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Investment Commentary—April 2013

Memo to Washington: "It's not always about you!" That's what the U.S. stock market and economy seemed to be telling policy makers in the first quarter. Despite three months of ominous headlines about the fiscal cliff and the sequester, the stock market turned in a fabulous quarter, punctuating its performance by pushing the S&P 500 Index to an all-time high on the last trading day of the quarter[1].

The market's sharp rise resulted at least in part from strength in the economy. Based on headline GDP, we appeared to enter 2013 in a weakened state, with Q4 2012 clocking in at 0.4%. But that paltry result was due solely to sharp inventory reductions and decreased government activity. Private final demand was up a reasonably robust 3.3%. That relatively strong showing seems to have carried into 2013 and analysts have upped estimates of first quarter growth. Consumer spending, business investment in equipment and software, and construction all look solid.

Speaking of construction, homebuilding continues to be a real bright spot. Housing starts have climbed steadily for about a year and a half now. Until recently there hasn't been a lot of evidence that all that homebuilding has added many jobs. But that shouldn't be a surprise. For starters there is about a six-month lag between the time permits are filed (a "housing start") and construction begins. Further, most industries are subject to "labor hoarding," whereby companies that downsize during a recession retain some excess workers to be able to respond quickly when the economy turns. Labor hoarding creates a further lag between an upturn in housing starts and growth in construction jobs. Analysts at Merrill Lynch recently estimated the combined lag due to both permitting and labor hoarding at fifteen months. That would imply housing employment started to rise around the beginning of the year. And that seems to have happened.

Employment in general has been strong over the last several months (but please see the paragraph immediately below). While it's nice to see job growth accelerating, it is especially nice to see it happening in a sector with good wages. A recently published study[2] indicates that median household income has fallen 7.3% from the beginning of the recession. One of the major reasons is that the bulk of the employment growth

[1] More sober-minded types would point out that on an inflation-adjusted basis the S&P 500 is considerably shy of the all-time record set in March of 2000. Party poopers! In all seriousness, the market in 2000 was vastly overvalued which set up a decade plus of poor stock market performance. Reaching those levels on an inflation-adjusted basis is not yet justified nor would it be desirable.

[2] From Sentier Research LLC. URL:
http://www.sentierresearch.com/reports/Sentier_Household_Income_Trends_Report_February2013_03_25_13.pdf

during the recovery, such as it has been, has been in low-wage jobs[3]. A meaningful increase in construction work is good news for hundreds of thousands of U.S. families to be sure but because the jobs pay well it's also good news for the economy.

The economic indicators in the last week of March and first week of April weakened, with initial jobless claims, employment data and the widely followed ISM indices (manufacturing and non-manufacturing) all faring worse. These data may reflect statistical noise, early signs of the effects of the sequester, or an indication of yet another year when strength in the early months peters out as the year progresses. If it's the sequester (or just noise) the market will be nonplussed as the effect will likely be temporary. Organic weakening would be more problematic.

While the U.S. economy has—at least until recently--helped to justify the market rise, the same can't be said for Europe. Several weeks ago Cyprus became the focal point for the ongoing debt crisis when an attempted rescue of the banking system was rejected by the Cypriot parliament. European banking officials and President Anastasiades proceeded to do an end-run around the legislature, putting in place a plan to radically restructure Cyprus's largest bank and shut down the next largest.

The original plan would have imposed a hefty tax on all depositors, including those protected by deposit insurance. It thus appeared to undermine efforts to establish a region-wide deposit insurance scheme. Plan B spared smaller account-holders but stuck it to those with deposits over 100,000 euros, many of whom are wealthy Russians avoiding taxes back home. The most curious aspect of the rescue came after the deal was struck when Dutch finance minister Jeroen Dijsselbloem touted the package as a template, indicating that large depositors and senior bond-holders should expect to pay dearly in future banking bail-outs. Dijsselbloem quickly walked back his comments, indicating in a written statement that the Cyprus rescue was a unique situation. Which was it, a template or a one-off? Time will tell.

Banks in Cyprus ultimately reopened in an orderly fashion but only because capital controls were put in place. Imposing capital controls in just one country seems to contradict the idea of a single currency. But we're not so sure that is a bad thing. It's hard to know where the euro zone is ultimately headed when all of this shakes out many years hence but even under the best of circumstances it's likely to be somewhat of a mongrel. There is something to be said for giving capital markets time to absorb that idea.

Some have argued that Germany--who, it is more clear than ever, is calling all the shots--should have just ponied up the very modest amount it would have taken to bail out Cyprus's banks without devastating its economy (which the deal most certainly will do). That may be true as a matter of economics but it was a non-starter as a matter of politics. The chances of real progress

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[3] The San Francisco Fed estimates that 60% of the lost jobs in the recession were "mid-wage" jobs whereas 58% of the jobs added in the recovery have been "low-wage," many of them in the retail and food-service sectors.

toward a resolution of Europe's sovereign debt crisis will have to wait until after Angela Merkel is reelected in September permitting her to communicate more candidly to German voters.

Speaking of politics, Italy continues to suffer the consequences of having delivered 26% of the vote in its recent parliamentary election to the Five Star Movement led by (ex?) comedian Beppe Grillo. Mr. Grillo refused to negotiate a role in a coalition government, calling the leaders of the mainstream Italian parties "old whoremongers." It's enough to make one count the days until Merkel's reelection allows her to deal a bit more generously with Southern Europe, something that will hopefully forestall its radicalization.

While Europe remains a drag on the global economy, we continue to think that positive economic forces in the U.S.—recent softness and/or the sequester notwithstanding--combined with a slight pickup in China and perhaps some renewed growth in Japan add up to a gradually reaccelerating global economy. Is that enough to justify the S&P 500 climbing over 40% in the last eighteen months? Skeptics (most recently former Reagan-era budget official David Stockman) argue that it's all a Fed-induced bubble, with rock-bottom interest rates pushing investors out of bonds and into other asset classes, blindly chasing higher returns. While there is merit in what Stockman and others are saying, we take comfort from the fact that retail investors are not rushing headlong into equities (bullish sentiment according to the AAII sentiment survey, for example, is running right around its long term average). Further, there has been a great deal of healing in the wake of the financial crisis. State and local governments are in much better fiscal condition than they were just a few years ago. Housing is doing reasonably well in terms of both home prices and home construction. And households have reduced their debt considerably.

Even if you don't subscribe to the view that it's all a Fed-driven bubble, you can worry about how skillful the Fed will be in winding down its bond purchases and raising interest rates when the time comes. And to be sure the Fed will face a difficult challenge. It has to choose carefully when to begin the process and how fast to proceed. Tricky stuff. Given the Fed's explicit statement that, barring signs of inflation over 2.5%, it will wait until unemployment hits 6.5% to raise interest rates, a full-blown tightening is some time off. However, the end of the Fed's third round of quantitative easing (bond purchases) could come as early as this summer. Stay tuned.

We wait eagerly to see whether the hints of weakening in the U.S. economy over the last couple of weeks amount to anything more than temporary effects of the sequester and how the Fed will react if strength in the economy persists. In the meantime we recognize that the market has climbed sharply and is probably due for a breather but welcome the fact that the U.S. economy has been providing at least some justification for that steep rise.

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