

Summer 2010 Newsletter “Unusually Uncertain”

Fed Chairman Bernanke’s July 21, 2010 characterization of the economic outlook as “unusually uncertain” attracted a lot of attention and comment and caused considerable investor concern. The day-to-day volatility in the markets experienced since May suggests that there are a number of national and global realignments taking place “out there” that are significant, but not yet fully understood. In an attempt to better understand the issues that my clients are worried about, I have been doing my “summer reading” by concentrating on the commentary of the portfolio managers that I respect the most. Here is what they are saying.

Bill Gross, co-Chief Investment Officer at PIMCO, the firm credited with the now familiar “New Normal” characterization of the current economic environment, is not very encouraging about the outlook. He comments in his “Investment Outlook” dated July 2010 that the continuation of the “DRD” (De-leveraging, Re-regulating and De-globalising) that began in response to the onset of The Great Recession of 2008 has created a lack of aggregate demand in the global economy. The developed nations have too much debt and are no longer able to be the “willing-to-continually-leverage-up” consumer that kept the global economy going for the last 25 years. On the other hand, the developing nations have too little debt and too little willingness to borrow to become the consumer that can take up the slack created by de-leveraging in the U.S. and Europe. This lack of demand is contributing to what Gross calls “half size” growth prospects (1-2% GDP growth in the future vs. an historical average of 2-4% – the “New Normal”) and an outlook for only single digit return prospects for stocks and bonds.

Mohamed El-Erian, Bill Gross’ colleague at PIMCO and his co-Chief Investment Officer, goes on to say in the August 3, 2010 edition of the “Financial Times” that the “DRD”-inspired realignments going on in the world have served to undermine the rules of thumb that served investors for a long time. El-Erian argues that the historical benchmarks and correlations that investors continue to rely on are no longer valid given the structural changes that are taking place. He also believes that the probability of a policy mistake, given the broader and more complex involvement of government in the economy, is materially higher today, especially as policy measures are subject to lags. In his words, “uncertainty is changing the investment landscape”.

Mike Avery and Ryan Caldwell, who jointly run a global asset allocation fund at Ivy Funds, concur with El-Erian in their “Portfolio Perspectives” dated June 2010 that the markets have become more sensitive to policy decisions. They attribute much of the volatility we have experienced this summer to questionable policy decisions in some of the developed markets – they comment that the European Central Bank did not make clear its intentions regarding the manner in which it might address debt problems in Greece, Spain and Portugal and to a smaller degree, the U.S. did not make clear its policy regarding financial institutions, which created uncertainty in the global markets. By contrast, China’s policy makers have reacted in ways that make a lot more sense to Mike and Ryan than their counterparts in the U.S. and Europe.

Jeremy Grantham, founder and Chief Investment Officer at GMO, an investment management firm in Boston which is noted for its seven year expected return forecasts for a variety of asset classes, concurs with Bill Gross about subdued growth prospects for the global economy in the long term. In his “Quarterly Letter” dated July 2010, he foresees a difficult period that he calls “seven lean years” during which he doubts the developed countries will reach a growth rate of 2%. However, Grantham does acknowledge the potential for the stock market to experience what he calls the “last hurrah” before transitioning to a slow growth scenario. The “last hurrah” scenario, which Grantham assigns a 45% probability to, is driven by the high likelihood that Chairman Bernanke will keep interest rates at rock bottom lows for the next 18 months or longer. Low rates in his view create a long steady incentive to borrow and speculate. Hedge funds can leverage easily and in their drive to make money will emphasize more and more aggressive investments, which could drive the S&P 500 all the way back to 1500 to 1600 by this time next year. Jeremy has another shorter term scenario in which several of the long list of potential problems come home to roost and knock the market down in a painful manner, perhaps all the way down to “fair value”, which he believes is now about 900 on the S&P 500.

OK. That is what my favorite pundits have to say for now. Not very encouraging, even if taken in the best light. So what basic portfolio strategies make sense given the current uncertain investment outlook? My thoughts are these:

1. Don’t give up; we have been here before. Difficult as it may be from an emotional standpoint right now, investors should most importantly resist the temptation to abandon their exposure to the stock market. Pessimism and Cash in Money Market Funds are at or near all-time high levels. The corporate sector is doing well and generating a lot of earnings and cash. The valuation on stocks relative to other asset classes is attractive, even if the conventional benchmarks are less useful than they have been in the past.
2. Stock selection is very important. Look for high quality (good balance sheet, seasoned management, enduring franchise) companies in industries that can grow independently of the overall economy and that sell their products to customers who are mostly in the developing countries. Establish an attractive entry price and wait for the stock to reach that level before buying.

3. Capturing dividends is also important, not just to provide a real return in the event capital appreciation proves illusive, but also as an indication of the financial strength of the underlying company. Identifying companies that have an ability to increase their dividends is particularly important in developing an investment strategy for the current environment.
4. Investors should maintain higher than usual “near-cash” reserves, not for investment return, but as a strategic asset in the event that the high quality stocks on their watch list do get knocked down to very cheap levels.

I know that the volatility of the stock market makes it “tough going” for investors right now. However, I do look forward to helping you find the right investment strategy. Talk to you soon.

The Standard & Poor’s (S&P) 500 Index is an unmanaged index that tracks the performance of 500 widely held, large-capitalization U.S. stocks. Individuals cannot invest directly in an index.

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