Economic Outlook
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Until there is greater clarity regarding the global financial system, individual and institutional investors will apparently be content to suffer negative real returns on bonds rather than the potential of large absolute losses in stocks.

- PIMCO

"The market is increasingly getting convinced that the Fed will do whatever it has to do…."

- Boston money manager on October 2, 2007,

one week before the start of the 53% decline

in the DJIA which didn't end until March 9, 2009

Many an old Western film contains the scene where the town sheriff squints out his office window, rubs his 3 day beard and says to his deputy, “It’s quiet……….too quiet”. It has become easy to sympathize with the sheriff these days as an investor. While on the surface, the threats to global growth, all too real over the past six years, seem to be diminishing. But underneath this somewhat more sanguine economic landscape still lurk the very problems that six years earlier caused the most extensive worldwide financial crisis since the Great Depression. These elements can be held in check for a time but if they’re not resolved, can reemerge, like a beach ball held underwater, in an abrupt and unpredictable fashion. This is most likely the circumstance that we face today in global markets and economies – suppressed unresolved issues have created what could be called a latent volatility in all countries.

Certainly in the U.S. the drumbeat of economic statistics is showing that its economy is improving in many areas. Most notably, the housing sector is advancing steadily, well off its bottom but still well below the peak levels of 2005-6. This residential recovery has been of substantial benefit to the overall economy due to meaningful support to ancillary industries such as furniture, appliances, carpeting, etc. The employment picture has brightened as well with the unemployment rate falling to 7.7% from over 10%. Probably most attention has been attracted by the stock market which has recovered all of its prior losses from March 9, 2009, hitting an all-time high recently as measured by the DJIA.

The news flow from other countries has turned less negative, with the European Central Bank easing sovereign and bank credit fears which had reached a peak in 2012. The weakness in the Chinese economy seems to have been alleviated for the moment while Japan is just now launching a full-blown quantitative easing program, a la the U.S. Federal Reserve.

Regrettably, the underlying realities are less encouraging. The primary issues which led to the difficult economic and financial experiences in recent years are still unresolved. Governments around the world, most notably in the U.S., remain infected with a severe case of deficit reduction disorder. For all the tumult over “the Fiscal Cliff”, “the Debt Ceiling” and “the Sequester”, very little has been accomplished in reducing the enormous fiscal deficits in our country. Even with the Sequester being allowed to take effect on March 1, 2013, total federal spending will continue to rise, only at a somewhat slower rate. Deficits over the past four years have exceeded $1 trillion per year, with fiscal 2013 now projected at around “only” $900 billion. This red ink has caused U.S. total indebtedness to rise to over $16 trillion, thus, ignoring the current fiscal year, in four years total federal indebtedness has risen 33%, not including any social program liabilities which are now variously estimated at between $50 to $55 trillion. Since the U.S. borrows roughly 45% of each dollar it spends, it is highly dependent on the “kindness of strangers” – it does not control its own destiny. China, the U.K. and Japan are the major buyers of U.S. debt securities. These foreign sovereigns along with investors of all sizes have piled into U.S. Treasuries as a haven during the financial crisis. Finally, the Federal Reserve, as part of its quantitative easing programs, has vacuumed up most of the Treasuries issued over the past year. These factors have combined to give the U.S. some of the lowest interest rates in the world, and the lowest in post-war history. Combined with aggressive stimulative policies in all other major countries, the resultant rock-bottom interest rates have given a substantial (and welcome) boost to the U.S. and global economies and stock markets.

The European political and financial systems are a long distance from being in a stable mode. The lending and bond markets remain dysfunctional and resistance to austerity measures is rising, suggesting that political reforms will be slow in coming and political flare-ups a likelihood. Euro-area unemployment has reached unheard-of levels of over 17%, with Spain registering 26%. Further GDP contraction is expected this year on the order of negative 1.5%.

The question to be answered in light of the above is "have the economic and financial fundamentals changed or have perceptions of them changed?", the answer is clearly the latter. If the proximate causes of the Great Recession were historically high levels of debt on the part of governments, corporations and individuals, in addition to excessive monetary and fiscal policies, then those factors have only gotten worse in the past four years. In order to heal the global economic system in actuality, meaningful <u>reductions</u> in deficits and leverage will need to occur over time. In the event, we have seen deficits rise and borrowing rise in most sectors in most countries – only the U.S consumer has reduced debt over the past four years.

As noted above, central banks around the world have pursued record-setting stimulus policies in an attempt to reflate their economies and offset the fiscal drag from governments striving to lower their deficits. From all evidence it appears that very little of that stimulus has resulted in economic growth mainly because liquidity and low interest rates were not the causal factors of the crisis. Most of the central bank liquidity has bypassed the real economy and has instead pooled up in capital markets, unused by the economy, where its owners have attempted to earn some sort of positive return. These funds have found their way into all of the different investment markets (including stocks) as well as hard assets like gold, silver, commodities, art and real estate. Thus, the rise in prices at varying points in time in these markets has been due essentially to excess funds from central bank pump-priming (for example, a Merrill Lynch study finds that there is an 85% correlation between the growth of the Fed balance sheet and the S&P 500 Index.)

This extraordinary type of monetary liquidity provision has in the past resulted in rising inflation and gross misallocation of resources. By the latter is meant when economic resources, in this case capital, have no real productive economic use, they tend to find their way into <u>unproductive</u> investments. The intense search for some – any - return on those assets leads to investments in higher yielding securities or other types of assets, either through current income or capital gains, which by their nature are riskier. The past year has seen a remarkable return in demand for these types of assets, many of which will bring back corrosive memories from the financial implosion of 2007-8. Examples of this reach for yield (or "dash for trash") include:

1. High yield corporate bonds issued with very loose covenants ("covenant- lite junk bonds") and the majority having the lowest bond ratings

2. Private-issue mortgage securities, i.e., not backed by FNMA, GNMA or FHLMC

3. Leveraged buy-outs

4. CDOs and CPDOs (!)

5. 100% mortgage loans

6. High risk commercial real estate loans

7. Debt issued to pay dividends and/or buy back stock

8. Bond funds lowering the quality of bonds in their portfolios

9. Student loans being issued in prodigious amounts with poor underwriting

Needless to say, the reemergence of these trends is hardly the healing process necessary to address the financial distortions in the global economies brought about by excessive central bank easing and overutilization of leverage. Longer run, the Fed and Treasury are debasing the U.S. dollar which will lead to domestic inflation, reduced standards of living and reducing the debt burden through inflation over time at the expense of savers. In the short run, the markets can keep going as long as the central banks can keep the music playing. No one, including the Fed, knows how long that will be. There are many things outside the control of the Fed and other central banks such as unrest in the Mideast, European banks and politics, long term interest rates and even North Korean missiles which could upset the current delicate balance in world economies, not to mention the unknown timing and pace of the ultimate withdrawal of monetary injections. And this, then, is the conundrum for investors and businesses. They will need a steady hand in the coming period of time to balance the need for at least minimum returns without exposing themselves unduly to a potential resurgence in volatility. Just like the sheriff, we can enjoy the current period of quiet while keeping an eye out for trouble.