# **A l t m a n I n v e s t m e n t M a n a g e m e n t**

# MARKET PERSPECTIVES

August, 2011

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***CURRENT PERSPECTIVES :***

- **For years, New York had been the financial capital of the world. But unfortunately Washington has temporarily replaced New York in that role over these past several months.** On Tuesday, in both houses of Congress, Republican and Democratic leaders reached an interim agreement on spending reductions that allow the debt ceiling to be raised. However, until a more comprehensive agreement on fiscal consolidation is achieved, public rather than private decisions are likely to remain the major determinant of market sentiment.

- **Under any of the various directions that the budget talks might have taken, an inability of the government to honor its debt obligations was never the real concern, even in the unlikely event that the debt limit was not to be raised.** Just as the capital structure of a private corporation dictates that bondholders are paid first in the event of a cash flow shortfall, so the ongoing tax revenues (of around $200 billion per month) that fund 60% of government spending would unquestionably have been used to pay creditors first; obligations to equity holders (that is citizens) would have been sacrificed instead. After the votes were cast, what remained a concern for investors were the potential implications for economic growth, and the potential fallout from a rating downgrade that could follow the passage of the deal. Credit rating agency S&P had indicated that only a 'grand bargain' (deficit reduction in the region of $3.5-$4 trillion) could prevent it from acting.

- **For now, the debt limit uncertainty has been removed until early 2013.** Congress will have multiple opportunities to vote against debt limit increases over the next year, but since the President would clearly veto these resolutions and Congress would not be able to muster the two-thirds vote to override his veto, the uncertainty surrounding this issue is now effectively removed through 2012. We estimate that a $2.1 trillion increase in borrowing authority would probably last until around January 2013. A $2.4 trillion increase would probably last until late spring or early summer of that year.

- **But with all the focus on Capitol Hill, the issue that has arguably received the least attention – the real economy – may be the one that deserves the most.** Though data releases have recently been overshadowed by press releases, its worth mentioning that the U.S. economy was already in a soft patch within a soft recovery before the additional obstacle of political instability was introduced. Unlike governments in peripheral Europe, the problem for the U.S. has not been one of funding or solvency, but the debilitating effect of uncertainty on the real economy. Even with a budget deal signed, the risks associated with an ideological divide in Washington further exacerbate the already tenuous economic future. An immediate Pavlovian rally in markets was expected earlier this week as the proposed plan received congressional approval, but questions over whether meaningful deficit reduction can be achieved politically remain unanswered.

- **Indirectly, policy uncertainty has taken its toll on both consumer and business confidence, especially given the record that 27% of household income that now comes from government spending in the form of salaries and transfers.** But more directly, skittish markets themselves will threaten growth. The past two weeks' $54 billion of net outflows from U.S. money market funds was not necessarily anomalous, but should this mini liquidity squeeze persist or worsen, the need for money funds to ensure adequate cash balances will only further constrain lending to the private sector. This situation could of course been compounded if a sovereign downgrade led to lower ratings and higher funding costs for major banks, which partly derive their own credit rating from that of the federal government. But whether from direct or indirect consequences, slower growth will only slow tax revenues, making the task of deficit reduction harder still.

- **In addition, the latest round of economic data has offered no relief.** Even though initial unemployment claims improved, durable goods orders for June were weak, and the Federal Reserve's Beige Book report pointed to worsening conditions in eight of the 12 regional Fed districts. Home prices were flat, while second quarter real GDP grew at a paltry 1.3% (annualized), taking the year-on-year rate to just 1.6%. Historically, a recession has rarely been avoided when year-on-year growth has dipped below 2%. In short, given its fragile state, the last thing the real economy needed was an additional shock, especially a self-imposed one. In the end of the day, a deteriorating economic outlook may be just what markets are pricing. It is therefore not surprising that Treasury yields moved sharply lower this week, as debt fears intensified and global equities significantly underperformed.

- **Congressional policy has clearly been driving markets over recent weeks but, looking forward, the question still remains whether the current conditions in the real economy can improve even if the deficit crisis has been avoided.** Both parties agree that the social contract has to be renegotiated, but the big political failure is the way in which the ideological distance between them impaired their ability to negotiate with each other. Even in its aftermath, the political disarray in Washington has further unsettled investors as economic developments have taken center stage again. Additional stresses have also resurfaced in the eurozone as investors question latest support measures that have resulted in additional headwinds for equity markets.

## ***THE ECONOMY:***

- **We are plagued with the fact that while over half a million jobs have been lost in the state and local sectors since 2009, reform is taking place against the background of high fiscal deficits and budgets that have to be balanced by law.** It's worth mentioning that reform of the federal government in order to move towards balancing the budget would also take a heavy toll on employment. With unemployment currently at 9.2%, and approximately 43 million people on food stamps, the reform of the federal government should ideally take place when the private economy is expanding at a faster pace than currently. Since the economic recovery started after June, 2009, economic growth has averaged only 2.7% with two million jobs having been created versus the eight million lost in the Great Recession. Economic recoveries after recessions caused by financial calamities, such as the banking and housing crisis in the recent recession, are historically quite anemic.

- **The renewed slowdown in the first six months of 2011 with growth of less than 2% is quite disconcerting coming at a time when the European Union is experiencing a sovereign debt crisis in five of its weaker peripheral countries.** Economic growth in the European Union is even slower than in the U.S. Also the faster growing Asian countries, led by China, were recently raising interest rates to combat rising inflation. Food inflation is a major concern in China and much of it has been caused by bad weather.

- **Energy inflation is also a major global concern as it reflects itself in the costs of many products and services, such as transportation.** At present, the social and political revolution in much of the Arab world where much of the worlds' energy is produced has led to higher oil prices in 2011. The U.S. however, is blessed with an abundance of natural gas which can now be extracted from shale deposits thanks to new technologies which offers some hope for the future. Overall, a better balance between environmental regulations and economic growth could help reduce the costs of production. Global warming in recent years has caused more droughts, earthquakes, flooding, and general weather disruptions which have contributed to increased food inflation. From an investment perspective, this phenomenon has affected economic growth rates and raised prices in the farming sector. Recent statistics reflect a slowdown in employment, industrial production, and retailing. Capacity utilization remained at 76.7% with retailing still up 8.1% from last year's level. Business inventories rose in May and are up 11.6% year-over-year. However, the U.S trade deficit has risen to $50.2 billion as exports weakened and the cost of energy increased imports. As expected, the worsening trade balance negatively impacted the U.S. dollar.

- **On the positive side, consumer prices (CPI) fell in June but remain high at 3.6% from a year ago levels.** Producer prices also fell in June but are up 7% over the past year. Durable goods orders reversed in May and business equipment spending has been a strong bulwark throughout the current business expansion. Finally, the Conference Board's leading indicators increased, albeit at a slower pace than May but still confirming a slow but positive growth trend ahead.

- **Since the debt extension has been passed by Congress (the national debt is $14.3 trillion), and a bill will soon be proposed to reduce government expenditures coupled with tax reform (lowering tax rates while removing most of the special interest tax exemptions), we believe that the economy will continue to grow.** However, we have revised our forecast for GDP growth at a below-average rate because we are living in the age of debt deleveraging. We continue to believe that there will be a modest pickup in the second half from current growth rates such that real GDP should grow on an annual basis at 2.5%, down from our original forecast of 3.0%, and potentially rise to 3.0% for 2012. We have moved our inflation targets down to 2.8% and revised corporate profits growth expectations to a gain of 8.0% for 2011. Unfortunately these downward revisions to growth are probably insufficient to stop the unemployment rate from drifting a touch higher. Slower U.S. growth and a softer core inflation picture reinforce our view that the Fed will be on hold until at least 2013.

## ***IMPLICATIONS FOR THE FINANCIAL MARKETS:***

- **During the second quarter, the equity markets were weighed down by a large number of financial and economic concerns which have already spilled over into the third quarter results.** Although the final quarterly returns for the U.S. equity markets as measured by the Standard and Poor's 500 were flat in the second quarter, overall equity markets began deteriorating after April. Weaker economic statistics, combined with the sovereign debt crisis in the European Union and the political maneuvering over extending the debt ceiling in the U.S., have placed extreme stress on many investors. This backdrop has forced investors back into in U.S. Treasury bonds, rallying the 10-year U.S. Treasury bond prices and pushing current yields to 2.60% versus 3.0% only just a month ago.

- **While the Federal Reserve's quantitative easing program (QE2) ended on June 30, its monetary policy of keeping short-term interest rates at 0-25% on federal funds remains in place for an extended period.** Given the extent of the current slowdown and its resultant weak employment numbers, the current policy with regard to federal funds could last into 2012 unless inflation significantly increases. Higher inflation seems unlikely at present, although the rise in gold prices and a weak U.S. dollar index adds some uncertainty. Keep in mind that recent money supply statistics have accelerated to 11% annualized growth rates over the past three months and 7% over the past six months. Certainly, the Federal Reserve has been vigilant in maintaining an expansive monetary policy since the end of the Great Recession.

- **Commodities have remained strong over the past month despite the slowing economic statistics.** Gold ($1650 per ounce) is up 4.4%, copper ($4.37 per lb.) is up 6.8% and oil ($99 per barrel) is up 4.2%. All commodities, as measured by the CRB index, have increased 0.4%. The U.S. dollar has weakened, down 10.6% from a year ago. Equities have had a tendency over the past year to perform well when the U.S. dollar is weakening and when commodities have been rising. Perhaps this trend has been reinforced by the aforementioned monetary easing by the Federal Reserve.

- **Corporate profits have performed well since the economic recovery began with profit margins hitting all-time highs.** Costs have been kept well under control as productivity has soared. We expect corporate profits to slow in the second half for an overall gain of 8%. A gain to $92.36 per share on the S&P 500 stock index would represent an increase of 8% over 2010 earnings. The consensus of strategists on Wall Street is still somewhat higher. Nevertheless, the current P/E ratio on our estimate is 14.7, not an excessive valuation.

- **Unless the current slowdown were to turn into another recession, valuations appear reasonable given the low interest rate alternatives.** Overall, we believe that some caution is warranted since economic conditions globally are slowing. Also, the political move by many governments to policies of austerity in the face of huge financial deficits could take a toll on economic growth which has its own unintended consequences.