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Quarterly Investment Outlook

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Will Politics Rewrite the Global Growth Story?

In our June Investment Outlook we warned that a soft patch in the recovery might bring about a correction for the stock market. Even though several weeks of unprecedented volatility made it feel like a meltdown, the stock market hasn't exceeded our worst expectations. It has priced in the debt ceiling impasse, the subsequent downgrade of US debt, and the inability of those in Washington to formulate either a budget or a fiscal policy for the future. More importantly, The Euro-zone is proving itself to be equally inept as it grapples with a debt crisis that is about to topple Greece and other sovereigns in the region. As the markets traded lower this summer on fear and an erosion of confidence, the global economy has shown surprising resilience in key areas. However, we see potential damage to the global growth story arising from a failure of the Euro-zone to address its problem while in the US the period leading up to the election is shaping up as another "lost" year for its economy. The question has to be asked: Can the Global Growth Story persist if policy-makers in the developed economies are unable to lead and make hard choices?

They're Baaack

Congress, that is. After a month-long vacation of laying low and avoiding uncomfortable town hall meetings in their home districts, elected officials have returned to pick up where they left off: Stuck in the middle, between competing ideologies, with No Budget. No Plan. No Action. Our leaders have been busy playing the blame game for the last two years, leaving the Fed to do the heavy lifting. However, Chairman Ben's quiver is nearly empty and now it's time for fiscal policy-makers to step up. Unfortunately, all we're getting is more of the same: a surfeit of "speechifying" and a scarcity of action that has set a new standard for Washington. That's a polite way of saying that we're advising investors to lower their expectations for action even further: to a level where the relevance of this White House and Congress to the global growth story comes into question.

The old adage: "Lead, Follow, or get Out of the Way" applies here. We think investors will eventually catch on to a few things: That inaction by the US government will do less harm than a bad plan and may actually have a positive impact on the Global Economy in the year ahead: That a private sector, having built a productivity surplus, can successfully drive the US economy even when burdened with 9% unemployment. That, despite dour consumer confidence and sentiment polls, those who have a job are consuming like its 1999. Yes, that may sound a bit tongue-in-cheek but we've come a long way since 2009 without the benefit of a budget, a plan, or meaningful action from our elected leadership. By failing to act, they essentially "got out of the way" of this recovery. We're betting the global economy can improve further despite Washington's paralysis.

Elephant in the Room

The de facto "timeout" for Congress leaves attention focused where it belongs: Europe. While the sovereign debt crisis threatens the balance sheets of major banks in the Euro-region, the structural integrity of the global financial system isn't at risk such as it was in 2008. This is about the IMF, European Central Bank, and major financial institutions in the region deciding how to allocate losses arising from the default of Greece and any other dominoes that may be toppled. In the old Common Market days, Greece would simply default on their obligations, devalue their currency, and restart their economy with a clean balance sheet. Today, a default isn't so simple. Greece is now part of a club whose members share a currency.

The Euro-debt crisis will have to be sorted out, either by the markets ("hard default"), the ECB ("bailout"), or the banks ("soft" default). The ECB and IMF have to look beyond Greece to assess what method can best avert a "domino effect" in the Euro-zone. In our mind, the ECB has a choice: Keep the Euro-zone intact; Or not. The former would likely employ a *share-the-pain* approach to allocating losses: Combine a soft default with a scalable bailout and follow with a recapitalization of the major banks. Everybody takes a hit in the short-term in exchange for preserving the club and restoring its solvency. "Plan B" would see Greece default and be expelled from the club. The drachma would be reincarnated and the Greeks would fend for themselves as the "low cost" manufacturing option in the region. Whatever the choice, the sovereigns would foot the cost of resolving the crisis by shoring up the banks to prevent other dominoes from falling. We betting on "Plan A" since it's the least disruptive approach and should provide a blueprint for assisting other sovereigns in the club.

A Happy Ending to the Story

Imagine you have entered a world where the US and Europe suffer from a loss of confidence in both its leadership and institutions; One where fear could become a self-fulfilling prophecy of recession; One, where the US economy runs slightly above stall speed while the sovereigns and banks of Europe stare into the abyss of a debt crisis. You've just entered the Volatility Zone. That's where we've been these past few months and it's been exciting and sometimes harrowing to see the markets process all the possibilities of an uncertain future. Jim Stack of InvestTech is one of our favorite analysts who we've followed for decades. He's a market historian and strategist who's seen it all in the stock market. Until now. In his August issue he offered these nuggets from the summer and put them in perspective: A 77:1 ratio of declining stocks over advancing on August 8. The last time that happened? *Never*. 5 of 6 days with 4% market moves? *1932, the beginning of the post-depression bull market*. During these past few months we've endured unprecedented volatility and conflicting market signals courtesy of the media. Jim closes by asking: "How much of this is noise and how much is real?" It's a rhetorical question for us.

We've offered a cynical view of the Fear Trade: the willingness of investors, both big and small, to take a snippet of information, speculate about the unknown, form an opinion, and then immediately place a *bet* on market direction. That's something other than investing. It also explains the periods of high volatility we see each year. What has been described by a number of fevered commentators as a "crash" or "meltdown" this summer turned out to be the mere correction we had been calling for since April. Why the distortion? While the print media generally separates objective reporting from opinion for the reader, television media doesn't concern themselves with such journalistic conventions. How else could they create the high drama that sells advertising? We view most of what's offered by real-time visual media as having little value as a tool for investing. It does a great job of driving sentiment and volatility. That's our definition of "noise". Investors have to discern between objective reporting and opinion. The opinions we value come from proven analysts who adapt their views to changing economic and market conditions. Our suggestion: Don't get your investment advice from talking heads.

So, what is "real" about the stock market these days? After this recent bout of volatility we're left with a market that reflects a reasonable doubt about the rate of global growth next year and a possibility, not probability, of recession. The next chapter of the global growth story will be about Europe and whether a globally coordinated solution to their debt problem can be crafted. We think it can. The orderly insolvency of Greece, even Portugal, would likely have only minimal impact on the global growth story. Failing to save Italy and Spain is another matter. How the ECB resolves the situation in Greece should provide clarity to the question of whether a contagion of default will consume Europe and force investors to reevaluate and alter market expectations. As we write this, the ECB is conferring with its members, trading partners, the Fed, and the IMF to initiate a process that will allocate losses from Greece and provide liquidity to insulate the banks from the second order effects of that default. Whether they succeed won't be known for some time but the market will instantly respond one way or another as traders place their bets. Investors would be wise to wait for the volatility to subside before making any major portfolio-altering decisions. The global growth story isn't a fairy tale. It's a documentary with a happy ending. The events ahead won't change the ending, only the plotline of how we get there.