As painful as it may be, the current correction is not entirely surprising given the 28% move up we saw from August 27, 2010, until May 2, 2011. We have given back a lot of gain in the equity markets but have still seen reasonable returns over the last 12 months. Focusing on the longer-term returns is helpful in putting the recent market action in perspective.

The rally that began on August 27th of last year was fueled by Fed Chairman Ben Bernanke's speech in which he announced that the Fed was prepared to stimulate the economy through unconventional measures if needed. What followed was the Fed's bond buying program, called QE 2 (the second round of quantitative easing).

There could be another announcement from the Fed that will help reassure the markets. In the meantime, we can hope that the elected officials in Washington that added to the problem over the last few weeks can finally be part of the solution. Wouldn't that be a nice change?

So………….. turn off the news and try to enjoy the rest of your Summer.

Diahann

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