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Financial Markets Perspective

Weathering the Weather

July 2011

Overview

April 2011 picked up exactly where the strong first quarter ended as equities enjoyed their best month of the year and bulls appeared to be firmly in control. Then a funny thing happened on the way to the end of June: the fallout from the earthquake in Japan began to be felt throughout supply chains in the auto sector and manufacturing experienced some real weakness. The sequel to the Greek debt tragedy of 2010 was met with dubious commentary as regulators, governments, and central bankers argued over ways to handle a new bailout. Domestic politicians took to their own grandstanding as the deadline for raising the U.S. debt ceiling approached and partisan bickering threatened the longstanding AAA rating. Lastly, Osama bin Laden is no longer a terrorist threat – a positive in an otherwise negative quarter overall.

Foreign Turmoil and U.S. Financial Markets

Tiny Greece continued to steal world headlines as the International Monetary Fund, European Central Bank, and the European Union had input about the best way to tackle that country's fiscal challenges. With its credit ratings dropping well into junk status, the Greek parliament approved a 28 billion euro austerity plan that practically guaranteed new funding from appropriate sources. Germany and France helped the 17-country euro-zone experience its strongest combined GDP in over three-and-a-half years while Ireland, Italy, Portugal and Spain continued to struggle. Nevertheless, the ECB raised interest rates in April to combat fears of inflation. Across the globe, China continued to take steps to slow its "overheating" economy by raising the reserve requirements for banks on a few more occasions.

Revolutions in a number of Arab and North African states are disrupting the flow of oil to western democracies. As a result, crude oil rose above $110/barrel early in the quarter until the government announced the tapping of the Strategic Reserves to counter the inaction of OPEC and make up for lost production in violence-stricken Libya. Oil plunged below $90/barrel (briefly) before settling around $95 at the end of June. Gas, on the other hand, fell sharply from late May and vacationers enjoyed a nice reprieve at the pumps. Unfortunately, there are too many revolutions taking place in that part of the world that will continue to disrupt financial markets on a day to day basis.

During the second quarter, the U.S. earnings season proved successful again as growth actually replaced "cost cuts" as the primary driver. Technology companies posted solid results and energy companies benefited from a jump in oil prices and better refining margins. Though automakers posted nice profits, many struggled as the quarter progressed and sales slumped due to repercussions from the earthquake in Japan. Boardrooms continued their optimistic ways as Wal-Mart engaged in a stock buyback and Target increased dividends. According to S&P Indices, dividend increases rose 33% during the second quarter. After gains in April and declines in both May and June, domestic stocks still finished up 6% for the first six months of this year. Global markets were mixed as Germany and France managed to register healthy gains despite the ongoing challenges in Greece and the potential for contagion. Uncertainty about economic growth hurt stock markets in Asia: China, Hong Kong, and India finished down for the first six months of the year. Conversely, bondholders remained happy as the 10 year government bond yield fell below 3% in early June and the 30 year government bond hovered close to a 4% yield. Remember that bond yields move inversely to price so long-term government bonds have appreciated dramatically over the past few years resulting in unrealized capital gains.

The Debt Limit and the Fiscal Policy Crisis

The political battles in Washington about extending the federal debt limit are threatening the economic recovery. The federal government is unique because it is not constrained by any rules that limit its ability to spend money. The notion that it has to borrow or to tax to get "money" to spend is fallacious since the federal government prints money. So, the posturing about whether or not there will be an extension of the current debt limit is the equivalent of a self-inflicted wound. The problem with dithering in Washington is that the federal government is wasting time rather than coming up with a serious solution to grow our way out of our current economic malaise.

Back in 1995, there was a cessation in government spending as a result of a disagreement over the federal budget. The outcome penalized the innocent for no reason and shortly thereafter an agreement was reached, spending resumed and the economy returned to normal. This time around an extension of the debt ceiling is a no-brainer.

The comparison of the current rate of growth of 1.8% can be made to the historical average GDP growth of about 3% from 1870 to 2008. Despite displacements—wars, depressions—we have always returned to this solid upward trend. The risk now is that the political stalemate in the capitol coupled with increasing measures of austerity will cause the economy to go into recession.

We will need to see a solution to the crisis that is characterized by policies that foster economic growth that leads to higher revenues in addition to creating new jobs. By focusing on spending and higher taxes the politicians are not addressing the real problem.

Unusual Weather and Financial Markets

After just six months, natural catastrophes have already resulted in record global damages. Economic losses of $265 billion so far this year easily exceed the total losses of $220 billion for all of 2005. Most of the losses were caused by the earthquake in Japan on March 11th. The 9.0 magnitude earthquake, the strongest ever registered in Japan, was also the costliest natural catastrophe on record – even more expensive than Hurricane Katrina in 2005 which caused economic losses on the order of $125 billion.

The full force of Mother Nature was seen as a Chilean volcano erupted in early June for the first time in 50 years. In addition to disrupting air travel, the volcanic ash cast a cloud over Argentine agriculture prompting authorities to declare a state of emergency for farmers. Tourism in two popular winter sports destinations was also thrown into disarray by the fall of up to 18 inches in ash. Additionally, the flooding in Australia in January was the costliest natural disaster ever for that country with estimated losses of $15 billion!

While not having the global impact of the Japanese earthquake, the Midwest floods along the Mississippi and Missouri rivers have decimated farmland and local businesses. Similar unusual flooding in North Dakota inhibited normal business operations there while tornadoes in the southeast leveled homes, factories and businesses. Through mid-June 2011, an unprecedented eight extreme weather events have become billion-dollar disasters in the U.S. according to the National Oceanic and Atmospheric Administration (NOAA). No other year on record (since 1980) has experienced this many such disasters year-to-date. In fact, the only other year with more billion dollar weather events was 2008, which had nine but over a 12 month period (compared to eight over six months this year). These natural disasters will detract from business activity in the near-term but rebuilding efforts will likely contribute to economic growth in the latter half of this year and well into 2012.

The Outlook for Financial Markets

On balance we remain optimistic that the risks facing the U.S. financial markets are temporary in nature and a series of acceptable solutions to these risks plus better economic data will contribute to a stronger stock market by yearend. We highlight three specific factors that will help drive a stronger second half performance from the U.S. economy. At the top of the list is an anticipated rebound in motor vehicle production that will add a little more than one full percentage point to GDP growth. The second contributor is the recent pullback in fuel prices --in particular, prices at the gas pump have retraced a portion of the sharp run-up experienced earlier in the year, and futures market quotes suggest that prices should fluctuate around current levels over the next year or so. Third, the business expensing provision of the December 2010 tax bill is slated to expire at the end of 2011. With the current level of capital spending unsustainably low and business balance sheets flush with cash, we think that there will be a noticeable improvement on investment.

The global economy may continue to exhibit divergence between countries with fiscal crises of their own making and countries that continue to grow at an above average rate. China's second quarter growth rate of 9.3% suggests that many third world nations will continue to benefit from rising Chinese imports of raw materials. Many emerging markets continue to do well even in the face of turmoil among industrialized nations.

Stock markets remain challenged by the ongoing global disruptions courtesy of Mother Nature and the propensity to implement austerity measures to solve fiscal problems. Success at growing profits remains the key to higher stock prices even in the face of financial market turmoil.

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