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Investment Perspective

WHAT COULD GO RIGHT?

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A tumultuous 2011 ended with U.S. stock market indexes clawing back to near their opening levels. It was a hopeful end to an otherwise frustrating year. Investor sentiment swung between hope and despair, depending on the news of the day. This lack of conviction defined the backdrop and set the stage for a volatile, but range-bound market.

The list of challenges has been well batted about. The European financial crisis continues to fester, as the ECB fiddles while Rome burns. Each successive summit to end all summits has failed to produce a definitive plan to address the Continent's problems. Meanwhile, the debate rages as to whether China's economy will implode due to an overheated real estate sector. The Shanghai stock index has certainly been quite ugly for awhile. In the United States, high unemployment persists, the housing market remains sluggish, and our political elites seem unable to address looming fiscal challenges.

So understandably, the airwaves and blogosphere are replete with references to what could go wrong. Sitting here today with the consensus so dour, we think it would also be prudent to ask, *What could go right?*

Promising trends

With most of the focus directed overseas, gloomy prognosticators have been overlooking a promising trend: The U.S. economy seems to be finding its footing. After anemic, sub-1% growth over the first half of the year, gross domestic product rose by 1.8% in the third quarter and is forecast to have risen by more than 3% during the fourth. This is not particularly robust for a recovery, but it should not be ignored. Indeed, it was not that long ago that we were being bombarded by warnings of a double-dip.

Moreover, given the subdued 2½-year recovery, there should be significant pent-up demand that will eventually be unleashed. For instance, sales of new automobiles have been running below the scrappage rate. Housing starts have been running at about half the normal household formation rate. This is a mirror image to the mid-2000s, when starts were at twice the pace of new households. That environment was unsustainable, and so is the current one.

The corporate sector could also prove to be a coiled spring. Capital spending has been near record lows as a share of cash flow. The capital stock, in real terms, remains at 2008 levels. In other words, business investment has been enough only to offset the impact of depreciation. But the spring will not be released until confidence picks up. And the timing of that is impossible to predict.

Big biz doing great; small, not so

It is important to point out that corporate America overall remains in solid financial shape. Profits after taxes have doubled from their recessionary lows and now stand at record levels. Total cash flows are also running above previous peak levels. However, it is important to distinguish between large businesses and their smaller brethren. Many smaller companies are clearly still struggling and are nowhere near peak profitability.

This contrast partially explains the sluggish jobs recovery. Firms with fewer than 500 employees account for a majority of private-sector jobs and most job growth. When this segment is cautious, the economy feels it. A monthly survey by the National Federation of Independent Business (NFIB) continues to indicate "poor sales" as members' single largest challenge. But NFIB members are now almost as likely to cite "government regulation" or "taxation" as their tallest hurdles.

These results imply that the political and policymaking landscape has been impeding the recovery. Think about it from a business' standpoint — whether small or large. Regardless of a firm's cash balance, it will be reluctant to commit substantial capital to expand its workforce or invest in plant and equipment if it does not know what it will cost to run the business, how much it will be taxed, etc. The political bickering and lack of leadership at both ends of Pennsylvania Avenue have contributed to an uncertain climate for decision makers. Nevertheless, small business optimism has started to move up over the last several months from its low levels. And job growth has begun to pick up as well.

Europe smolders along

But what about events overseas? Couldn't they derail the grudging U.S. recovery? The European financial crisis could certainly end badly. After all, the saga has persisted for almost two years. Picture a smoldering wildfire. If not extinguished, eventually the winds may pick up and spread the problem until it is a self-sustaining force, out of control. If so, woe to anything or anyone that stands in its path. Europe has not yet reached the point of no return, but it's a lot closer than it was twelve months ago.

To rehash the basic challenges, the Great Recession collided with years of deficit spending, straining national finances. Bond markets revolted, sharply driving up borrowing costs for a handful of countries, further pressuring their finances. European banks, significant holders of this now-questionable sovereign debt, found themselves severely undercapitalized. Instinctively, they ducked down into their foxholes and cut lending.

Austerity makes it worse

To qualify for relief, struggling nations have had to agree to a series of "austerity measures" and other reforms to improve their fiscal positions. However, such measures have served to further weaken their economies and thus aggravate rather than aid their public finances. Yields on sovereign bonds have continued to move up in response, threatening the capacity of some nations to fund their governments. It's a vicious spiral.

Our sense is that the European Central Bank has been engaged in a bit of brinkmanship, allowing high yields to persist in order to force governments to follow through on meaningful reforms. This is a dangerous game. Fortunately, policymakers seem to be on the verge of stumbling over the fact that the fire has spread. The ECB began to shift its policy stance in November. Rates have been cut twice, the first such moves in two years. More important, the central bank also introduced an unprecedented three-year lending program to provide liquidity to the financial system. In effect, banks may borrow unlimited amounts of money from the ECB at 1% and reinvest the proceeds into higher-yielding sovereign bonds or other assets.

At its core, this represents a camouflaged attempt at quantitative easing. No doubt, the hope is that banks will tap these funds and purchase sovereign bonds to earn the spread over the 1% borrowing cost. It would be essentially free money, right? The jury is still out as to whether banks will really be willing to expand their balance sheets, particularly with more sovereign debt. Nevertheless, this is an important effort that could begin to reduce the financial stress in Europe. If it fails, the ECB will have to hold its nose and directly make large-scale purchases. Either way, risk assets such as stocks would eventually benefit.

The price of land in China

Assuming Europe finally contains its crisis, China could be the larger question mark this year. The Middle Kingdom avoided a significant growth slowdown during the West's recession, thanks to a massive stimulus program earmarked for infrastructure and other investment spending. However, the initiatives also stoked inflation and exacerbated some speculative areas. Policymakers spent the last eighteen months tightening monetary policy to cool off their economy.

Consequently, money and credit growth have been slowing as intended. But in recent months, manufacturing activity has shown signs of shrinking, a worrisome new trend. Policymakers have thus reversed course and begun easing again. Predictably, a debate is starting to rage between proponents of soft and hard landing views. The discussions tend to center on the outlook for China's once red-hot property sector.

After rising sharply for years, Chinese home sales have been falling lately — and not just in the major cities in the East. To be sure, across the four so-called Tier 1 cities, the housing market has certainly been very frothy. Faced with excess inventories, some developers are reportedly cutting prices on new units. But nationally, one has to reach to find evidence of a true housing bubble. Ninety percent of China's urban population resides in cities other than the big four and, generally, prices in those other urban areas have not risen nearly as dramatically. In fact, since the housing boom began in the late 1990s, urban home prices have only matched per-capita income growth.

Real estate differences

That is a key distinction between the real estate market in China today and the inflated U.S. market of the last decade. We all know that the surge in U.S. home prices could not be justified by rising incomes — or by any other fundamental factors, for that matter. A second key distinction relates to the nature of home financing. In the U.S. it was not uncommon for a buyer to put little or no cash down. So even a modest price drop would put such homeowners under water. In China, homebuyers are required to post sizable down payments, and those levels have been raised as the market heated up. The restrictions on investor-purchased homes are even tighter as far as the equity required.

The ruling class fears domestic social unrest more than any other threat. To absorb the tens of millions of migrant workers moving to urban areas in pursuit of the *Chinese Dream,* the economy must expand at a robust rate. Unlike some of their Western counterparts, Chinese policymakers possess plenty of dry powder, both fiscal and monetary, to counteract a slowdown. Also in contrast to the experience in the U.S. and Europe, you can bet there won't be much squabbling about whether and how to act. A command economy does have its benefits. So we are in the China soft landing camp.

Entering 2011, many market observers were fairly sanguine about the prospects for economic growth and stock market returns. Results for both proved disappointing. Today, the consensus is much more subdued, but as we have seen, the consensus is frequently wrong. Individual investors and hedge funds alike have reduced their exposure to stocks. We agree that the backdrop is still fragile and fraught with risks, but we also think many of those risks are already factored in.

Stock up for 2012

Nevertheless, we expect that 2012 will remain volatile as the tug-of-war continues between the forces of reflation and deflation. But if Europe can stem its hemorrhaging, China can engineer a soft landing, and the U.S. economy continues to muddle along, the backdrop should be fairly favorable for stocks. Central banks globally have adopted more accommodative policies that should be inherently pro-growth. Meanwhile, after contracting last year, stock multiples appear attractive given the current inflation and interest-rate regime.

— Christopher J. Singleton, CFA, Managing Director
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