

Investment Commentary—October 2012

In place of the usual commentary, we're providing brief thoughts below, supplemented by an essay on "The Power of Cashflow Reinvestment." The essay covers important ground on how to think about stock market returns. We've discussed this material in bits and pieces over the years but wanted to address it in the depth it deserves.

In late 2011 and early 2012 the U.S. economy appeared to be shifting into a higher gear, only to retreat in the spring to the very slow pace that has thus far characterized the recovery from the financial crisis. To be sure there have been hints lately of something better on the horizon. Most notably the summer delivered very clear evidence of rising home prices. In addition economic data released in recent weeks, including the latest employment report and Institute of Supply Management indices, painted a somewhat brighter picture. And while we're skeptical that the third round of so-called quantitative easing from the Fed will have a big impact, it can't hurt (at least in the short run), and the commitment to purchase more than \$40 billion of mortgage bonds each month until the labor market improves substantially creates some certainty around Fed policy for an extended period of time.

Still, with the deleveraging of consumer balance sheets ongoing, Europe still mired in a recession and debt crisis, the fiscal cliff looming in the U.S. and growth in China continuing to disappoint, caution is in order.

China is in some sense the biggest disappointment. Policymakers in Beijing are much less constrained politically and fiscally than their western counterparts, and many had hoped that freedom would translate into an aggressive response to the economic deceleration that set in at the end of 2011. Chinese leaders have long feared that weaker growth would create social instability. But in spite of the current slowdown, income and employment have held up tolerably well, perhaps giving Beijing more leeway than it's had in the past. For years ten percent growth in China has depended on exploding exports and/or massive internal infrastructure projects. Perhaps authorities are prepared to accept seven or eight percent under a more sustainable growth model. In the long run that's all to the good. In the meantime, commodity prices and companies that derive a lot of their revenue from China will have more pain to endure.

Meanwhile, Europe continues to muddle along. The central bank now has the authority to buy bonds of Spain, Italy and other troubled governments. That authority significantly lessens the likelihood that the crisis will spin out of control. By taking some pressure off, it may also forestall a true resolution. But none was on the horizon anyway.

In the U.S., all eyes are on the fiscal cliff, whereby a variety of tax increases and spending cuts is poised to land a blow to the economy absent congressional action. Much will depend on the outcome of the election. The worst case would probably be a mixed message—for example, Obama re-elected but the Republicans faring well in the Senate and in the House. If the election offers a reasonably consistent verdict, such as a Romney win and a Republican takeover of the Senate, we would anticipate a relatively quick resolution of the fiscal cliff in the lame duck session. If the election gives both parties grounds for digging in, our concern over the fiscal cliff would increase.

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Boston, MA