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Consulting Research Group

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Post the U.S. debt ceiling debate being temporarily shelved by a last minute Congressional bill, global markets have remained volatile. While we are pleased for a brief reprieve from rampant political bickering dominating headlines, attention has shifted to what appears to be a global economic slowdown. We have already experienced global equities falling ~8%, commodities -7% and other traditionally risky asset classes also demonstrating poor performance from late April/early May peaks. However, we remind clients that markets can overshoot both to the upside and downside, and all asset classes have a price. Recent weakness has brought many asset classes to attractive levels, and we reiterate the importance of diversification in the current market environment.

Regarding the economy, the forward path for the U.S. economy is typically a harbinger or reasonable approximation for global growth. Macroeconomists typically dissect four principal variables when assessing economies: consumption, fixed investment, government spending and trade. As we evaluate recent data on each component coupled with a prescriptive look at what may follow, our view is that we are likely to see more persistent macroeconomic weakness than most economists, including the Federal Reserve, forecasted at the start of this year. Here is a brief look at each component.

Consumption: Consumer spending has languished in recent months, with May and June data slipping into negative territory while personal savings rates have increased. Although we think a more balanced spending/saving split is healthy for the economy long term, it comes at the expense of current consumption and therefore growth. Persistently weak housing data as well as sticky unemployment have contributed to a slower rate of purchases, and concomitant meager income growth trends have not helped the situation. Consumption remains the single largest economic driver. Should companies decide to ramp up hiring or should asset prices (home values, retirement/investment accounts) appreciate, we could see some upward movement on the spending front, but for now we are not expecting the average consumer to step up their purchases from current levels without a catalyst. Gas prices are also a factor to watch here.

Investment: This refers to business fixed investment in nonresidential property, software, infrastructure and equipment, and this component has been a bright spot in recent macroeconomic data points, including leading indicators. Many businesses have historically strong balance sheets, ample cash and access to cheap credit given low interest rates. However, businesses must anticipate what consumers will do; should businesses anticipate weaker demand, they may not continue to spend at recent or anticipated levels. We will continue to monitor these trends.

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Government Expenditures: Given the political rancor in Washington as well as the ongoing stimulus withdrawal, the economy is seeing a negative sequential contribution from government spending. While defense spending has bounced back, state and local municipalities have ratcheted back outlays which in aggregate have detracted from GDP readings. We anticipate this trend to continue, and while many hope for potential stimulus to reenter the conversation, political hurdles seem very high.

Trade (Exports less Imports): Coming out of the recession, businesses retooled their models to take advantage of growth sectors (global government, health care) and geographies (emerging economies). With government spending slowing in the face of austerity, a mixed health care picture and emerging economies facing higher borrowing costs from central banks adamant on tempering inflationary pressures, recent trade gains may contract. The one bright spot remains the dollar, which continues to weaken relative to a trade-weighted basket of other currencies. A weaker dollar makes U.S. goods more attractive to foreign buyers.

The individual growth components above could see some further slowdown beyond the anemic growth cited in first and second quarter GDP reports, but as noted in the introduction, that does not necessarily mean that asset prices will sell off further. The capital markets are forward-looking mechanisms, and the fact that asset prices did not instantly recover once President Obama signed the debt ceiling bill indicates that market participants have been focused on the potential hurdles ahead. This has resulted in opportunities across global asset classes as fear has forced many investors to vacate holdings at a potentially inopportune time. Recent intraday activity, various survey data we analyze as well as several market indicators suggest fear has been a major market driver.

As we have stressed in this communiqué, we urge clients to remain diversified as well as patient as the capital markets assess- perhaps correctly, perhaps incorrectly- the forward growth path. We have emphasized diversification across the major and sub asset class levels, and also the need to communicate with us if your capital needs have changed. We anticipate more headline-driven reactions and back-and-forth data to drive investor behavior, but we see several compelling places to allocate capital amidst the recent market weakness. If we can be helpful, please do not hesitate to let us know. Thank you for your trust.

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