Investment Commentary—April 2011

It's often said that the stock market "climbs a wall of worry." What a wall it climbed this quarter with the S&P 500 up 5.4% in spite of very troubling situations in the Middle East (revolution in Egypt, civil war in Libya and unrest throughout), Japan (an earthquake, a devastating tsunami and a nuclear disaster), Europe (an ongoing debt crisis) and Washington, DC (the threat of a government shutdown).

The number and intensity of crises currently confronting investors (and citizens of the world generally) are not unprecedented--1968 comes to mind--but it's still remarkable. While the human toll of these crises is immense (particularly in Japan and the Middle East), we'll focus here on the investment implications. From that perspective, Japan may be the least of our concerns. Many observers have cited the precedent of the Kobe earthquake in 1995 when Japan's GDP took a significant hit in the immediate aftermath but rebounded sharply during the reconstruction. There are two key differences in the current situation. First, directly affected factories going offline has disrupted supply chains of companies around the world in numerous industries. These disruptions should be short-lived as supply chains can, with rare exceptions, quickly be restored using other suppliers. More importantly, Japan will be hard-pressed to make up in short order for the loss of nuclear-generated electrical power. Restoration of lost capacity will be protracted and problematic, but Japan's size as a percentage of the global economy has shrunk over the last twenty years[1], so we don't expect the impact outside of Japan to be too significant.

Moving from Japan to Europe, we're also sanguine about the ongoing debt crisis affecting the euro zone, at least in the short run. Germany, France, et al. have the will and the wherewithal to keep Greece, Ireland and Portugal afloat for the next two years. If Spain needs a bailout, that will and wherewithal (not to mention the continued existence of the euro as we know it) will be sorely tested, but Spain seems to be muddling through. Down the road, we expect that Greek, Irish and/or Portuguese debt will need to be restructured, a painful process the Europeans have gone to extraordinary lengths to avoid[2]. But that's a crisis for another year.

While the European debt crisis simmers, partisan bickering over escalating U.S. debt may come to a head this spring. True, Speaker Boehner, Majority Leader Reid, and President Obama agreed on a deal to avoid a government shutdown not much more than an hour before the deadline. The deal cuts current fiscal year spending by $38.5 billion. In the short run, reduced spending will make the still somewhat fragile recovery just a bit more fragile. Still, the massive national debt is a huge concern, and one can't be too critical of any significant step Congress takes to tackle the problem. Of course, entitlements were left untouched and that—especially Medicare and Medicaid--is where the real money is when it comes to federal spending. Yet even on entitlements there is good news, as Republican Rep. Paul Ryan put forward a long-term budget proposal that bends the debt curve by replacing Medicare and Medicaid with a voucher system and block grants respectively. Don't count on anything resembling Ryan's proposal passing Congress. Still, by going where angels fear to tread, Ryan seems to have forced the President's hand, and a genuine debate about how to address the debt crisis appears to be underway.

Well before any long-term budget plan is enacted, however, the U.S. debt ceiling needs to be raised. The current limit of roughly $14.3 trillion will be exceeded in May. Treasury Secretary Geithner has some wiggle room, but that too will run out in early July. Unfortunately, Speaker Boehner, egged on by the very large and very aggressive class of freshman Republican representatives, has suggested that he will use the need to raise the debt ceiling as leverage to extract agreement on further spending cuts. It's one thing to have a high-stakes partisan negotiation when failure would result in suspension of the non-essential functions of the federal government. A high-stakes negotiation whose failure would result in the U.S. defaulting on its debt is a much more serious proposition, as a default would surely shake financial markets. It's very unlikely that matters will get that far; at some point the bond market will demand action, and when that happens the pressure on lawmakers will be intense. Still, with partisan tensions running high, the battle over the debt ceiling is likely to bring some anxious moments.

Finally we come to the Middle East. The grievances of the masses, why they coalesced into a series of revolts against long-entrenched rulers, and how it will all unfold are topics beyond the scope of this commentary. Suffice it to say that we share the hopes of those who see democracy ascendant in that part of the world and the fears of those who don't. The big worry for investors, of course, is the possibility of a spike (beyond what has already taken place) in the price of oil. The consensus seems to be that it would take something like $150 a barrel in order to tip the economy back into a recession. Fortunately, we're a long way from $150 a barrel oil. Still, two scenarios loom. First, if unrest spread to Saudi Arabia, oil prices could skyrocket. So far there are no signs of that happening, and Middle East experts doubt that it will.

The other scenario also involves Saudi Arabia and relates to their spare capacity. For decades, Saudi Arabia has served as a release valve for any oil supply disruptions. They've been able to do this because the amount of oil they could pump has been consistently and significantly higher than the amount they do pump. As long as this differential is bigger than the size of plausible supply shocks, Riyadh keeps oil markets calm (especially with the U.S. and other strategic oil reserves able to help out while the Saudis crank up) [3]. The big problem with relying on the Saudis is that they are very, very secretive about their oil reserves. No one really knows how much spare capacity they have. If it's north of three million barrels a day, as the Saudis have maintained, all is well, but if it's around one million barrels a day, all is decidedly not well. Some analysts point out that the largest Saudi fields are quite old and probably undergoing rapid declines in daily production. These analysts suggest that spare capacity may be perilously slim. At the same time, the situation in Libya and the Middle East generally creates uncertainty around just how much spare capacity the world might need (though so far Libya is the only major producer significantly affected). The combination is a serious concern. Most likely, the day of reckoning with regard to Saudi Arabian production capacity is many years off, but this is something we'll be keeping a close eye on.

With serious problems afoot on four continents, just how did the stock market maintain its poise? First, although crises get headlines, it's almost always (emphasis on almost) other, more quiet forces that drive the U.S. economy. One of those is a job market that is gradually but steadily improving. In February and March, the private sector added 240,000 and 230,000 jobs respectively. Job growth lifts incomes and, even among those who already have a job, tends to make consumers less fearful. To be sure, consumer spending decelerated sharply in the first quarter from its torrid fourth quarter pace. Some of the deceleration may have been related to the rough winter. A more ominous explanation is that inflation reared its ugly head, with food prices jumping sharply in January and February. Inflation news didn't get better in March or April, as gas prices surged to nearly $4 a gallon, and recent wholesale trends suggest that food price increases will continue for at least another few months. Furthermore, the first hints[4] that inflation might be spreading from volatile food and energy categories into core prices appeared.

Still, there's a plausible case to be made that job creation will gradually improve as the year goes on. And by early next year there's a good chance that housing construction (especially in the multi-family sector) will be providing significant lift to the economy. Beyond that, the Fed continues to stoke the economy with quantitative easing (Treasury bond purchases) and near-zero interest rates. While the current round of quantitative easing (QE2) will end in June, Chairman Bernanke and friends are likely to maintain rock bottom rates through the end of the year. With the jobs picture gradually improving, and with the Fed on their side, stock market bulls brushed global crises and inflation worries aside and pushed the market higher.

April 14, 2011
Boston, MA

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[1] From 14% of global GDP in 1990 to 9% in 2010.

[2] Former Clinton adviser James Carville once remarked, "I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." Angela Merkel and Nicolas Sarkozy would doubtless agree. They have gone to great lengths to avoid restructuring troubled European debt, fearing the bond market would punish such a move by lifting rates on all European government issues.

[3] This is a bit of an oversimplification. For example, Libyan oil is "sweet" (low sulfur content); and some refineries require sweet oil. For broad macroeconomic purposes, though, we can think of oil as fungible.

[4] For example, the Bureau of Labor Statistics reported in March that "core inflation" increased in February at an annualized rate above the Fed's target of 2%. One month's data is not a trend, but this bears watching.