



Six observations for February

1. The US Federal Reserve Board has spoken. It is certainly not that at ease with the strength of the current business cycle in the United States. It has announced it will keep interest rates low until 2014. Originally, the Fed had announced that a low-rate regime would last until 2013. But it now stands ready to keep short-term rates low for longer and to enact a third round of quantitative easing to buy long-term bonds. By implication, the Fed is supporting long-term and even risky assets, but its real goal is to stimulate job growth and perhaps to stabilize the housing market.
2. Europe's slowdown or imminent recession seems contained at this point. It is evident at the beginning of 2012 that the peripheral European countries are showing negative growth or contraction. However, parts of Europe, namely Germany and France, seem to be holding up rather well. We are certainly not witnessing the type of production cuts or rapid deceleration in overall growth that we saw during the financial crisis of 2008. Importantly, initial industrial indices turned up in late 2011, and the weakness of the euro seems to be boosting the exports of Germany, Europe's largest economy. Assets, which are now pricing in a European recession, may be poised to rally if Europe sidesteps the expected recession and bank failures.
3. Everyone has been looking to the European Central Bank (ECB) to pull out the big guns and unveil a US-style TARP (Troubled Asset Relief Program)-like program to shore up the European banking system and to prevent a widespread credit crisis. The ECB has disappointed, however, and has taken a series of half-measures that have helped to hold the euro together. The ECB has deployed medium- and long-term asset programs that were not highly heralded but seem to have effectively moderated the borrowing costs in some of these countries and in effect blunted the risk of owning peripheral country bonds for European banks. It seems eurozone leaders are intent on holding things together, albeit without a major fix to the underlying crisis.
4. The US economy — amid its initial signs of acceleration — stands out among many other regions of the world that are slowing and even faltering at the outset of 2012. In the United States fourth-quarter numbers showed improvement over those of the previous three quarters of 2011. The pace of production has quickened. Inventory-to-sales ratios are low; retail consumption is holding up; and gas prices are stable and at this point don't present a threat to consumer spending. While the US economy seems to be in good shape, we are likely to witness a slower pace of growth in the first and second quarters. I say this because we saw significant growth in the fourth quarter of 2011, and while a lot of that growth was organic, some of it was pent-up demand that stemmed from the supply disruption after the Japanese earthquake and tsunami.

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5. As far as earnings go, we are coming to the halfway point in the fourth-quarter earnings reporting season. The bottom line is that earnings across the board will probably be comparable with third-quarter earnings. Even though those third-quarter earnings hit records, it is still disappointing that fourth-quarter results aren't better because the fourth quarter is usually the strongest of the year. It doesn't look like that will be the case this year. Some of this weakening results from a transatlantic transmission mechanism. Sales to Europe and to emerging markets, which have also been affected by Europe, are slower. There is a slowdown in growth in the EM countries and certainly a downward trajectory in Europe. That slowing is affecting the top-line sales of big US multinationals that trade in Europe. It is certainly not a disaster, and in many sectors there have been very good positive surprises. Markets have already priced in a quarter that will not break records.
6. So, what does all this mean for asset allocation? Again, we are likely to experience a muddle-through, but not a negative, period. The expansion is continuing, and it now has the support of the Fed. From a historical point of view, spreads are wide. At the same time, companies have high liquidity levels and pretty good profits. So credit markets are likely to be a good place to invest. The forward price/earnings ratio of the US stock market is a little better than 12x earnings. The increasing dividend payout now seems to be supported by the Fed's two-year policy of low rates. It is clear that the slowdown in Europe is affecting the large Standard & Poor's companies, but smaller and mid-cap companies, which sell more within the United States, are still experiencing sales and margin growth. One bright spot in this earnings season, among the various sectors of the market, is technology. Many software providers and tech-oriented companies have surprised Wall Street with earnings on the upside of forward estimates.

It is notable that the US economy is growing a bit faster, while many world economies are slowing. It is also interesting to note that US corporate growth and consumer spending, while not moving forward at the torrid pace of the 1980s and 1990s, are moving ahead without added debt. There is no debt expansion relative to total assets on company balance sheets, and the consumer debt load is being whittled away. That decreased debt load is resulting in a consumer much more able to service remaining debt. This strikes me as a much more sustainable and organic expansion, albeit running at a slower pace than normal. This expansion does not suffer from the risky "juiced" effects of leverage. In my view that makes the expansion more durable and able to withstand the painful effects of a possible credit contraction down the road.

No forecasts can be guaranteed.

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