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Market Commentary
Byron Wien

Time for a Pause
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Uncertainty has finally caught up to the equity markets around the world and we shouldn't be surprised. At the beginning of the year, most investors were optimistic about the outlook, partly as a result of the quantitative easing begun by the Federal Reserve in the fourth quarter of 2010. Much of the liquidity that poured into the system found its way into financial assets rather than the real economy. Even though a number of events that would be considered negative for equities took place in the first four months of the year, the indexes moved higher. The market was able to withstand the 9.0 (Richter scale) earthquake in Japan and the resultant tsunami, the Fukushima-Dai-ichi nuclear accident and related manufacturing disruptions, floods in Australia, severe winter weather in the United States, regime change in Egypt and Tunisia, civil war in Libya, a sharp rise in oil and other commodity prices, major credit problems in Greece and Portugal again casting doubt on the viability of the European Union and the euro, the possibility of a government shutdown as a result of hitting the debt ceiling in the U.S. and an inability of Congress to reach a compromise on cuts in the Federal budget.

Finally, however, the optimism began to wane. We have learned that the best time to buy stocks is when most investors are pessimistic. Points of extreme pessimism in terms of investor sentiment most recently occurred in March 2009 and August 2010, both important buying opportunities for U.S. stocks. As investor confidence improves and cash is employed, equities can have a sustained move. If investors are already positive, as they were at the beginning of 2011, stocks can still rise but it is likely that the energy of the market will dissipate and a correction will begin before too many months go by. The decline will be blamed on the factors that the market successfully plowed through during the upswing. The question then becomes: How vulnerable is the market and how far down will stocks go? Sentiment seems to be turning. Some survey-based indicators which were very optimistic (and therefore negative for the outlook) have shifted to neutral and the transaction-based Chicago Board Options Exchange put/call ratio is approaching a bearish reading which is favorable.

It is my view that the current market pullback was inevitable and is not indicative of a reversal of the positive move in equities that began last September. I still believe the basic underlying fundamentals are constructive. The U.S. economy grew 1.8% in real terms in the first quarter and I think forces are in place for real growth of 3% or more for the remainder of the year. There are three principal factors driving the growth: exports, capital spending and the consumer, and they are still in place, although perhaps not as robust as they were a few months earlier. The first quarter real gross domestic product report showed equal 1.5% contributions from the consumer and private investment. For the consumer, durable goods (primarily automobiles) and services made equal contributions of .7%; for private investment, equipment and software provided the largest share, much of it for productivity-improving devices. Net exports were a disappointment. Although exports were reasonably strong, the increase in the price of oil resulted in a small net loss for the category.

A number of observers are worried that the end of quantitative easing (QE2) will result in a sharp slowdown in the economy and a resultant market decline. While I believe the withdrawal of liquidity might contribute to the correction running its course, converting the optimism of the beginning of the year to concern or

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pessimism, I do not believe we are at the start of a prolonged market decline or the beginning of a recession. The negatives are well known: the rise in the price of oil has drained some consumer spending capacity; the slow decline in the unemployment rate has also deprived the economy of the buying power of more people finally at work again; the tightening of credit in the emerging markets to dampen virulent inflation has diminished demand for imports by those countries from the developed world; and uncertainties related to the viability of the European Union as a result of the possible default of sovereign credit in Greece, Portugal and Ireland have unsettled investors everywhere. The turbulence in the Middle East and North Africa confused investors as well. While many cheered the coming of the Arab Spring, it is not clear that democracy will thrive under the new regimes. One thing we do know is that oil production in Libya has stopped and the world no longer has access to the 1.5 million barrels a day that were being produced there. Events in Europe, North Africa and the Middle East have driven investors looking for a low-risk place to put their money into United States Treasury securities. The yield on the 10-year note is approaching 3% as fear capital from everywhere floods into America. Concern about slower growth in the U.S. economy has created a “risk off” attitude among domestic investors as well.

While the negative factors are far from illusory, there are some positives to consider as well. We are finally beginning to get some better news about housing. New home sales rose in April according to a Commerce Department report. Most of the other housing-related data are still seriously negative, however. The overhang of houses with mortgages that are 90 days or more delinquent is several million. Partly as a result of this, the Case-Shiller index of property values in 20 cities is still depressed, and sales of existing homes are still declining modestly month-to-month, but I believe the housing industry is approaching a bottoming process. This is important because construction workers comprise a key component of those unemployed. Some improvement in housing starts over the next year would be a major positive for the economy.

The liquidity provided by the quantitative easing program of the Federal Reserve must be replaced for the economy to continue to expand. There is some evidence that this is happening. Bank loans and commercial paper issuance have been increasing over the past four months and commercial and industrial loans have been rising for six months. Clearly some business people have enough confidence in the future to begin borrowing again and some banks are willing to grant the loans to facilitate their needs.

The credit situation in Europe is clearly worsening and the real risk is that the commercial banks may be vulnerable if the weaker countries default on their sovereign debt. Greece is the most troubled, and the mid-teens yield on its 10-year paper and the high cost of its credit default swaps are signs that confidence in that country’s ability to meet its obligations has all but disappeared. It now appears that a “soft restructuring” is likely, which means that debt maturities will be extended. There can be no doubt that the financial condition of Greece, Portugal and Ireland is extremely weak and the political climate makes a major austerity program in these countries difficult to implement. I still believe the stronger countries – Germany, France and The Netherlands – have more to lose than to gain if the European Union (EU) dissolves and they will provide substantial transitional aid to the weaker members. Even if one or more of the smaller countries does go through a debt restructuring, I think the EU and the euro will survive. Right now I think time is being bought. If progress isn’t made in the next three years, more substantial changes will take place in the EU.

It appears that the manufacturing situation in Japan is improving. I spent a day in Tokyo in May and it is clear that business activity has slowed down. Traffic moves freely and Narita airport is almost ghostly as fewer travelers are passing through Japan. Industrial production in March was down 15.5% from April and the impact of the nuclear accident on automobile production both in Japan and the United States has been significant. Evidence is beginning to emerge, however, that manufacturing is returning to normal, but concerns about inadequate supplies of electrical power this summer are troubling many companies. Toyota plans to work weekends during the summer and take two weekdays off. Both non-manufacturing indexes and department store sales are improving, and there are growing expectations that manufacturing will approach normal levels during the summer. Japan is no longer a major contributor to world growth, but it is an important component supplier and a return to normal manufacturing output is an important development.

During the past few months there has been considerable focus on the inflation issue. This has been particularly pronounced in the developing markets where food and energy are 30% or more of their respective consumer price indexes. China and India have tried to address this problem through monetary policy and there is evidence that they have achieved some success, but the major improvement in the inflation outlook has come from the commodities themselves. The possibility of Qaddafi stepping down in Libya has been a factor in reducing crude prices, but I believe oil and agricultural commodities got ahead of the price that was demand-induced because of an abundance of financial speculators buying futures. Once the prices showed signs of topping, traders got out and commodities pulled back to levels closer to those created by normal demand, thus reducing inflation pressure. I continue to believe inflation will remain relatively modest in Europe and the United States because wages and house prices will not be showing significant increases. In the developing world we have probably seen the worst because I believe commodities have peaked for 2011.

Certainly one cloud hovering over the equity market is the prospect of an impasse on the $14.3 trillion debt ceiling in the United States. In my view a government shutdown would be a negative for both political parties. If the government was unable to send out benefit checks and pay its bills, and could only maintain essential services, the American public would lose confidence in the political system as a whole and the Republicans would not get credit for their fiscal discipline and the Democrats would not get credit for trying to continue support for those in distress. In the eleventh hour (perhaps August), some compromise will be reached, but the trade-off may be costly. At the end of last year, the Republicans approved an extension of unemployment benefits (which the Democrats wanted) in exchange for the extension of the Bush tax preferences, resulting in a bigger budget deficit this year and next. Who knows what the deal will be this time?

As for the budget itself, the $4 trillion and $5 trillion savings in the proposals of both political parties are mostly achieved at the end of the decade when many of the people involved will not be in office. Near-term cuts are modest. Unless Congress is willing to make major adjustments in Medicare, Social Security and defense spending, our annual deficits will continue to run over $1 trillion. The recent Congressional election in a normally Republican upstate New York district in which a Democrat won may be instructive. The Republican supported a major change in Medicare on the grounds of fiscal responsibility. The Democratic victory came as a result of the voters choosing the candidate who wasn’t going to take something away from them that they were clearly counting on. This is why it is so hard to reduce government expenditures. If the goal of anyone in office is to get re-elected, it is difficult for any incumbent to practice fiscal discipline. We are seeing the same problem in Europe as the troubled economies try to implement austerity programs. The political future of democracies in developed countries may be a battle between populism and conservatism with some form of financial crisis determining the outcome. It won’t be pleasant to witness.

One favorable factor is that state and local government budgets are in surplus, having offset the cutbacks in Federal funding. Quarterly state revenues are up 10% from the previous year, a sharp change from the 15% decline during the recent recession. This doesn’t mean that some of the more troubled states like New York, California, Michigan and Illinois have solved their problems, but in aggregate the overall state of municipal finance seems to be improving.

Another persistent worry is that the Chinese economy is in the midst of an economic bubble or blow-off that is sure to come to a bad end. Concern is that the housing industry there is vulnerable and the banking system might be threatened as a result. The country’s high-single-digit growth has been fueled by excessive capital spending and much of that is wasted, the critics argue. I just returned from my second trip to the region this year and I remain an optimist. The Chinese economy has many problems, but the basic strength results from growing consumerism and I believe we will continue to see impressive growth for several more years, at least.

Overall, I think the world economy continues on a modest growth path. The developed economies should expand at a real rate of 2% and the developing economies at 5% or better for an overall rate of 4% for 2011. The rise in initial unemployment claims, some weak reports from regional Federal Reserve districts, mixed housing data and the disappointing durable goods report have many observers worried that the economy is seriously slowing. Many economic observers are reducing their estimates of economic growth for the United States for the remainder of the year. This may be what is needed to convert investor sentiment from optimistic about the outlook to serious concern and that could form the platform for a better market after the summer.

Click here to register for the Wednesday, July 13, 2011, 11:00am ET Blackstone Webcast: Byron Wien presents "Outlook for the Second Half".

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