Third Quarter 2012 Investment Outlook

Intervention

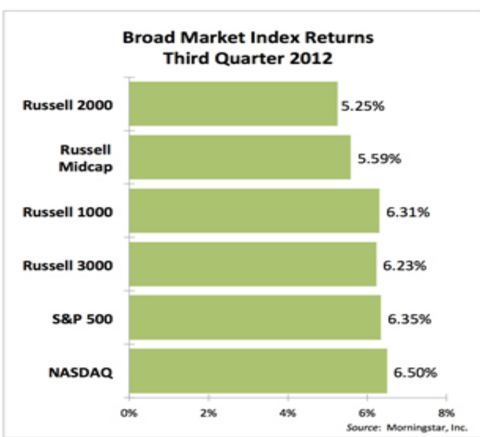
One of the more fascinating reality TV shows is Intervention on the A&E channel. The show, which won the 2009 Emmy for Outstanding Reality Series, is about real families intervening to save a family member with a major addiction to drugs or alcohol. Because it is a show about the human destruction and woe, it gets plenty of viewer interest. Global financial markets are in the Era of Intervention with central banks taking unprecedented policy actions to try to stave off more financial crisis/distress and to try to juice economies higher. Wouldn't it be fascinating if Intervention was really a show that captured the behind the scenes drama of central bankers? Imagine if Mario Draghi or Ben Bernanke allowed reality TV cameras to follow them around and film their interactions with other central bankers or politicians about our current global financial woes. Every serious investor or trader in the world would watch every episode religiously. For some of us, it would be fascinating to watch, but the ratings would probably suck. Why? Because the vast majority of Americans prefers to watch reality shows about a bunch of losers from the Jersey Shore, a 10 year old named Honey Boo Boo from Louisiana, or a group of strangers locked in a house or on an island for with cameras rolling 24/7 to try and win a large cash prize so they don't have to work at a real job (that is, if there were any real jobs to be had).

The real Intervention show supposedly has a 71% success rate, which is way above the norm for typical drug abuse intervention work. Boy, the world could sure use a 71% success rate if Intervention was really about my proposed Intervention show (as an aside, any executive producer looking for a new reality show idea can contact me at the email address at the end of this newsletter. I am willing to sell the rights so I can retire and avoid trying out for Big Brother or Survivor). Unfortunately, central bank intervention over the past five years has not shown a success rate at all like the real show Intervention and has been unable to pull the global economy out of its ongoing malaise. It doesn't mean they won't keep trying though as central banks around the world engaged in large scale intervention during the third quarter.

Can I Borrow Your Bazooka, Ben?

For countries drowning in debt, high yields on bonds are like a death sentence. If the yields on the bonds remain elevated or increase, their budget problems get worse. Issuing more debt at higher yields requires budget cuts (austerity) in other areas, which leads to lower economic growth, which leads to increased unemployment, which leads to lower tax revenues, which leads to higher budget deficits, which requires more bond issuance, which requires more budget cuts, which means depression. This death spiral is the current situation in Greece and arguably Spain is headed for the same outcome. Something had to be done to change the game and ring fence the problem. In July, European Central Bank head Mario Draghi pulled out a bazooka and fired away. He used strong language in a July press conference about unequivocally backing the euro and suggesting that bond buying was within the ECB mandate and that no one should be mistaken in their resolve. The ECB followed that up in early September with a formal program called Outright Monetary Transactions (all obfuscating names from other central bank intervention programs were already taken). The objective of OMT is to drive down the yields on peripheral European bonds that had made it difficult for those countries to finance their wide budget deficits. The following chart shows that Spain's 10- year bond yield peaked near 7.5% in mid-July and began a dramatic and rapid move lower after Mr. Draghi's comments. Additionally, the German high court ruled in mid-September that bond buying was allowed by the European Stability Mechanism program. These actions served to drive peripheral Europe bond yields lower and drive risk assets higher.

The most recent round of intervention appeared to be a well-coordinated event. The Fed and the Bank of Japan joined the party in September with both announcing new initiatives to try to juice employment and economic growth on their respective home fronts. Risk assets like global equities were a key beneficiary of these moves during the third quarter with emerging and European markets outperforming the U.S. after having lagged the U.S. during the first half of the year.



Since the financial crisis began, each new round of central bank intervention appears to have had less effect than the ones before it. According to JP Morgan Research, the four major central banks (Fed, ECB, Bank of England, Bank of Japan) have pumped $3.9 trillion into global economies since 2009. This figure is before the latest rounds of QE undertaken by these banks. Four years later, what we have is anemic global growth with the U.S. the best of the sorry bunch, hitting just 1.3% real GDP growth during the second quarter. Nonetheless, the central banks apparently have decided that to stand on the sidelines and do nothing is not an option, despite than the unknown and unintended consequences of these unprecedented policy actions.

One can imagine how bad our situation in the U.S. would be if our government bonds had yields similar to Spain's (6% or higher vs. U.S. 10-year Treasury bond yield at 1.7%). The interest expense on our $16 trillion of outstanding debt would balloon massively higher and require unprecedented austerity actions here in the U.S. Instead, the Federal Reserve, through its QE program, is massively expanding its balance sheet (now $2.8 trillion and growing) and buying up 70% of U.S. Treasury issues to keep interest rates artificially low. The Fed actions have given U.S. politicians a hall pass (as if they needed more reasons to not accomplish anything). Congress hasn't passed a budget in three years and has not been forced to make tough decisions because financial markets haven't forced their hand yet the way skyrocketing bond yields have forced Spain, Portugal, and Greece to make massive budget cuts. Spain and Portugal are in severe recessions and Greece is in a depression.

Time will tell what the long-term impact of these extreme central bank intervention policies will be on the global economy. The size of the global debt problem has created more deflationary pressures in recent years but the most likely long-term outcome is inflation given the massive amount of money printing taking place. Today, we see real assets like oil at prices that don't jive with the current global economic conditions. How is it that oil can trade at over $110 a barrel (Brent crude price) when there is ample global supply and Europe is in a recession, England is in a recession, Japan economic growth is near 0%, U.S. growth is below 2%, and China growth is decelerating? Maybe Ben Bernanke or Mario Draghi know the answer.

Warning: Wrong Way, Go Back

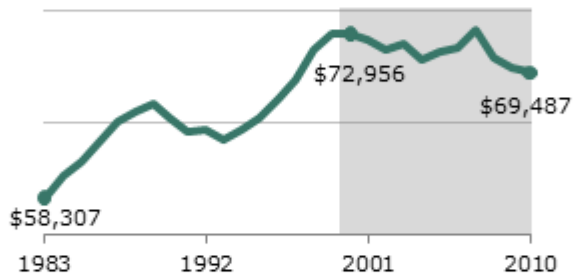
The American Dream is part of what makes the U.S. a special place in the world. The American Dream typically manifests itself (through hard work and just rewards) in the form of improved income trends over time. Unfortunately, the American Dream trends have been going in the wrong direction for a long time. According to a study from Sentier Research, median U.S. household income fell 4.8% to $50,964 since the recession ended in June 2009. Since December 2007, average U.S. household income is down 7.2%.

The Pew Research Center put out a long-term study on the U.S. middle class and the picture is equally bleak. As shown in the following charts, it's been a long and painful road for many Americans for over a decade.

A Decade of Decline

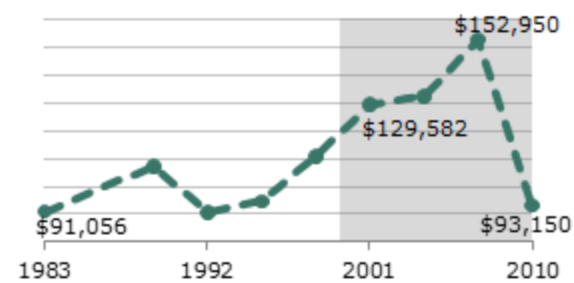
Middle-Tier Median Household Income Falls ...

Incomes are scaled to reflect a three-person household (in 2011 dollars)



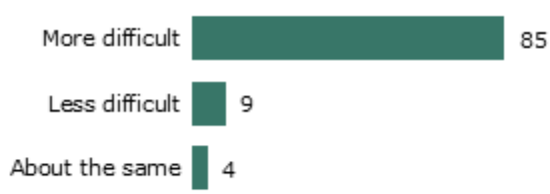
... Median Net Worth Plummets ...

in 2011 dollars



... and the Middle Class Says its Lifestyle is Harder to Maintain

% of middle-class who say it is ... for middle class to maintain standard of living today than 10 years ago

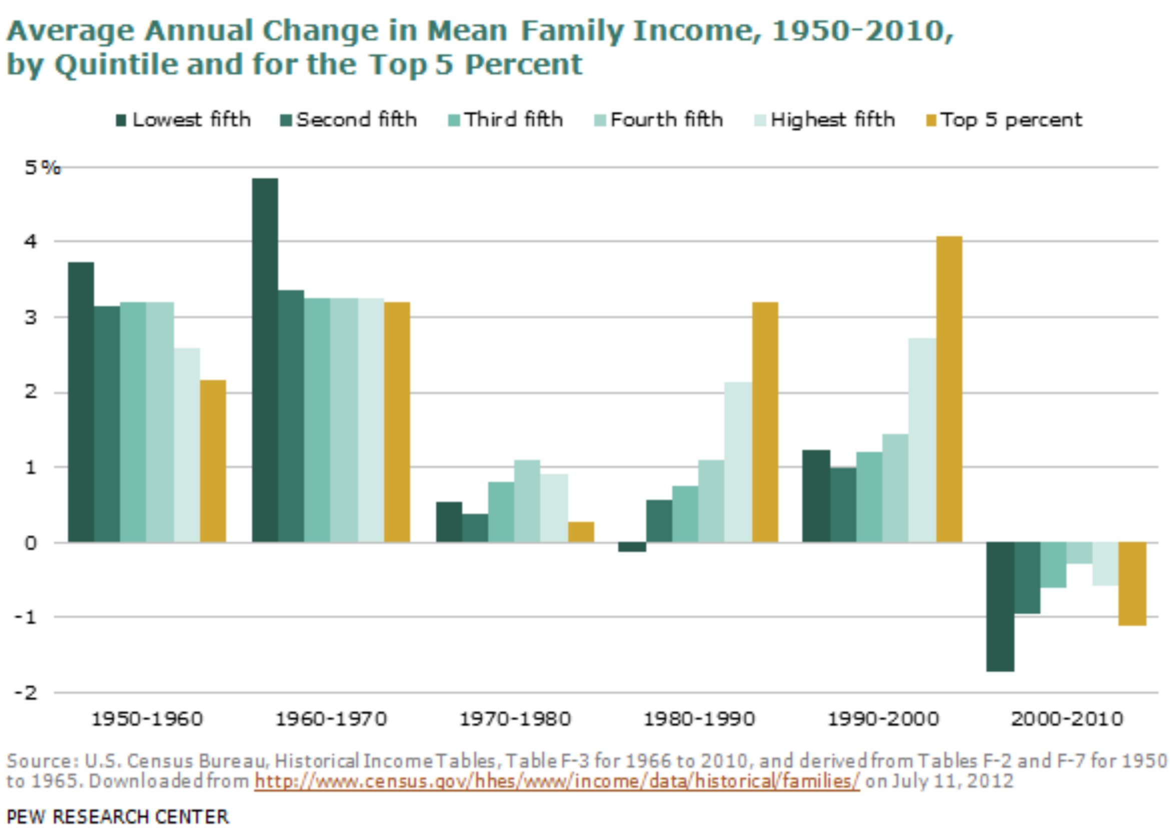


Notes: Income and wealth trends based on households with household-size adjusted incomes 67% to 200% of the national median. Attitudes chart based on respondents who say they are middle class, n=1,287. "About the same" is a volunteered category. "Don't know/Refused" not shown.

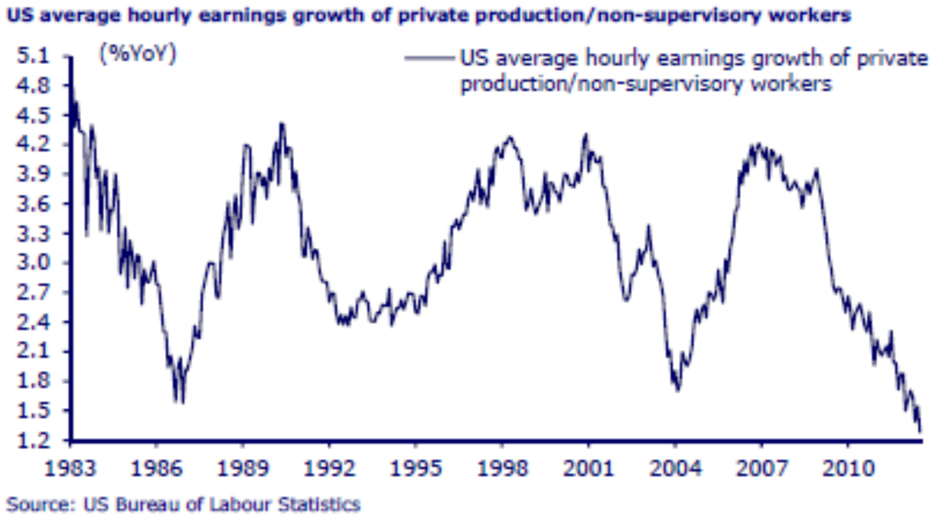
Source: Pew Research tabulations of the Current Population Survey, Annual Social and Economic Supplements, 1984-2011, and Survey of Consumer Finances, 1983-2010; Pew Research survey, July 16-26, 2012

PEW RESEARCH CENTER

The next chart, also from the Pew Research study, provides a snapshot of average annual family income growth over the last 60 years by decade. Each decade is broken down by income quintiles (20%). We can see how a growing middle class was established from 1950-1970 and how income disparity in America accelerated during the 1980-2000 period as the top two quintiles (top 40%) of Americans saw significant income growth relative to the bottom three quintiles. The first decade of the current century has not been kind to anyone but has hit the bottom 40% of Americans the most.



The next chart provides more proof of how the standard of living of the average American has declined due to very low income growth. From recent peak of 4.2% in 2007 before the Great Recession hit, average hourly earnings growth has plummeted for five years to 1.2% and is at the worst level of the past 30 years.



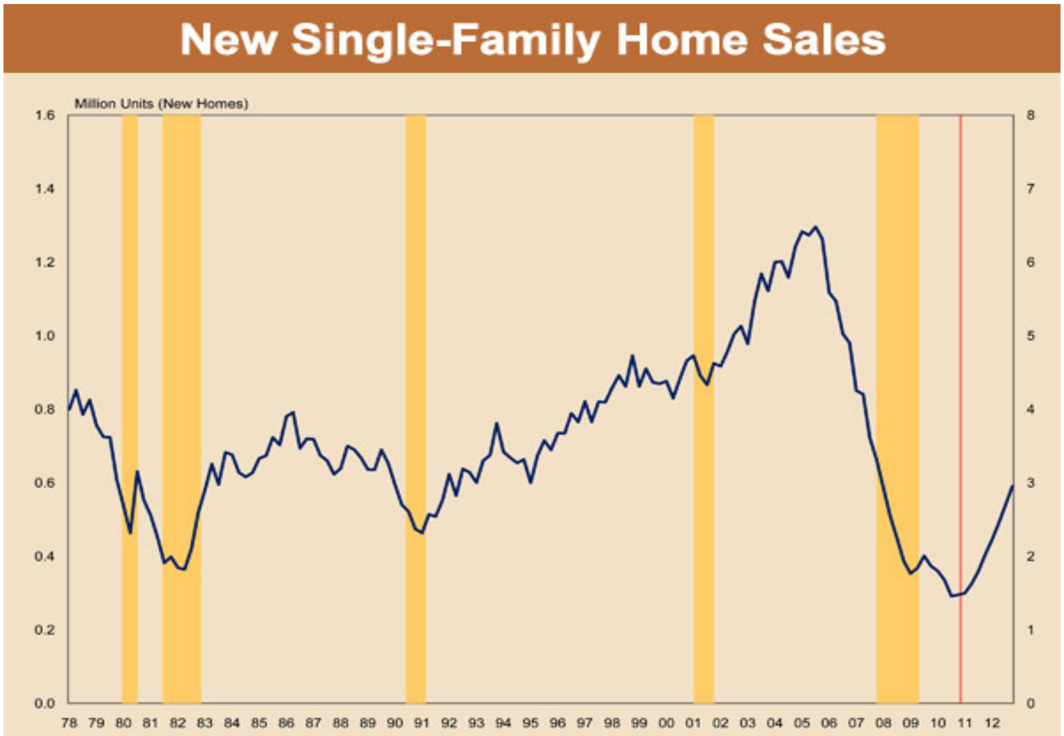
When we consider how the costs of things we need to live like healthcare, food, and gasoline (up over 100% since 2003) have gone up considerably over the past decade, we can see that income growth is not keeping pace, which is why most Americans feel poorer and the standard of living is declining.

Income inequality is an increasing source of tension in the U.S. According to income research work done by Emmannuel Saez at the University of California, the top 10% of Americans now control 50% of all income, up from 35% level that held from 1942-1982. The top 1% of Americans by income control nearly 25% of all income while a record level of 46 million Americans (15% of households) are on food stamps. These growing income gaps lead to societal unrest, where the 99% blame the 1%, the 1% talk about the 47%, and politicians no longer can produce bipartisan legislation because there is no longer an acceptable common ground to be found.

A royally screwed up tax code, uncontrolled government spending, and massive central bank interventions have all contributed over time to our current state of affairs. It's time to reset the clock in order to get America back on a proper course so that everyone's standard of living begins to improve again. But, make no mistake, there is a lot of pain to endure between here and there.

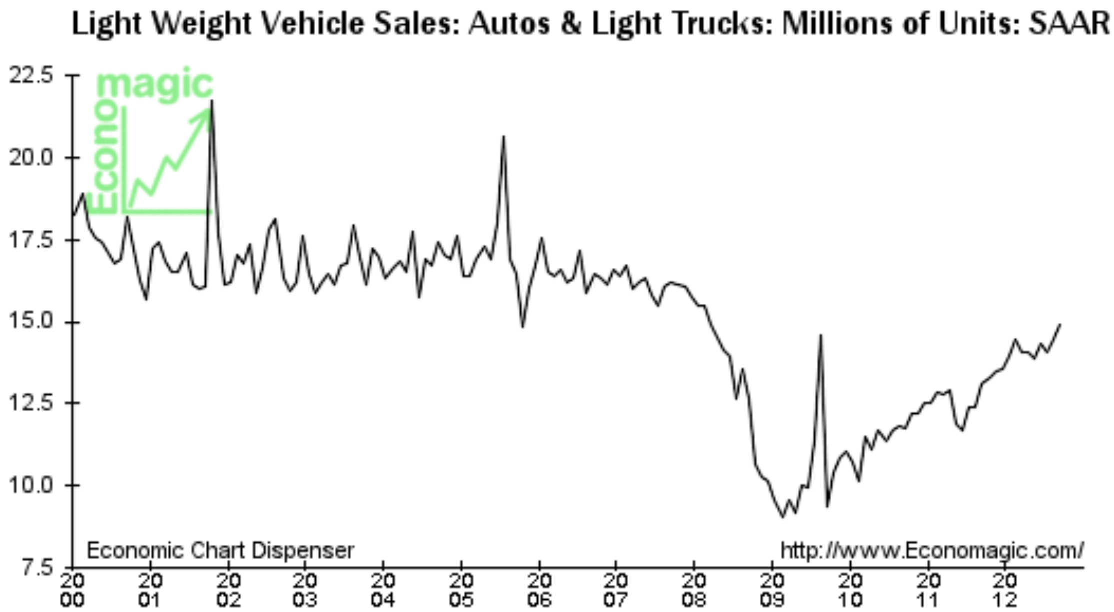
Two Improving Areas in a Dull Outlook - Housing and Autos

Inevitably, this period of unprecedented central bank intervention to keep interest rates at extremely low levels has to show up in a positive way somewhere, right? Yes, the domestic picture, while struggling overall, has a few bright spots. The two sectors of the U.S. economy that took the biggest hits in the financial collapse were housing and auto sales. Even with the very weak economic performance of the U.S. economy overall, new housing and auto sales have improved and are now two of the few bright spots of the U.S. economy. Yes, the annual sales numbers are still well below the peaks of 2006/2007 in both categories but they are no longer contracting and detracting from U.S. GDP growth. Because new housing starts declined so dramatically (see next chart), it no longer is a big kicker to the economy at current levels so its recent strength is not having a large impact on real GDP growth. Housing related stocks are one of the strongest performing areas of the stock market this year.



Source: NAHB.com

Unlike housing, which just began to revive this year, auto sales have seen a slow grind higher since the 2008/2009 recession (the huge pop in following chart during 2009 was due to the Cash for Clunkers program) but are also still well below prior peak levels. Cars wear out faster than houses so purchase deferrals can only go on so long with autos and light trucks. The average age of a car in the U.S. is nearly 11 years and has never been higher. Auto and auto related stocks have not done as well as housing stocks this year because the main industry players have European and China exposure and those areas are still seeing significant weakness or decelerating growth.



Source: Economagic.com

Autos and housing are two key areas of the U.S. economy benefiting from the unprecedented low interest rate policy of the Fed. Rates on mortgages are at historic lows and auto loan rates are now at levels where even consumers with lower credit scores can pass muster with credit providers because the monthly payments are lower.

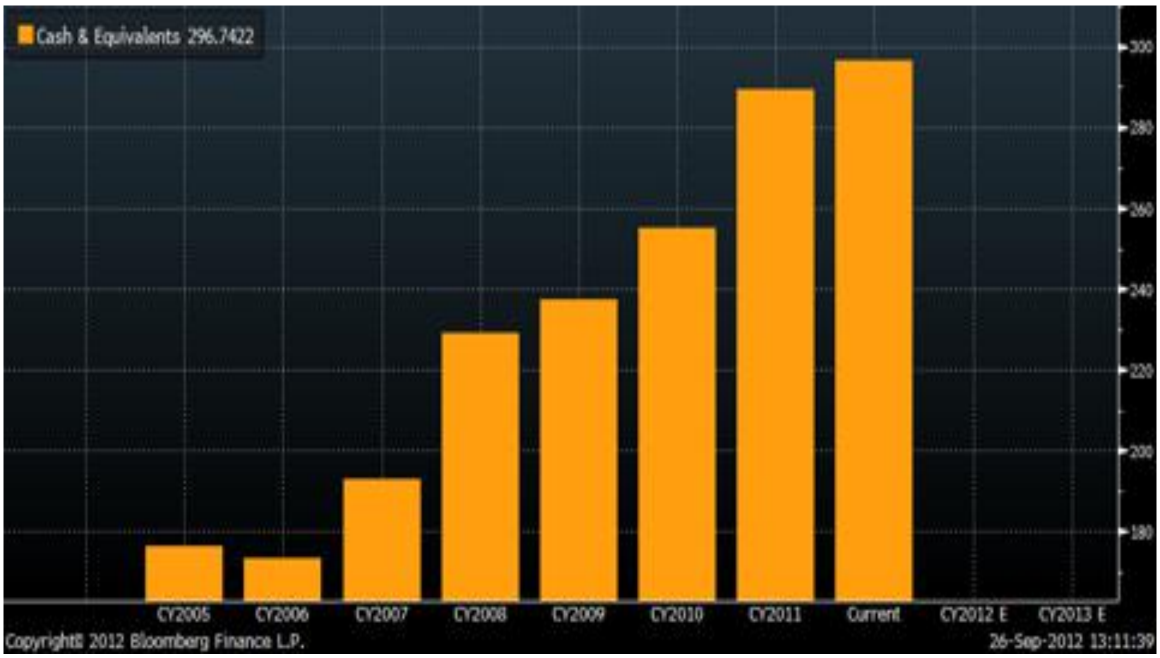
Corporate America is also taking advantage of the generational lows in interest rates by issuing large volumes of debt, most of which is being used to refinance higher rate debt. This is a no-brainer move for high quality companies (investment grade). Investors, who are getting close to 0% on their savings (Ben Bernanke giveth, Ben Bernanke taketh away), are tripping over themselves to buy corporate debt at higher yields in order to earn some level of return on their money. Companies can extend debt maturities to lock in these low yields for a longer period of time. Ultimately, issuing bonds with lower yields leads to lower interest expense, which leads to higher profits, ceteris paribus (just for you, Latin fans). Another major goal of Ben Bernanke's intervention policies is to move the stock market higher so people feel richer and will spend more.

Of course, the U.S. Treasury is also a key beneficiary of the Fed's current policy, allowing it to issue debt at historic low yields and allowing it to continue to fund our massive budget deficit. There is no doubt that if the Federal Reserve was not expanding its balance sheet and buying up a significant amount of U.S. government debt, U.S. bond yields would be much higher than current levels. The quality of the U.S. government as a borrower has deteriorated as our outstanding debt has ballooned to $16 trillion.

Politics and Uncertainty

The U.S. election is down to the final stretch. For now, it looks like President Obama has a modest lead in several important swing states but the remaining debates are likely to shape the final outcome. The outlook for control of the House and Senate remains cloudy. Just given the poor economy and languishing employment picture, you would think sentiment against Obama would be much stronger but so far that has not been the case.

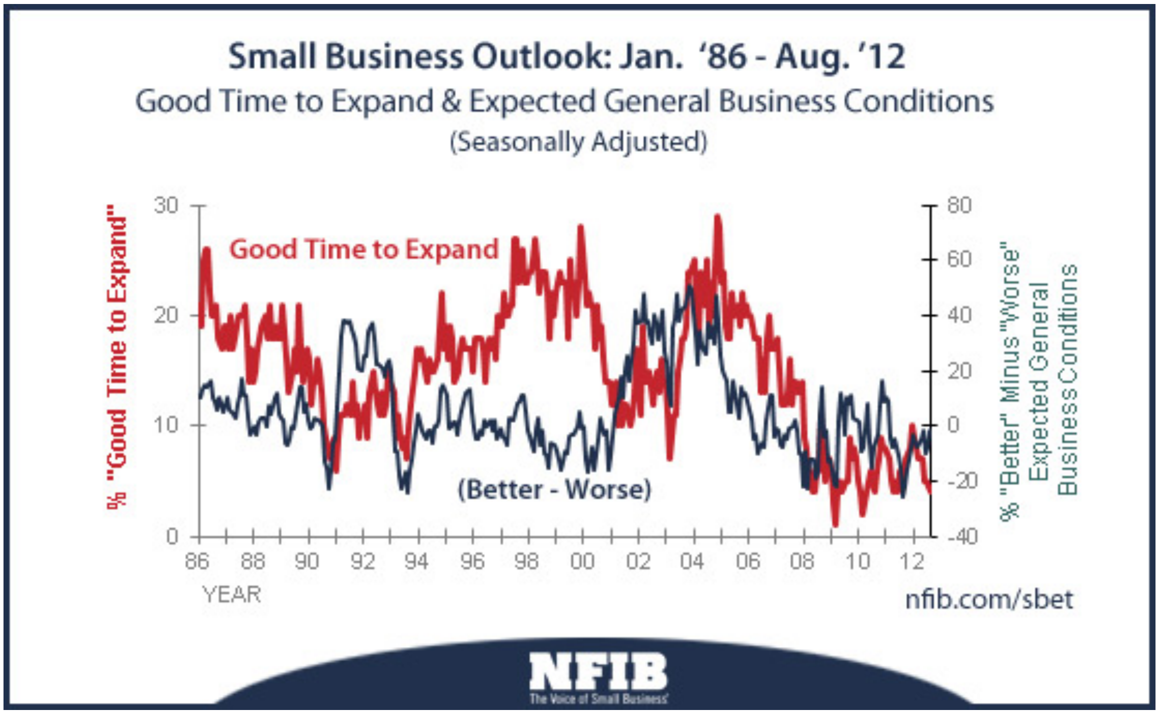
The inability of Congress and the President to craft a bipartisan plan to address the U.S. long-term deficit problem has cost the U.S. economy and contributed to the weak economic growth profile. The level of uncertainty is too high for companies to invest and hire, as shown by the increasing amount of cash (earning virtually 0%) on the balance sheets of corporate America.



Source: Bloomberg

The prevailing uncertainty and malaise extends down into the small and medium business sector as well. The confidence readings as taken by the National Federation of Independent Business survey are still languishing near past recession lows. Unsurprisingly, taxes and government policy/red tape are the two main reasons businesses cite for their lack of confidence.

If the November election produces a status quo outcome (Democratic president, Democratic controlled Senate, and Republican controlled House) the stock market is likely to experience a severe bout of indigestion because expectations of a compromise to address the fiscal cliff on a timely basis will decline dramatically. Significant cuts to government spending will kick-in on 1/1/13 without bipartisan cooperation.



Single Most Important Small Business Problem - Aug. 2012

Problem	Current	One Year Ago	Survey High	Survey Low
Taxes	23	18	32	8
Govt. Reqs. & Red Tape	21	19	27	4
Poor Sales	20	25	34	2
Comp. From Large Bus.	7	8	14	4
Cost/Avail. of Insurance	7	8	29	4
Inflation	6	6	41	0
Quality of Labor	6	4	24	3
Other	4	8	31	1
Fin. & Interest Rates	3	4	37	1
Cost of Labor	3	3	9	2

NFIB
The Voice of Small Business
nfib.com/sbet

Source: NFIB.com

Summary

For any steward of other people's money, these are difficult and challenging times to invest. If you have a risk management component to your investment process, caution and defensiveness are the prudent and proper course because the global macro risks remain elevated and large and the fundamental outlook remains weak. 2012 has been all about intervention, which has undermined the defensive investment strategy. Central banks have made fools of many investment professionals this year so far and the statistics tell the story. As measured by Morningstar, and using the average return, not a single category of U.S. stock mutual funds has outperformed the passive S&P 500 Index benchmark or broader Russell 3000 Index through mid-October. Hedge funds, where typically the best and the brightest (and most overpaid) in the investment business ply their trade, are having a terrible year, with the average fund returning less than 5%. Yet, we suspect the typical investor with broad stock market exposure will likely be pleased with their portfolio returns (average balanced fund is up approximately 10%) when it feels like the markets should be giving them something much worse.

The fourth quarter doesn't get any easier. The pending November election results are unlikely to alleviate the prevailing uncertainty as the likelihood of the fiscal cliff being addressed during a lame duck session of Congress seem remote, particularly if the election outcome is status quo. Stock markets generated healthy returns during the third quarter as the economic data worsened but the prospects of more central bank intervention increased. However, once the actual policy decisions were announced, the stock market has declined in the face of a weakening earnings outlook. At some point (are we there yet?), central banks will run out of intervention options and economies and markets will have stand on their own two feet. Will we cheer or cry when that day arrives?

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