MVCM Quarterly Newsletter

Third Quarter Ended September 30, 2010

Thirty days has September…

As the market lurched around in August, mostly downwards on low volume and a drumbeat of dour economic data points, it would have been easy to conjure up fears of a September meltdown once all the money came back from vacation. Such fears were sent packing in the first days of the month and never came back. The Russell 3000 gained 9.4% for the 30 days of September, and all major US broader market indices moved into positive territory for 2010 year-to-date.

What caused the September rally? It certainly wasn't any phoenix-like rising from the ashes by the US economy, which remains mired in a nasty combination of high unemployment, income stagnation and flagging consumer confidence. But while US households are struggling, large US companies are seemingly doing just fine, thank you. 2Q earnings were overwhelmingly positive, measured by the yardstick of positive-to-negative earnings surprises.

That may seem ironic – yet in the context of today's economy it really is not. Our domestic corporations are less dependent today than ever before on the health of the US economy. Look at the income statements of industry leaders on the S&P 500 – they are deriving ever-increasing amounts, often more than half, of their revenue from non-US sources, especially the fast-growing markets of China, India, Brazil and the like. That has helped shore up the top line – while the bottom line has benefitted from widespread investment in productivity enhancing tools and strategies (not to mention reduced workforces).

This may be less a one-time anomaly and more a structural trend. "Twin doubles" – double-digit US unemployment and double-digit S&P 500 earnings growth – may be a persistent economic reality. That concerns policymakers and is one of the key variables at play in one of the big stories of 4Q 2010 – economic stimulus via "quantitative easing" engineered by the US Fed.

…still going strong in November?

In the middle of the 3rd quarter we got the first glimpse of how the Fed feels about quantitative easing. QE is an unconventional tool introduced in early 2009 to fight the panic then reigning in risk asset markets. It involves printing money (which the Fed has the authority to do) and buying assets (such as agencies and mortgage backed securities) outright – essentially a monetary stimulus program aimed at encouraging credit creation to foster economic growth.

The first securities from the March 2009 QE program came due this past summer. The Fed had three options: (a) do nothing and let the securities mature (restrictive); (b) reinvest the proceeds in new securities (neutral); or (c) reinvest the proceeds and then print more money to buy more securities (expansionary). The original plan had been to retire securities as they came due to shrink the QE balance sheet, but in July the Fed eased its stance to neutral.

That was then. Now, facing the increasingly evident reality that the US economic recovery is going to be slow and fragile, markets consider it to be all but certain that at its November Open Market Committee meeting the Fed will shift out of neutral into drive – i.e. a new round of easing (QE2), perhaps in the range of $1 trillion or so.

As this view has settled into conventional wisdom investors have made increasingly confident moves into equities – indeed, into a whole spectrum of risk assets including energy and precious metals commodities (particularly gold), fixed income securities and emerging markets currencies, while the US dollar weakens. We see a compelling case for this feeding into a year-end momentum rally, and have made tactical moves to increase equities exposure in our portfolios.

However the potential for unintended consequences in relation to QE2 is high, and our views going into 2011 are tempered accordingly.

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