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Financial Markets Perspective

Surviving Global Austerity Part II

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Overview

In July of last year we concluded our Financial Markets Perspective with:

> "A smooth track to economic expansion has been interrupted by another financial crisis in Europe, a tragic man-made disaster in the Gulf of Mexico and a series of government interventions into free markets that could be viewed as constraining growth. Plans for austerity measures around the world in response to large budget deficits may impede the continuation of the global expansion that got underway last year. In addition a big tax increase in early 2011 might also be a roadblock to better economic times. On the other hand, corporate profits should remain strong for at least the next four quarters with dividend-paying companies increasing payouts. Unfortunately, yields on the safest investments will remain near zero and extending the maturities of bonds will be the only way to boost that income short of going into stocks with modest yields".

As Yogi Berra said: "It's déjà vu all over again." So far this year we have faced a series of the worst weather-related incidents in history in addition to the implementation of both fiscal and monetary tightening measures in several countries around the world. Politicians have been demanding reduced spending and higher taxes to solve budget deficit problems, but the reality is that such policies portend an economic downturn. As a result, the risks to future global growth are skewed to the downside primarily reflecting the recent loss of momentum on both sides of the Atlantic and the potential fallout from the European debt crisis.

Navigating financial markets will continue to be a challenge going forward as interest rates will remain at historical lows penalizing individuals who rely on income from investments to maintain their standard of living, corporate profit growth will slow and regulatory initiatives out of Washington will continue to keep business spending on hold. Potential tax rate hikes, an ongoing weak housing market and persistently high unemployment add to investor uncertainty. While we do expect some improvements in economic data over the next six to nine months, our optimism is tempered by negative developments around the world. On a positive note, Americans' dissatisfaction with the way the country is being run could provide the impetus for a reformed political landscape that would result in improved domestic policy initiatives and economic growth.

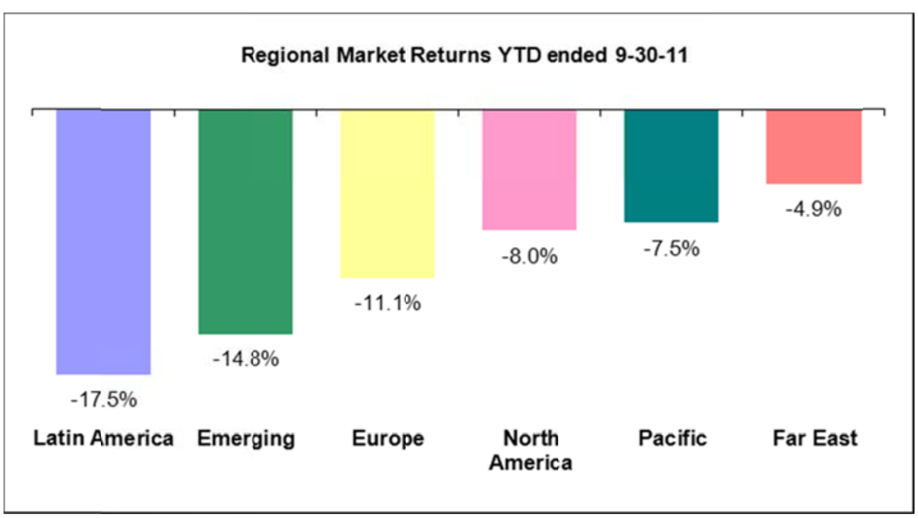
European Turmoil and Global Financial Markets

In September, markets worldwide declined even though five of the world's major central banks took coordinated steps to pump liquidity into the European banking system. The action by the European Central Bank, the Bank of England, the Swiss National Bank, the Bank of Japan and the Federal Reserve was aimed at avoiding a 2008-like credit crunch where interbank lending dried up due to fears of counterparty risk stemming from exposure to subprime mortgages and related securities. In the case of the Eurozone, withering liquidity and rising funding costs result from fears about the vast amount of weaker nations' deteriorating sovereign debt on bank balance sheets. Unlike 2008, central bankers are better able to inject emergency funding into banks to quench a liquidity drought than they were three years ago.

Markets failed to respond favorably when officials of the Group of 20 leading industrialized and developing nations, including Europe's, issued a statement committing "to take all necessary actions to preserve the stability of banking systems and financial markets as required." The recent International Monetary Fund meeting in Washington, D.C., highlighted that Eurozone nations are considering leveraging the size of the European Financial Stability Fund (EFSF) by borrowing against it and using the additional money to fund a special purpose vehicle that would exchange sovereign debt from banks for its own bonds. The EFSF is the bail-out fund established earlier this year to help Greece and other debt-laden peripheral nations. The fund is projected to have about $400 billion left after emergency loans to Greece, Ireland and Portugal.

Any expansion of the EFSF would likely not occur until early November after all 17 Eurozone legislatures have ratified a July 21st plan to restructure Greece's debt. If the expansion plan can be agreed upon by all involved, Eurozone leaders might have the ability to isolate a Greek default by boosting bank capital and building a firewall around the stronger, unaffected and larger economies. Any strong action by the Eurozone to quell sovereign debt fears and bolster its banking system would have a steadying impact on world financial markets.

The aggressive response to a prospective Greek bankruptcy was necessary to forestall a collapse of equity markets in Europe. Unfortunately, the rest of the world has been affected by the devastating impact of uncertainty resulting in year-to-date losses through the end of September.



As reflected in the above graph, Far Eastern and Emerging markets are also grappling with negative economic surprises. In the last two weeks, the Bank of Israel joined the central banks of Turkey, Brazil and Russia in easing monetary policy, while China has already eased fiscally. The case for Chinese demand keeping markets buoyant has failed as the decline in demand for Chinese goods in Europe and the U.S. pummeled foreign stocks. Without global buyers of Chinese output, the 8-10% economic growth rates that so many thought were invincible are now coming under greater scrutiny. For financial market investors there seems to be no place to hide.

Living with Zero Interest Rates

Near-zero interest rates have distorted the financial and economic landscape by pushing many investors into risky investments in foreign lands, commodities, junk securities and other investments they may come to regret. But many remain in bank CDs and money market funds for safety despite almost nonexistent returns. Money market 7-day interest returns are a trivial 0.03%, and they would be negative in many cases if fund managers had not waived their fees. This situation will likely persist.

The federal funds rate target, which rules other short-term returns, has been in the 0 to 0.25% range for three years, and the Fed intends to keep it there for two more years, barring a burst of inflation or a big drop in unemployment which we do not foresee. More importantly, the yield on the ten-year Treasury is at a 60-year low hovering around the 2% level threatening the incomes of many retirees in addition to pension funds and other investors who require higher yielding securities.

In part to entice investors away from low-yielding Treasurys, the Fed announced that it will sell $400 billion of its $1.65 trillion in Treasury securities with maturities less than three years and use the proceeds to buy those with maturities longer than six years. Dubbed "Operation Twist" for the dance craze popular in the 60's when the Fed first tried this plan, the process is designed to lower borrowing costs and encourage consumer spending, business expansion, investment in equipment and hiring. In a further effort "to help support conditions in mortgage markets," and the still-depressed housing sector, the Fed said it also will reinvest proceeds from maturing mortgage-backed securities into more mortgage-backed securities rather than Treasurys.

We would all welcome a healthy housing sector that would have a positive impact on financial markets and add to economic growth. Housing prices in major metropolitan markets on average are down almost 30% from their highs while fixed-rate mortgage rates have declined from a little over 6% in 2006 to just over 4% today – translating into a 22% reduction in a homeowner's monthly mortgage rate for a given amount of borrowing. Added together, the decline in real housing prices and the decline in mortgage payments have reduced the effective cost of buying a house by about 50% in the past five years! Yet the damage caused by the mortgage bust of yesteryear changed lenders' willingness to make loans and rising rates on adjustable mortgages are forcing more residential foreclosures and adding to the inventory of unsold homes. A recovery in the housing market seems to be moving further into the distance.

Gridlock in Washington

President Obama proposed a $447 billion American Jobs Act to help put some of the 25 million unemployed Americans back to work but it requires approval by Congress that continues to exhibit partisan conduct. If passed in its current form, the jobs act could provide more impetus for a stock market rally. The plan proposes to cut payroll taxes for workers from 6.2% to 3.1%, up from a cut of 2% this year, which would save the typical family about $1,500. The same tax cut would be provided to small businesses, along with elimination of the payroll tax for new hires or increased wages and tax credits for hiring the long-term unemployed and unemployed veterans. Small businesses would also be permitted to continue expensing new investment at 100%, which could boost growth. On the other hand, temporary tax cuts don't seem to have lasting benefits.

The problem is that politicians are politicians. The good news is that the country as a whole has never been so dissatisfied with the way the country is being governed. Some of the most recent findings from Gallup are:

- 82% of Americans disapprove of the way Congress is handling its job.
- 69% say they have little or no confidence in the legislative branch of government, an all-time high and up from 63% in 2010.
- 57% have little or no confidence in the federal government to solve domestic problems, exceeding the previous high of 53% recorded in 2010 and well exceeding the 43% who have little or no confidence in the government to solve international problems.
- 53% have little or no confidence in the men and women who seek or hold elected office.
- Americans believe, on average, that the federal government wastes 51 cents of every tax dollar, similar to a year ago, but up significantly from 46 cents a decade ago and from an average 43 cents three decades ago.
- 49% of Americans believe the federal government has become so large and powerful that it poses an immediate threat to the rights and freedoms of ordinary citizens. In 2003, less than a third (30%) believed this.

These statistics have major implications for next year's elections since the election will essentially be a referendum on fiscal policy. More importantly, the sentiment is that things are so bad right now that they are almost surely going to get better.

The Outlook for Financial Markets

The overwhelming risks at both the political and economic levels have clouded the outlook for financial markets. Earlier this year we were more optimistic that a combination of improving corporate profits and new fiscal policies would bolster private sector optimism. We even thought that rebuilding economies after natural disasters around the world would show up as a backstop to a weaker economy. The confluence of a political battle in Washington, a downgrade in U.S. credit and no change in unemployment has increased domestic uncertainty.

The underlying problem in the global economy is still the banks. Moody's downgrade of three U.S. banks speaks volumes about the state of the U.S. economy. In the Eurozone, Italian banks are in a liquidity trap thanks to profligate government borrowing. Greek banks are in for more pain when a sovereign debt restructuring finally materializes. French banks find themselves at the center of an ongoing recapitalization debate with the French government that expects more investment. At least Europe's policymakers recognize that more financial engineering is required to save the Euro. Even if a catastrophe in Europe is avoided, the prospects for the world economy are darkening as the rich world's fiscal austerity intensifies and slowing emerging economies provide less of a cushion for global growth. Politicians in Washington are, once again, threatening to wreck the recovery with irresponsible fiscal brinksmanship. Continued negative commentary from major corporations around the world sends a warning despite the fact that businesses are generally doing well and generating profits. Lastly, the increasingly onerous and uncertain regulatory environment will only further weigh on our current global economic malaise.

Despite our concerns, we do not foresee another financial meltdown similar to 2008. Even if corporate profits don't live up to expectations, they remain strong and higher dividend payments are subsidizing consumer spending. The price of oil has fallen from $110 to under $80 this year providing breathing room for both consumer and transportation providers. Lastly, if we are entering a recession then why are Baltic freight rates rising? Why are railroad shipments and intermodal loadings increasing? Why is port traffic up in Los Angeles? Additionally, why have tax collections in the 46 states that have reported so far risen 11.4% (year-over-year) in the second quarter? This gain is the sixth consecutive quarter in which revenues were up and the strongest showing since the second quarter of 2005. All states reported growth in personal income tax revenues. Both personal income and corporate tax revenues increased 16.5%; and, sales tax revenues rose 5.9% according to the Rockefeller Institute. For these reasons, and the fact that our economy has not built up any new excesses give us a modicum of confidence that we will muddle through. Unfortunately, the fact that both political parties in Washington are more interested in positioning themselves for the 2012 elections than in reaching the compromises needed to steer our economy away from a hazardous course does not bode well for financial markets. We will remain defensive in our investment strategy.

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