Debarred from Certainty

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Waiting. For the FOMC, ECB, politicians, decisions. And for the answer to "Where does growth come from?"

There are no clear answers and so markets hide behind the broad "uncertainty" excuse, track sideways with the occasional downward lurch. No red-blooded businessperson is intimidated by uncertainty. All capital spending, innovation and product renewal jumps all over it, more than happy to win share from less decisive competitors. The real issue is lack of aggregate demand with a very high liquidity preference. If that sounds too Keynesian, so be it. Fiscal policy is in disarray with unintended contraction coming. And interest rates reflect worry about deflation not borrowing or money supply. But there are unequivocally good things happening in the US. These include a healthy corporate sector, lower household and enterprise debt, low inflation and a slow clearing of the housing market. So press on.

Breaking Rules: An economy with excess capacity throws up anomalies.

Excess money supply leads to inflation.	It doesn't. M2 has grown over 12% recently. Core CPI less than 3%.
Government borrowing sends interest rates soaring.	Federal spending started its climb in 2002 and accelerated in the 2008 recession. Meanwhile GT10s fell from 6% to less than 2%.
Inflation threats are everywhere.	Occasional supply tightening (think energy) can change end-user prices but the government has been able to borrow at negative rates[1] for the last year and a half.
Government crowds out the private sector.	The New Issue Market has no problem borrowing around $25bn a week at record low rates. Ninety-two (92) percent of small businesses say credit supply is no problem.[2]

And why the exception to these rules? Because the economy has so much spare capacity. At the 2008 peak, nominal GDP was around $14.5 trillion, in line with potential GDP. This year it will run nearly 5% below, equivalent to $730bn of lost output. It gets worse. From 2008 to 2012, we will have produced $3.7 trillion less than our capabilities.[3] This waste of economic resources shows up in the underemployed rate of 16% and capacity utilization stuck at around 77%.[4]

Inflation and Deflation: At the core of the economic debate is whether inflation, through government spending or monetary easing, is more a threat than deflation, through austerity and low demand. Let's be clear. Deflation is an unmitigated disaster for an economy. Banks do not lend because collateral is instantly worth less than the loans and consumers postpone purchases indefinitely. All normal activity seizes. But inflation is manageable. Nominal growth is vastly preferable to inactivity. We're in a middle ground today. And the morality debate between austerity and spending is not confined to the US, which is why we see social unrest, whether benign (Occupy Wall Street) or Molotov slinging (Greece).

Year-end Crunch: We know about 1.2% of fiscal spending falls away at the end of the year. This would be the sum of payroll tax credits, the 2009 stimulus and accelerated depreciation allowances. There's nothing to replace it although the jobs bill could fill in about 0.5%, slightly more in later years. This has not really sunk in yet despite Bernanke's very clear statement on "misplaced fears of inflation...and unwarranted disaffection" for fiscal spending and investment. On top of that, we know households have reduced debt by about $80bn a quarter for four years and personal disposable income is unchanged since 2007. So it's a slow build. Enough of the gloom, let's look at some positives.

1. As measured by the 5-Year Treasury Inflation Indexed Security, Constant Maturity
2. National Federation of Independent Business
3. Congressional Budget Office estimates
4. Federal Reserve Bank of St. Louis, Economic Research

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1. **The US Economy:** No double dip. This is for two reasons. One, history shows that monetary tightening instigates a double dip, of which, of course, there's no sign. Second, there are no excesses in the economy: no inventory build up, price increases, supply bottlenecks or demand. There's not even asset price inflation (bonds don't count, they're a finite-upside asset class and gold is too weird). Less theoretically, we saw nearly all the Fed regional surveys and ISM data say the same thing over the summer: shipments, volumes and orders down but prices and employment steady. This reversed in September as manufacturers reported better conditions. More importantly, a full 28%[5] of companies think all major activity measures will improve in the next three months. This seems in keeping with the trend of manufacturing, agricultural and industrial growth and low consumer expectations. It's one reason why ten of the twelve federal reserve districts reported better or unchanged conditions in October.

2. **European Melodrama:** For much of the last year we saw the various EU players agree that there might be a problem, that something should be done and that they were implacably committed to the euro and Europe. So far so clear. But the markets have also digested and priced in a worst case scenario: i) Greece can not grow its way out of its current problem, so it will default ii) banks will shrink their balance sheets to recapitalize and iii) the EFSF[6] will take on more buying power. The inevitable economic slowdown, again from fiscal consolidation, will be around 1% but, one hopes, accompanied by a reversal of the rate hikes earlier in the year. The markets can live with this. There may be more re-pricing to come, like the widening Bunds/OATs[7] spread and a deal that prevents a CDS payout (thus obviating a much used risk management tool) but the worst is probably over.

3. **Patience in China:** The change in China is from a trade protected, subsidized industry, government preference and undervalued exchange rate mode to an open, consumer, high value manufacturing strategy. This takes years. Authorities have tried to contain inflation and dilute some of the property woes through increased reserve requirements and bank lending restrictions...hence the sovereign wealth fund's recent buying of bank stocks. This will slow the economy to around 8%. But this is tough to do in an orderly way, especially as nominal GNP remains around 18%. Infrastructure growth is bound to slow; there is no marginal utility in adding more high-speed trains once the first big project is complete. Hence the concern around risk assets and the big underperformance of the Shanghai market both YTD and since the recent bottom on October 3rd. So we wait the transition.

The innocent pre-2008
are days gone.
Expect volatility.

What this means for capital markets

The innocent pre-2008 are days gone. Expect volatility. Markets distrust most of the news and there's little conviction in any one direction. Vanilla investors are on the sidelines. Day to day trading is mostly position covering and range bound investing. That's fine with us. The more algos and high frequency trading noise, the easier to spot fundamental anomalies. The challenge is to keep fluid between seemingly different but highly correlated markets. Here's our process:

Bonds

We thought rates would fall sharply from beginning year levels of 3.3% to around 2.2%...but all the way to 1.75% took us by surprise. The entire yield curve is below the CPI rate. This time last year, the long bond had a real rate of 2.7%. The bond rally is due to a cocktail of i) some pretty deft handling of Twist and transparency from the Fed ii) the risk-off trade liquidity preference iii) growth expectations and iv) the euro's obvious shortcomings as a viable reserve currency. The best play for bonds right now is:

1. **Trade the GTs:** The 10-year note and 30-year bond regularly have 2% to 3% intra-day price moves. Yields can be wiped out quickly. This is not an asset class to buy and tuck away. But clear (to us) price ranges form and Treasuries have very low frictional costs. For now, a 2.10% to 2.5% range for GT10s looks well underpinned.

2. **MBS:** have the duration advantage and running yield. Refis and loan modification plans can spook prices but we try to manage this by allocating to the 15-year tranches.

3. **Corporates:** correlate to equities so spreads, which drive corporate bond fund management, have widened out from the equity pull back. This will probably change and trading opportunities will come around. But, we're not thrilled at lending to corporate America for 10 years at 125 over Treasuries. We'll wait before committing more.

5. Federal Reserve Bank of Richmond
6. European Financial Stability Facility
7. French government bonds

Equities

Equities exhibit all the symptoms of ADHD. They carry one theme for a while, reverse and focus on innocuous details. That's good for us as we take the longer-term view and like to seek bargains. Let's look at some drivers:

1. **Financials:** are likely to have a rough time. This used to be more serious in the days when a healthy, lending financial sector was the transmission mechanism for corporate lending. But that's no longer the case. Nearly all the banks are going through a once in a lifetime deleveraging process. They simply cannot make 14% ROE (a target from one well-known firm) without risk and a 40:1 liability to equity ratio. Most trade well below book values, which underscores the skepticism that investors have in the value of the book. A couple of banks tried taking price falls (and so lower repurchase prices) in the value of their debt through the P&L. That's poor quality earnings in any language.

2. **Correction:** P/E multiples have dropped by a quarter in five months to around 11x. That's equivalent to a 20% EPS fall, which is in line with full-blown recessions. But we're not in a recession. So the correction is more due to sentiment and some lower guidance. Meanwhile cash flow yields are around 7%, which is 40% more than the equivalent Moody's Baa yield, and drive a 20% ROE. That looks like a solid foundation.

3. **Dividends:** We always like the dividend growers because cash in hand, growing and well covered, is a lot better for investors than share buy-backs and capital reinvestment. Share buy-backs have been long on promise and short on delivery. Management invariably does less than they announce at market tops. They should try running their purchases through the P&L instead of hiding them in treasury stock; the legerdemain would be self-evident. Dividends also tend to fall less than earnings and we find plenty of opportunities where we are paid to wait.

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So we're not rushing into any markets. There are no screaming bargains but neither is there much overvaluation. The earnings season is generally favorable and EPS growth looks around 18% YOY. That's enough to support prices and outperform most other asset classes in the next six months. We don't expect volatility to subside so it will pay to have cash at hand and to remain above the noise.

So putting it all together...

1. Markets have priced fiscal withdrawal and misplaced austerity but...
2. there's no relief likely on unemployment...
3. which means low inflation.
4. Eurozone will continue to play out a Good North/Bad South morality story. No real winners.
5. Move bonds into lower duration MBS.
6. Bond markets are taking too sanguine a view of interest rates, so trade around these.
7. Buy stocks that won't make cash calls and have a history of returning real cash.
8. Dividends accounted for 50% of S&P returns in the last 140 years...don't bet against that.

Source: Sentinel Asset Management, Inc.

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