Insights
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Commentary from Katherine Ellis Nixon, Northeast Region Chief Investment Officer

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The capital markets packed a lot of action into a holiday-shortened week, and the global flight-to-quality trade continued. Fears of a global economic slowdown, or a double-dip recession, took hold along with continuing concern around the euro zone sovereign credit crisis contagion. After a positive tone earlier in the week, markets fell with a vengeance on Friday, with the Dow Jones Industrial Average (DJIA) dropping 3.2% and the Standard & Poor's (S&P) 500 losing 3.4%, with every sector ending in the red. U.S. Treasuries rallied, with the 10-year yield falling 16 basis points to 3.20%. The U.S. dollar rallied versus the euro, as the European currency fell below $1.20, a four-year low. Reflecting the double whammy of strong dollar and fears of a global slowdown, the Reuters-Jeffries CRB commodity index fell 2.3%. Small capitalization stocks were not immune to the rout, losing 5% on Friday and down 4.2% for the week, although the Russell 2000 is one of a precious few indexes around the world with a positive year-to-date return.

On the week, the DJIA lost 2%, the S&P 500 lost 2.22% and the Europe, Australasia Far East index lost 1.42%. After a volatile start precipitated by a leadership change, the Nikkei gained 1.4% on the week. It is clear that the global capital markets will likely continue to be driven by a combination of fundamentals and emotion, and an assessment of both is necessary.

In Europe, the fears of credit crisis contagion were ratified with an announcement out of Hungary that its economic woes were deeper than previously discussed, and the new Prime Minister (in office for a week) warned that the economy was in "grave" condition, highlighting the possibility of default. When assessing the numbers, it does not appear on face that Hungary is another Greece. With debt to gross domestic product (GDP) at 78%, Hungary profiles slightly worse than the European Union (EU) average of 74% and looks much healthier than Greece at 115%. Further, Hungary has been living under an austere budget for some time, having been supported by the International Monetary Fund, and has committed to a budget deficit of 3.8% as being reasonable. Finally, as of this morning, a significant amount of backpedaling had occurred, with Hungarian officials retracting last week's dire warnings.

Economic conditions out of the EU present a real mixed bag, with the "haves" like Germany posting positive manufacturing activity results and the "have nots" in the periphery continuing to struggle against austere fiscal measures. The weak euro, down 20% against the U.S. dollar since late 2009, has been the silver lining for Germany, and its export and manufacturing strength is the proof statement. After a surprisingly strong March advance of 5.1%, German factory orders rose 2.8% in April.

So the weaker euro provided export fuel? With much of the global economic improvement based on trade, currencies do matter and may continue to provide countries and regions with competitive advantages. The improvement in euro-competitiveness has not gone unnoticed. Japan's newly elected Prime Minister Naoto Kan previously expressed a view that favors a weaker yen, and he is widely expected to be more interventionist particularly in light of his key mandate to reignite Japan's economic growth. This will have interesting implications for currency policies around the world, and it is a trend that bears careful watching.

With global growth expected to slow into 2011, and with continued fiscal strains in major developed countries, the pressure to favor a weak currency will likely increase.

In assessing fundamentals here in the United States, it is clear that the economic recovery remains jobless. The U.S. non-farm payroll data released Friday confirmed that companies remain reluctant to hire. The headline number of 431,000 jobs was disappointing in and of itself versus the consensus estimate of more than 500,000, but the shock came when the data was disaggregated to reveal that 411,000 of the hires were temporary government Census Bureau workers. Although the magnitude of the miss was compelling, no one should be surprised that corporate America will seek more tangible signs of sustainability of economic recovery before committing to headcount additions. It is exactly this careful assessment that sustained corporate profitability during the economic turmoil of the past several years and for which corporate management was lauded.

The unemployment rate provided more disappointing news last week and heightened concerns that conditions remain intensely challenging. Although the overall rate dropped from 9.9% in April to 9.7% in May, the decline was a function of people dropping out of the job search. Disillusioned workers are indeed a challenge, as are the numbers of the long-term unemployed. A record 46% of unemployed have been out of work for six months or more, and this can provide some unique challenges even as the economy recovers. Skill set obsolescence and need for retraining will be real challenges in bringing these people back on the payrolls.

As for emotion, sentiment continues to skew negative, with the Volatility Index (VIX) reflecting increased fear. Uncertainty in the interbank market, as reflected in U.S. dollar/London Interbank Offered Rate (LIBOR), remains elevated, having doubled from the level of early 2010. Further, the continued widening of credit default spreads in peripheral Europe, particularly in Italy and Spain, suggest that distrust is the near term name of the game. Unfortunately, it is possible for perception to become reality and for market psychology to have an impact on fundamentals, and this is something that requires continued examination.

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