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Investment Outlook

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Markets Heat up Along with the Weather

It's been a long, hot summer for most of the US and some of that heat is spreading to the stock market. For those paying attention, this summer is shaping up as a pleasant surprise in many ways. Just when it looked like the "Go away in May" crowd would be proven right once again, July's advance in equity prices have many investors thinking "summer rally" in the most unlikely of scenarios. There has been no shortage of data pointing to slower global growth, a decline in US manufacturing output, waning consumer confidence, and higher unemployment. Add to that Europe's recession, the uncertainty of the election outcome and the fast approaching "fiscal cliff" here at home and you have headwinds and the makings of a lethargic, range-bound stock market. Instead, stocks have ignored the macro-level negatives and posted gains that have taken the indexes within whispering distance of the 2012 market high we saw at the end of Q1.

Could this advance be a knee-jerk reaction to reasonably good corporate earnings? The Q2 earnings season has seen almost 70% of S&P 500 companies reporting beat estimates but there have been some big misses too. S&P earnings are on track to post a healthy $102 for 2012 but many expect Q3 to mark the beginning of a slowdown in profit growth. That would seem reasonable given China's slowing economy and the US's *black hole* in fiscal policy that continues to erode confidence and discourage capital investment in this recovery. So, is the stock market looking beyond the US elections to a much brighter 2013? Hardly. We're giving most of the credit for this rally to Mario Draghi…. Who?

When the Going Gets Tough…….

The tough go on vacation. That's what leaders, finance ministers, and bankers do when work grinds to a halt every August in Europe. As long as the beaches remain open, there is no financial crisis that will deter officials from their appointed vacations. Before heading off, Mario Draghi, president of the European Central Bank, was thoughtful enough to leave us with something to get us through the month: A pledge "to do all that is necessary to save the Euro". We've heard this before in the past two years from the IMF, EU Commission, heads of state, and central bankers. The markets would rally for a day or two until details emerge, revealing that nothing new or substantive is in the works. Inevitably, we'd find the markets lower and Europe back where it began: Arguing the merits of Stimulus versus Austerity rather than agreeing on a plan that would change the downward trajectory of the Club Med economies.

However this time around, there are several things that could set Draghi's promise apart from others. First, the timing: His remarks mirrored earlier public comments by the Fed's Ben Bernanke regarding his intention to do whatever is necessary to keep the US recovery going. The Fed has used Quantitative Easing to inject liquidity into the system and avert a deflationary spiral in the aftermath of the US banking crisis. That hasn't gone unnoticed in Europe and Draghi's follow-up comments offer a hint that Europe will add stimulus to its agenda for stabilizing the Euro-Union. It appears he'll be taking a page from the Fed's playbook by having the ECB once again buy bonds directly from troubled sovereigns. This would occur in conjunction with a related plan that calls for the European Stability Mechanism (ESM) to directly recapitalize the banks of at-risk sovereigns .

If this comes to pass, it will mark a badly needed change in the public finance process that's emerged in the wake of the crisis. Currently, the ECB lends money to a country that would then recapitalize its banks with the condition that they buy that sovereign's bonds. This was a circular formula that served only to offload that government's insolvency to the balance sheets of its banks. The promise of a new approach by the ECB and ESM breaks that cycle and presents the opportunity for banks to lend and invest in the private sector once again, something that's essential to stimulating organic growth in their respective economies.

Also on the table is the issuance of collateralized bonds by sovereigns. Finland is leading a movement to demand collateral in exchange for its contributions to Spain and the ESM. They see this as a market-driven method of encouraging private investment and lowering the borrowing costs of sovereigns like Spain and Italy. And they know what they're talking about. This is exactly what Finland did during its financial crisis of the 90's. It allowed the country to dig out of trouble and regain its financial footing inside of a decade. Finland's experience can serve as the blueprint for the EU to emerge from the crisis. Much like it is in the US, a model for resolution in Europe isn't lacking, only the political will to get it done.

Will Europe Walk the Talk?

While much has been promised, very little has been done. The bare bones of a plan have been announced and most agree that certain aspects of it mark a departure from previous plans that served only to kick the can down the road once again. We take the view that investors should enjoy this rally while they can but, come September, the details of this comprehensive and convoluted approach to resolving the crisis will have to be revealed and a course of action decided. We're all too aware that markets detest uncertainty and there is sure to be no shortage of that when vacation ends.

As of today, Angela Merkel and Germany await the decision of its Constitutional Court on the question of whether the country can legally contribute to the ESM and under what conditions. Draghi and the ECB have yet to state their plan for the terms and conditions under which they will borrow from the EU "Haves" and lend to the "Have-Nots. Christine LaGarde and the IMF stand ready to act but offer no clues as to what the world's central bankers are willing to do and under what conditions. Lastly, the issue of debt mutualization with oversight and enforcement by a collective fiscal authority is still in the early talking stages. Whether that fiscal authority comes about in the form of a new entity or simply a more powerful European Commission remains to be seen. Plenty of questions and few answers at this point.

A lot has to happen within a relatively short period of time for all these pieces to come together to solve the multi-country/single currency puzzle presented by the European Union. We give it no better than a 50/50 chance that a workable plan will be agreed upon and in place within 6 months. That makes it unlikely that the stock market will breeze through what remains of 2012 with the wind at its back. However, we've noticed that investors have toughened up in 2012 when it comes to Europe. They've become used to the idea of Greece's departure from the Euro-Zone and are encouraged by the EU's newly found appreciation for a combination of both stimulus and austerity.

It's becoming apparent to all that the EU is slowly turning to embrace Bernanke's recipe for crisis management: Stimulate and Inflate. After all, inflation is the enemy we know and can conquer. Deflation is another animal that no central banker wants to confront. We believe this is why we're seeing higher lows in the market with each successive disappointment emanating from Europe. Solving the EU problem is a process and the recent promises and comments by Draghi and others lead us to believe the plans being discussed are evolving at a faster rate than before. So, while this rally may not have the staying power that we like, it represents a step up on the charts and an indication we've come significantly closer to the day that we can put Europe in the rear-view mirror as a driver of stock market action.