The Tale of Two Recoveries

Last week, as I lay on the couch battling the flu for the second time this season, I had been doing my best to read through my newspapers/research reports but my brain could no longer digest another bit of data, good or bad. I stumbled across an old rerun of Seinfeld. So I thought I would let Jerry and Co. entertain me for half an hour - anything to take my mind off of the aches and pains of the flu.

One of the storylines found Jerry and Elaine caught in a long line at a bakery. While they waited for their chocolate covered cake, Jerry spotted a black-and-white cookie behind the cookie counter which he just had to have. Jerry went on and on telling Elaine about how good the cookie was and that there was a method to the way one should eat such a cookie - you can't just have a bite of the chocolate or a bite of the white – you've got to have both in every bite! In Seinfeld fashion, by the time it was their turn at the cake counter, the chocolate cakes were sold out and Jerry had a terrible case of indigestion from his black and white cookie. I, too, had a case of indigestion - only I wished it had been caused by eating too many cookies. Not this time! This time it was the flu and if that did not get me, the newspapers lying on the floor forecasting anything but a "black and white" recovery would be enough to give the strongest of stomachs indigestion.

Last week the news sources I follow told the tale of two recoveries – foreign and domestic.

The economic environment and the mood in the United States is better than that of Europe. The head of the international monetary fund, Christine Lagarde, said in a speech last week "financial anxieties have eased to some extent but improvement in investor sentiment hasn't yet been translated into the euro zone economy." While the improved outlook since summer 2012 might be helping the credit markets, it's not helping people in terms of jobs or incomes, she said.

The European Central Bank (ECB) said on Thursday of last week that it expects the euro zone economy to contract again this year – an unwelcome trend that has been in place for the last five quarters, which is a decline in output as long-lasting as that recorded in late 2008 and 2009. Lastly, Lagarde in her speech last week said demand is unbalanced across Europe - much stronger in the north than in the south.

Certainly the interest-rate environment is in a more favorable position today than it was, say, last summer when Italy and Spain were facing 7% interest rates. But their employment situation has not changed - it's still extremely challenged – and a reliance on austerity as its main response to the fiscal crisis is increasingly being questioned. Italian voters rejected parties committed to that strategy in their recent election. Without the intervention of the European Central Bank and backstops from the international monetary fund, there's no doubt that the outlook for Europe would be much worse than it is today. So, the ECB will be forced to keep rates low – maybe even lower them further – to help the consumer gain traction. As we have written to you many times in the past, consumer spending is key to economic sustainability.

Here at home there's a little bit more to be optimistic about. Our nation's employers added 236,000 jobs last month which brought the unemployment rate down from 7.9 to 7.7%, which is its lowest level since December 2008. According to Dow Jones newswires the decline was not only due to job creation but also, and unfortunately, 130,000 individuals leaving the workforce.

Some headwinds exist today that were not present last year - higher taxes and gas prices being two of them. All workers, regardless of income, are being hit with higher payroll taxes this year. The payroll tax increase is likely to be a larger drain on spending than are higher gas prices. While every $10 increase in the price of a barrel of oil reduces GDP by half of a percentage point within two years, there's no doubt that consumers are becoming desensitized to $3.50 - $4.00 gas. A few weeks ago I heard someone on television opine that until gas reaches $4.75 - $5.00 per barrel that consumption won't change.

Wall Street and the financial services sector in general, continue to enjoy growing profits and balance sheet strength. A stress test recently conducted by the Federal Reserve indicated that 17 of 18 of the largest banks have enough capital to keep lending in a hypothetical sharp economic downturn. The institution's ability to withstand the shocks is due to a lot of factors but mainly their Tier 1 capital ratios. Tier 1 capital is the core measure of a bank's financial strength. Of the 17 companies who passed the stress test Morgan Stanley had the lowest level of Tier 1 capital at 5.7% and State Street Corp. had the highest at 12.8%. The minimum acceptable level is 5.0%. The purpose of the stress test was to forecast how well our financial institutions would fare should we experience 12% unemployment and a sharp decline in stock indexes, among other factors.

A speech given on February 7 by Jeremy Stein, a member of our board of governors of the Federal Reserve, has received a lot of attention lately. His key question was "What factors lead to overheating episodes in credit markets? I read the report….twice - my flu-infected brain just could not comprehend the theory the first time around! There were a couple of important takeaways – First, research has shown that when individual investors are most optimistic about future stock market returns, the market tends to be overvalued. This is because human beings are conditioned to believe that whatever trend is in place, good or bad, it will last forever. Our chief investment strategist, Jeff Saut, believes that there is a bit of room for the domestic stock market to keep going up in 2013. He could be right – corporate America is in pretty good financial shape today. But people like Jeff almost always cheerlead the markets…Wall Street always makes more money when investors buy and sell securities. Investors buy and sell more when they are optimistic. In 2012 53% of Goldman Sachs' revenue came from sales and trading. Investment banks want you to feel good about the markets so you will trade, generating nice profits for them.

Stein's second point – substantiated by research by Harvard's Robin Greenwood and Samuel Hanson - suggests that when high-yield bond issuance is elevated, future returns on corporate bonds (and often time stocks) tend to be low. Over $100 Billion of high-yield bonds were issued in 2012, exceeding the pre-crisis levels.

Stein said recent evidence suggests that due to investors' frustration with low returns on low-risk investments, we are seeing a fairly significant pattern of "reaching for yield" behavior in corporate credit. His third point, translated, means investors are frustrated with .5% (one-half of one percent) returns and, therefore, are willing to take some risk by purchasing stocks that pay 3% dividends and high-yield bonds that pay 5%. To some extent every investor should reach for yield. But it should be done in a manner that is consistent with their tolerances for short-term loss. My concern is that most people do not fully understand the incremental increase in volatility risk they are taking-on by employing such a strategy. Yet still they do because "earning something is better than nothing."

While the overall mood in the US is good now, the market rally has extended into overbought territory. Further, small storms are once again brewing in Euro-land. We will keep a watchful eye on the developments around the world and look for buying opportunities on a pull-back. We see a 3-5% retracement as being very likely.

We were intentionally conservative in 2012 and that caused us to miss a bit of the upside (as compared to our domestic stock benchmark, the S&P 500). Generally speaking our bonds had a great year last year but we expect those returns to moderate in 2013. Accordingly, we can use some of those assets to buy quality stocks and alternative assets on a pull-back.

We remain confident in our strategy of conservative growth – mindful that markets never go in the same direction forever and just when you least expect it, they tend to reverse course.

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