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A CLEARER NEW YEAR?

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A fool's errand perhaps, but the search for clarity should make some progress in 2011. Last year, stock and bond markets were decidedly schizophrenic, reflecting muddled and shifting economic and political landscapes. This is not to say there won't be plenty of background noise in the next few quarters. Nevertheless, we should ultimately achieve a better sense for how the waves will break.

2010 was all about the interplay of "risk on" and "risk off." Funds were moved in and out of stocks depending on the prevailing mood. Stock prices reacted accordingly, with wide swings. However, according to Ned Davis Research, volatility has now dropped back down to its historical averages.

Rays of solid light

The foremost question in investors' minds remains the resilience of the U.S. economic recovery. After at first rebounding from the sharp contraction of 2007-2009, the economy began to falter last summer. Fortunately, by a host of measures, it seems to have regained its traction. This year, we should be able to finally tell whether the expansion has enough momentum to be truly self-reinforcing. This question has been the primary concern of the Federal Reserve. One conceivable but unlikely alternative would be to slip into a Japanese-style morass.

The oft-slighted U.S. consumer has begun to shop again. Spending has risen for five consecutive quarters, albeit at a modest pace. In fact, personal consumption has returned to its pre-recession levels. Balance sheets are not entirely repaired, but they have improved. The household debt service ratio — the proportion of disposable income needed to cover mortgage and other consumer debt payments — has fallen back to its 30-year average. Absent a double-dip in housing or another leg down in the job market, the consumer should continue to slowly recuperate.

Home, land security

Speaking of residential real estate, there is a vigorous debate about whether home prices have bottomed. The number of mortgages that are delinquent or in foreclosure has begun to roll over, but remains very elevated at almost 1 in 7. Meanwhile, the inventory of homes for sale has also been persistently high. New home construction plummeted over the last three years, providing some relief on the supply side. Housing starts have been holding at a depressed annual rate of 500,000 to 600,000 units. Critically, household formation, the key driver of incremental demand, has averaged 1.3 million per year since 2000. So there's a pretty large gap between that and the rate of housing starts. The problem is that formation contracted sharply during the recession.

That said, it is difficult to envision construction activity falling much further from depressed levels. And even with the recent uptick in mortgage rates, housing affordability measures have improved substantially. Our sense is that a supply overhang will continue to pressure home prices this year, but we do not envision a severe drop from current levels.

A full-time job problem

Most of the drop in GDP has now been recovered, but only 15% of the job losses have been reversed. This is a striking disparity. Healthy productivity and profit-margin growth stand side by side with persistently high joblessness. The overall unemployment rate stood at 9.4% of the workforce as of December, but that masks the sharp differences by education level. The rate for adults without a high school diploma stands at 15.3%, while college graduates are at 4.8%. Estimates vary, but a sizable portion of the unemployment is likely structural rather than cyclical. The ranks of the "long-term" unemployed — those out of work for more than six months — have swelled to about 6.5 million. This group accounts for almost half of all the unemployed.

So the labor market remains a key challenge. Job growth tends to be tied to capital spending, which in turn depends on profit levels. But as we have noted previously, corporate profits and cash flows have rebounded sharply. Corporate America is sitting on top of a $2 trillion cash hoard, although admittedly, some is overseas and will not be repatriated. Small businesses will largely determine the rate of job recovery. They have been held back by regulatory uncertainly and scarce credit, but there seems to be some relief on both those fronts. Importantly, smaller companies are finally signaling that they may begin to modestly expand their workforces. We'll have to wait to see how this plays out.

Europe's debtors better

Events overseas will increasingly demand investors' attention, but here too we should gain a bit more clarity this year. First up is Europe and the multi-headed Hydra that is the sovereign debt crisis. In contrast to the U.S., many of the fiscally-challenged European states have begun to rein in their bloated public spending. Forced to choose between a riot by the bond market and riots by their own citizens, they went with the latter. We here in the U.S. are not confronting a riot by bond vigilantes — at least not yet. The DNA of elected officials seems to be wired to avoid upsetting the citizenry with difficult truths, so progress will likely be slow unless there is a crisis.

An improvement in the European fiscal crisis would obviously be welcome news for global stock markets. Spreads on many sovereign bonds are still wide, reflecting the ongoing uncertainty. Most of the stress has involved the smaller nations of Greece, Ireland, and Portugal. The doom and gloom case maintains that the next dominos to fall will be Italy and Spain — much more economically significant nations. A major credit crisis would ensue, the global economy could seize up, and it would be déjà vu all over again.

Not quite as serious, gracias

However, as with the global financial sector meltdown in 2008, it is important to distinguish between *solvency* issues and *liquidity* issues. The first is a chronic condition, while the second can be transitory. Greece, Ireland and Portugal are wrestling with insolvency. They potentially face downward spirals, with the crush of their debt increasingly burdening them. Growth may be insufficient to climb out of the hole, and their interest obligations will be sapping government revenues. One or more may well default within a few years. In short, the challenge goes beyond short-term funding issues.

On the other hand, with Spain and Italy, the risks are “only” in meeting their liquidity needs. They just need access to sufficient capital to roll over maturing debt and cover budget shortfalls. Their economies and banking systems should be sound enough to allow them to emerge. Think Caterpillar, Inc., which needed access to the commercial paper market for short-term funding needs back in 2008, vs. some of the commercial and investment banks that were simply overwhelmed by their liabilities. Ultimately, the IMF/EU/ECB should be able to provide the breathing room Spain and Italy might require.

China applies the brakes

The other key uncertainty involves some of the larger emerging markets, most notably China. While the developed world has been wrestling with the demons from subpar growth, many developing nations have been moving to slow down their overheating economies. Toward this end, Chinese apparatchiks have been raising bank reserve requirements and policy rates as well as reducing targets for credit growth. Much of the excesses are manifested in real estate. Some pundits therefore see a parallel to the West’s earlier bubble. Property markets in some cities are indeed frothy, but nationally, property prices have more or less risen with incomes. Moreover, the majority of real estate in China is purchased with cash or relatively small mortgages.

The developing world has been the engine of global growth, most importantly from the recent contraction. Hence the concern if their economies falter. China has $3 trillion of foreign currency reserves, along with a critical long-term need to maintain a robust growth rate. Policymakers there face a delicate balancing act, but odds are they will achieve a soft landing. At a minimum, their official statistics will no doubt reflect such a feat.

The free-lunch deficit plan

Back in the U.S., while the job situation remains the public’s top concern, the federal budget deficit is next on the list. According to a December poll by the Pew Research Center, seven in ten adults agree the deficit is a major problem that must be immediately addressed. Further, two in three believe that the best way to reduce the deficit is through a *combination* of cutting spending and increasing taxes. The poll indicated that these fundamental views cut across partisan lines.

The conundrum, however, is that such “consensus” disappears when specific proposals are considered. For instance, the Pew survey put forth a dozen deficit reduction proposals for reaction. Only *two* garner approval from the majority: Freezing the salaries of federal workers and raising the amount of income subject to Social Security withholding. Those alone won’t move the needle. We should probably not be surprised by such results, as Americans — and western citizens generally — remain in a free-lunch mode.

Meanwhile, Congressional members of all persuasions have been tripping over themselves to establish their fiscal bona fides. There may even be some anti-deficit lapel pins floating around out there. Nevertheless, there’s been a regrettable lack of specificity combined with a resistance to face the math. A cynic might observe that the more fervent the discourse, the lighter the specifics. Politicians are certainly all for targeting waste, fraud, and abuse. But as soon as you hear that solution proffered, stop listening — the speaker is still inside the box and unwilling to make hard decisions.

Between two storms

Potentially, the country is in a quiet period between two storms. The first, of course, was the private-sector financial debacle of 2007-08 brought on by the bursting of the housing bubble and its derivatives casino. That required unprecedented federal intervention, and one could argue that those policy decisions have laid the groundwork for a second upheaval. Most institutions were deemed too big to fail; the losses from all their sour loans were not fully recognized and allocated among the actual owners. In reality, many of the problems were merely transferred to the public sector. We are now sitting here with a massive budget deficit and an extremely easy monetary policy. Both will have to be unwound at some point, and it could get messy.

The low rate environment has provided the federal government with some breathing room. The average annual cost of our outstanding debt is only about 1.3% because much of it is of short duration. Specifically, 60% of the obligations will come due within three years. Seems to us that with long rates as low as they are, it would make sense for the U.S. Treasury to extend maturities. Otherwise, the U.S. is funding long-term liabilities with short-term financing. Wasn't that what Lehman and Bear Stearns did?

The long fall of interest rates

Going back to the 19th century, interest rates have tended to move in generation-length cycles. Since 1981, we have benefited from a protracted wave of falling rates. After peaking at 15%, the 10-year Treasury bond yield stands at just over 3% today. Clearly, the great 29-year bull market in bonds is over; after all, yields can fall only so far from here. The more salient question is whether we are at the cusp of a new cycle of rising rates. The short answer is that it's too early to tell.

Rates have moved up from abnormally low levels since late Fall, coinciding with the Federal Reserve's announcement of further easing. However, the rise seems to be more a reflection of an economy gaining traction than new inflationary fears. From that standpoint, the backup in yields is consistent with rising stock prices.

Clearer and better

We do not expect to reach closure this year on the many issues that have been confronting investors, but we do anticipate a better sense for how they will ultimately play out. The global recovery, with a hiccup here and there, should remain intact. Corporate profits will continue to rise, and the backdrop of significant liquidity should also act as a tailwind for stocks.

— Christopher J. Singleton, CFA, Managing Director

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