

Investment Commentary—April 2012

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Indications of a solid recovery in the U.S., which began to appear last fall, continued to accumulate over the course of the first quarter. The most impressive data has come on the jobs front. Since the numbers began to perk up last September, the Labor Department's monthly "establishment survey" has averaged a very respectable 190,000 new jobs per month¹. All the more impressive considering that the number of government jobs has *declined* during that timeframe. Meantime, initial jobless claims, which tend to be predictive of future job creation, have continued their downward trend.

Job creation has been strong enough to engender an economic puzzle. Typically growth in jobs and GDP are mathematically linked by a relationship known as Okun's law². Over the last six months, however, GDP has increased at an annualized rate of 2.4%—not terrible, but if Okun was right not in accord with nearly 200,000 new jobs a month. Gross domestic income (GDI) may help resolve the inconsistency. In theory GDI and GDP should be equal and over a full economic cycle they tend to be pretty close. Over shorter time frames they can diverge and for certain purposes some economists believe GDI is more useful. As it turns out annualized GDI growth over the last six months has been 3.5%, much better than the 2.4% growth in GDP and a pretty good fit with the Labor Department's monthly job creation figures³.

There isn't a clear consensus on what's driving the strong job numbers or the improved tenor of the U.S. economy generally, but we would suggest a combination of steadily improving credit markets, healthy auto sales driven by pent up demand, rising housing construction (especially multi-unit dwellings) and businesses that are gradually shifting from a hunker-down mentality to a willingness to pursue growth.

¹ After several months above 200,000 the March report came in at 120,000, causing some angst. The drop may be the residual effect of seasonal adjustments that didn't work properly because of the warm winter. Technical explanations aside, the financial media tends not to appreciate the amount of noise in this data series. Deviations of 100,000 or more from the underlying trend are common.

² The principle, named after U.S. economist Arthur Melvin Okun, asserts that in a given time period the percentage point differential between actual GDP growth and an economy's long-term potential GDP growth should be twice the change in the unemployment rate over that time period. For example, if the U.S. long-term potential GDP growth is 2.5%, then over the course of twelve months GDP would have to grow at 3.5% in order to reduce the unemployment rate by 0.5 percentage points $((3.5\% - 2.5\%)/2 = 0.5\%)$. It works both ways, so that a shortfall in GDP growth results in a corresponding increase in unemployment.

³ There is a slightly more pessimistic explanation for the recent failure of Okun's law. Specifically, while job creation has been higher than expected recently, job destruction during the Great Recession was much worse than Okun would have predicted. Some have suggested that employers panicked in the wake of the financial crisis in late 2008 and early 2009 and therefore went overboard in slashing jobs. Perhaps then recent unexpectedly strong job creation is simply the undoing of excessive paring of payrolls. This explanation would unfortunately imply that the robust job gains of recent months might be ephemeral. Pessimists also point to inventory rebuilding by manufacturers as a likely but only temporary basis for improved job creation.

These are all positive trends that absent external shocks should continue for the foreseeable future.⁴

Looking forward, we'd point to another encouraging factor: the possibility that home prices will soon bottom. The widely respected CoreLogic Home Price Index was up slightly in January and February when distressed sales (e.g. sales out of foreclosure) are excluded. Clear evidence that a bottom has been achieved would bolster the banking sector⁵ as well as consumer and business confidence. None of this is to suggest boom times are around the corner. They're not, for reasons outlined below, but it appears the U.S. economy is finally making a transition from a fragile recovery dependent on fiscal and monetary stimulus to a more stable, self-sustaining recovery. That is a significant change, and we've been managing client portfolios accordingly.

One issue likely to temper growth is trade. While figures bounce around from quarter to quarter, net exports have contributed positively to U.S. GDP growth since late 2010, adding about 0.3 percentage points to annualized GDP on average over the last five quarters. That modest tailwind appears to be turning into a headwind for 2012 as two of our largest export targets—China and the euro zone--are decelerating.

After growing at a roughly 10% clip for the past thirty years, China seems to be putting the days of double digit growth behind it for good. There are several reasons for Chinese leaders to both anticipate and relish a long-term shift to lower (albeit still very rapid) growth. First, the sheer level of Chinese exports to the west makes future double digit growth virtually impossible. And that's without considering the rise of local competitors such as Vietnam. Secondly, double digit growth has put a great deal of stress on China's resources (water, for example). Finally, inflation has become a big problem for low income city dwellers and threatens to impact social stability.⁶ China's desire to downshift was reflected in premier Wen Jiabao's recent forecast of 7.5% growth in 2012. Although these "forecasts," which are really more like targets, tend to understate actual growth, the pronouncement was striking nonetheless. Short-term factors are very much in play here as well with inflation having surged last year to 6.5%. And Beijing has been working hard to deflate property prices that appeared to be getting out of control. Government efforts on inflation and property prices are bearing fruit. There is a small risk these measures will produce a hard landing, but unlike their Washington counterparts, Chinese authorities have wide scope for monetary and fiscal stimulus should it be necessary.

⁴ In the case of credit growth, consider the recently conducted bank stress tests. Regulators examined capital ratios under truly severe scenarios. Almost all large banks had sufficient capital to withstand the hypothetical shocks. Encouraged regulators will likely permit the reins on credit to be further loosened.

⁵ In general banks have a significant and growing inventory of foreclosed homes (known as REO, or real estate owned). As a result, one of the biggest risks to bank balance sheets is significant further deterioration in house prices. A bottom in housing prices would remove a great deal of that risk.

⁶ This last point comes courtesy of a recent piece in the [Financial Times](#) by Jim O'Neill, chairman of the asset management division of Goldman Sachs. O'Neill's point is particularly noteworthy because Chinese leaders have long viewed unemployment as the greatest threat to social stability.

Trade is hardly the only headwind facing the economy—four dollar gas comes to mind, for example. While the price of petroleum is a concern, there are a couple of mitigating factors. First, research suggests that a surge in oil prices doesn't become a serious problem for the economy until the price significantly surpasses recent highs. Thus far spot crude prices have reached but haven't exceeded the high from last spring. And political considerations suggest that prices won't rise too much further, at least prior to November. Recall that the primary reason for the rise in oil prices is tensions with Iran. One imagines President Obama will be very cautious in ratcheting up the pressure in the run-up to the election. Further, the groundwork is being laid for a release from our and our allies' strategic petroleum reserves, should that be necessary. In short we think the President has the cards he needs to keep oil prices from going up much further and all the incentive in the world to play them.

Of course, much as we'd wish otherwise, these pages would be incomplete without a discussion of the European debt crisis. The good news is that the European Central Bank's three-year bank lending program, initiated last December and expanded at the end of February—one trillion Euros altogether—has been extraordinarily successful. In addition to dramatically limiting the likelihood of a major banking crisis, the ECB cleverly allowed banks to post sovereign debt, regardless of rating, as collateral thus goosing demand for Italian, Spanish, Portuguese and Irish bonds! The central bank's lending activities (known officially as Long Term Refinancing Operations or LTROs) are not without risk. For one thing, if the collateral plunges in value, the banks will be confronted with margin calls, perhaps at just the wrong time. Further, by creating extraordinary incentives for some buyers of troubled sovereign debt, the ECB is likely pushing other buyers away, perhaps permanently and dangerously shrinking the pool of investors in Italian, Spanish, Portuguese and Irish debt.

For the time being, however, the ECB's moves, together with the move toward a fiscal union shepherded by euro zone leaders Angela Merkel and Nikolas Sarkozy, were very effective in quieting the storm (more so, we'll confess than we anticipated in these pages three months ago). How long will it remain at bay? No one knows of course, but even aside from the risks associated with the LTROs cited above, there are reasons to remain wary. First, the rescue funds set aside for potential further sovereign bailouts may not be sufficient. Late last month, euro zone leaders bolstered the funds with an additional 500 billion euros. While helpful, the total amounts available would still likely fall short if Spain needs to be bailed out, a scenario investors seem increasingly to be contemplating in recent weeks. Above all, we're concerned with euro zone growth. The region almost certainly contracted in the first quarter as it did in last year's fourth quarter. And growth in the remainder of the year will be flattish at best. Credit remains a big issue, not least because unlike their U.S. banks, European banks have a long way to go in deleveraging. If regulators are too lenient confidence in the financial system will be undermined but if they push too hard there will be insufficient credit available to end the euro zone recession. And every quarter that GDP contracts, sovereign debt ratios get worse.

All that said, Europe has shown an amazing capacity to muddle through, and we expect that it will continue to do so. Having fought so hard to save the euro, Merkel et al will certainly go to extraordinary lengths to prevail (even if the cost to the taxpayers of northern Europe is vastly greater than heretofore acknowledged). But we would expect the debt crisis to flare up periodically. If nothing else a prolonged debt crisis will exert pressure on growth on this side of the Atlantic as the appetite of struggling European economies for U.S. exports remains tepid and European exporters gain an advantage from a weak euro.

The list of headwinds facing the U.S. economy is a bit daunting. Some, like deceleration in China and perhaps the rise in oil prices, are temporary. Others, like the European debt crisis and the need to control government spending⁷ here on health care and pensions, will be around for a while. We're encouraged though that certain of the challenges of the last several years are beginning to recede. Housing starts are picking up; home prices are bottoming; state tax revenues are on the upswing; and businesses are managing payrolls with a slightly more optimistic view. All of this is creating some sustainable momentum in the economy. Growth will still be moderate—don't look for 4% GDP growth, which has historically been the hallmark of a strong U.S. economy, anytime soon—but on a gradual, if occasionally halting, upswing.

The stock market, taking note of improvements in the economy, has now surged over thirty percent in the last two quarters. Given this surge and the fact that corporate profits are likely at or nearing a peak, the market may be overdue for a pullback. We spent much of 2011 positioning client portfolios defensively. We began to shift course gradually in the first quarter, and we'd look to use any weakness in share prices to move further down a somewhat less cautious path.

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⁷ We'd be remiss not to at least mention the cluster of issues that Congress and the President (or President-elect) need to resolve prior to year end. Absent legislative changes, the temporary payroll tax cut and the Bush tax cuts will both expire, unemployment benefits will be sharply reduced, and the spending cuts triggered by last summer's debt deal will kick in. All, more or less, simultaneously. Collectively these changes, all of which will hamper economic growth, at least in the short run, have been dubbed the "fiscal cliff." It's extremely unlikely that Congress will allow all, or even most, of this to happen in January. But there will doubtless be a lot of drama in Washington before the issues are resolved—or, should we say, kicked further down the road.