Brief Reflections

April 30, 2011

No big surprises came out of last week's Federal Reserve meeting and the press conference that followed. Investors were reassured that asset purchases by the Fed will be carried out in full and the maturing principal will continue to reinvest. At the same time, Chairman Ben Bernanke indicated that considerable warning will be given before policy eventually reverses course. By the Fed's own admission, this second round of quantitative easing (aka "QE2") was supposed to work principally through financial markets. As evidenced by a new cycle low reached in implied volatility, junk bond yield spreads narrowing and the trade-weighted dollar sinking to a new low last week, it would appear this policy has worked.

The stock market has been steadily climbing to new heights, despite all evidence of higher inflation rates and concerns associated with ending the quantitative easing program. The 10 year Treasury currently yields 3.3% versus 3.5% only one month ago, shrugging off higher energy prices and troubles in the Middle East. Rising absolute valuations have contributed to much of the advance. Earnings growth has played a major part as well with 2011 earnings expectations, currently more than four percentage points higher than they were at the start of the year. Additionally, with more than half of S&P 500 companies now having reported for the first quarter, 72% have delivered positive surprises. However, even earnings may not have risen independently of QE2. Higher commodity prices have meant that some of the largest upward earnings revisions for both the first quarter and the full year have occurred among energy and materials stocks. It is these two sectors that have led the broad market since QE2 was announced last August.

Nevertheless, we expect growth to remain under some pressure and have modestly lowered our GDP forecast closer to consensus estimates of 3.0% for 2011. Keep in mind that unemployment is still running at the 8.8% level, suggesting that it may take far longer to reach pre-recession levels of employment in the current slow growth rising inflationary period. Although the first dose of QE in late 2008 undoubtedly helped to prevent the distress in the financial system from overwhelming the real economy, exactly how beneficial it has been for real economic activity is still unclear. Outright deflation may have been skirted, but massive increases in consumer prices related to commodity strength and dollar weakness have been generated instead, while other prices more closely tied to domestic wages have been muted.

According to inflation expectations surveys, households look for this divergence to continue. While many investors see more generalized price inflation as a risk, Bernanke has posed the argument that the greatest risk may be that domestic wages and domestic-wage-driven prices continue to lag behind. In this sense, more broadly based price increases would actually be desirable, but the high unemployment rate and structural lack of wage bargaining power make it less likely.

Meanwhile the Fed's actions have also failed to lift housing prices, another would-be source of good inflation. Though no mention was made of housing during Chairman Bernanke's press conference, ongoing price declines (the 20-city Case/Shiller index fell for an eighth consecutive month in last week's report) remain a constraint on real activity.

However, consumption growth has so far been resilient, even strong. In a soft first quarter, personal spending actually contributed the most to GDP growth, rising at an annualized 2.7%. This is encouraging, but may require continued gains in equity wealth and a faster pace of wage growth to be sustained. This is especially true if housing prices continue to fall and as both payroll tax relief and extended unemployment benefits expire next year. Although a weakened dollar has contributed to an annualized 10.9% export growth in the recovery, and therefore has been beneficial for growth overall, it should be remembered that exports account for only 13% of U.S. GDP. Imports are larger and have grown as well, creating a slight drag on GDP since the recession ended.

Most economic statistics remain favorable for the economy, although the rate of growth is slowing. The ISM Manufacturing index experienced a modest drop in April, but remained above the 60 mark for a fourth consecutive month and at a level consistent with GDP growth of 5% annualized rate. With business activity, new orders and employment continuing to advance, alongside industrial production growth, we expect corporate profits to come in at 10% above last year levels. However, while risk appetite is currently being fed by accommodative monetary policies outside the U.S., we remain guarded in our optimistic outlook for real economic activity as broad money growth exceeds underlying GDP.

Peter Altman
President