Michael Sincere.com

Jun 01

Before QE2 Ends: What Investors Should Do Now

To get a clearer idea of where the economy is headed, I spoke with Bernard Baumohl, chief global economist of The Economic Outlook Group and author of *The Secrets of Economic Indicators* (Pearson Prentice Hall, 2007). He's had an excellent long-term record of making stock market forecasts.

2011: A good start with an uncertain ending

"It does appear that QE2 will end and that it will not be followed by QE3," Baumohl said, "at least for the time being. A lot depends on what happens to the economy in the second half. We came into 2011 with lots of momentum. Earnings expectations were getting stronger and the stock market did quite well."

In fact, Baumohl had correctly forecast a strong year for all the major indexes. "But as you know, midway through the first quarter, we began to experience a variety of geopolitical shocks as well as natural disasters," he explains. "Ordinarily, geopolitical shocks have a minimal impact on the financial markets, and are short-term at best. But the geopolitical shocks we have now, and continue to have, are on a scale and magnitude that we have not seen since the collapse of the Soviet Union."

The new norm: a higher cost of living

Baumohl says that investors should be prepared to live in an era that will be defined by geopolitical instability, primarily because of the turmoil in the Middle East. "What this means is the price of oil will likely remain elevated for quite some time. The new normal may mean a price of $90 to $130 a barrel, which will obviously keep gasoline prices higher than normal as well."

Baumohl explains that because we have little or no control over events taking place outside of the U.S., many Americans will have to adjust to a higher cost of living. "Food prices have jumped dramatically higher in part because of the strong growth in emerging countries," he notes. "We are seeing a wealthier middle class in other countries that are buying more things and paying for more expensive food. This will also cause upward pressure on prices. For the most part, food and fuel are what is driving inflation higher."

Disappointing corporate earnings

"Investors may be disappointed at the growth in corporate earnings from this point on," Baumohl cautions. "I'm not sure if investors are adequately discounting that the economy is weakening, and with that comes a softness in earnings. This will obviously be reflected in the stock market."

He agrees that the stock market has been struggling lately. "It reminds me of someone trying to swim in peanut butter," he quips. "You get the feeling there is an inflection point coming, but you aren't sure how much weaker the economy will be. But you get the feeling that something is in the midst of changing."

Although companies see commodity prices rising, they can't pass those prices onto consumers because the economy is weakening. "Therefore, profit margins will narrow," Baumohl says. "That is one of the reasons investors have to be more cautious about the earnings outlook."

The stressed consumer

Baumohl says that consumers are more cautious than they were at the beginning of the year. "Consumer confidence has been eroding, especially when we look at the weekly consumer confidence numbers like the Bloomberg Consumer Comfort Index, which has been on the decline. Consumers won't completely stop spending, but will gradually cut back."

Because people are paying more for food and energy, Baumohl believes they are feeling financially squeezed. "Unfortunately, because workers don't have the leverage these days to demand higher pay from their employers, there is a reduction in purchasing power, which has been reflected in the retail sales numbers." Take out gasoline and food, he explains, and retail numbers are quite weak.

The Middle East: a geopolitical Rubik's Cube

Baumohl says the Fed's argument is that the floods, drought, and turmoil in the Middle East are artificially lifting food prices, and that these transient factors will subside, and so will inflation pressures.

Does Baumohl agree with the Fed? "I'm not convinced these are transient factors. I think we are going to see continued violence, instability, and uncertainty in the Middle East. The rhetoric between the major oil producers such as Saudi Arabia and Iran could heat up and lead to a possible confrontation. This will unnerve financial markets. There is a high probability things will get a lot more tense in that part of the world, which could kick up oil prices."

If there is a further deterioration in the Middle East, which Baumohl believes is inevitable, oil prices will rise. “Yes, it’s transient, but how do you define transient? Will it last for three months, three years — or longer? I believe this is a longer lasting phenomenon that is putting pressure on oil to remain high. Someone called the eruptions in the Middle East a ‘geopolitical Rubik’s Cube,’ which is a great description of the utter ignorance about how this will be resolved.”

In addition, Baumohl points out, external events like the massive floods in the Mississippi, the droughts in France, and earthquakes are limiting the supply of agricultural goods at a time when the emerging countries are bristling ahead. “I think the demand for food from emerging countries is not temporary but will grow, and that will keep pressure on food prices for the long term.”

Part Two: Where You Should Invest Now

At the beginning of the year, Baumohl was much more confident about the pace of growth of the U.S economy. And now, he is concerned that unexpected shocks are starting to have an effect on corporate earnings and the overall economy. He lists some of the reasons why the economy seems so lethargic: Cuts in spending by federal, state, and local governments, a weak housing sector, a soft jobs market, household wages that aren’t keeping pace with inflation, and the rise in interest rates around the world

Where to invest now?

As a result, Baumohl is much more cautious moving forward. “We really should be seeing the U.S. economy grow faster than 4 % at this stage in the business cycle. Instead, it seems stuck in low gear and likely to expand at a lackluster pace of 2 % to 3 % this year. I am betting against a recession, but I am also betting against a big economic recovery.”

Because of the dramatically changing economic environment, Baumohl suggests that investors increase their cash reserves, and be more selective about equities going forward. “We are recommending that investors keep 25 % in cash, 50 % in equities, with half U.S. and half foreign, 15 % in short-term bonds, 10 % in agricultural and industrial commodities, and 15 % precious metals. You have to include precious metals in your portfolio because of the enormous geopolitical risks in the Middle East, the threat of sovereign debt default in Europe, and the decline in confidence in paper assets.”

For patient investors looking at a 10 to 15 year horizon, Baumohl suggests you invest in emerging countries like Brazil, India, Singapore, and China — even Mongolia. “Emerging countries may contribute 70 % to 80 % of the world economic growth for the next 10 to 20 years, so everyone should be exposed to that part of the world. We will also see a lot of U.S. companies taking advantage of the growth in these countries." Even small and midsized firms will need to export overseas to increase earnings, he notes.

Companies with exposure to emerging countries are especially attractive, he says, such as Rockwell Automation, Caterpillar, Procter and Gamble, Cummins, and 3M. "Other companies we like are CSX, Ford, and GM, who might do well relative to other stocks. It might surprise you but we also like the airline industry.

The two industries Baumohl is nervous about are banking and hotels. "Once they build a hotel, they are fixed assets that can't be cut back. Regarding banks, when the economy is good, they do well. But banks face a weak economy, a lack of loan demand, new regulations, higher compliance costs, and limits on how much they can charge consumers."

Cautiously optimistic

Nevertheless, Baumohl still believes the major stock indices, which are now positive, will end higher at the end of the year. "Based on our economic outlook and geopolitical assessment, we still expect the Dow to be up around 10 %, the S&P to gain 12 %, the Nasdaq 6 %, and the Russell 2000 up 8 %."

Baumohl cautions, however, "if events accelerate out of control in the Middle East that cause the price of oil to approach $130 a barrel, and gasoline to rise beyond $4.00, then we have to reassess the situation. The probability this will occur before the end of the year is still a high 40% to 45%, so it can't be dismissed altogether."

The day that QE2 stops

"Don't panic on that day," Baumohl advises. "Nothing major will happen; it should be a non-event much like the millennium transition to 2000. Many people won't even realize it. But after June, you must watch the FOMC statements very carefully for any hint of what the Fed might do next. My guess is the Fed won't do anything, and pursue a wait-and-see attitude. If the economy is coming back strongly, and if companies are ramping up hiring, and inflation pressures pick up, the Fed will embark on monetary tightening measures. But I just do not see such Fed action this year."

On the other hand, if the economy loses momentum, Baumohl says we could see another round of easing by the Fed in the form of QE3. "If the economy weakens dramatically, we cannot rule out QE3. By weakness I mean it continues to grow below 2 % and companies dramatically scale back hiring, the Fed may then feel obligated to launch another round of purchases of Treasury securities to keep interest rates historically low."