February 2, 2010

View from the Pier

As we enter a new decade, massive intervention by governments and central banks are helping the global economy emerge from the Great Recession. The measures taken to climb from the depths of the credit crisis have been nothing short of awesome in scale and scope. Frighteningly, we have moved the scale of expansionary policies from "billions" to "trillions", the size difference being very hard to comprehend. The fiscal and monetary policies have, however, stabilized the global financial system, and have contributed to economic growth that continues to accelerate across many regions of the world. As we've expressed since mid-2009, and maintain today, the short-term prospects for economic growth in the U.S. are fair, stronger in Asia, and shaky but positive in Europe. But, as expansionary policies begin to fade and the inventory replenishment cycle is completed, we are less optimistic that the private sector is prepared for the hand-off. Further, the current upturns in consumption, investment and asset prices that have been induced by the expansionary policies, come at a rising price. With gaping budget deficits across most of the developed world and exceptionally low interest rates, there exists an enormous burden on getting the exit strategy right; it is not an overstatement to say that the stakes are incredibly high and cracks can occur almost anywhere and at almost any time.

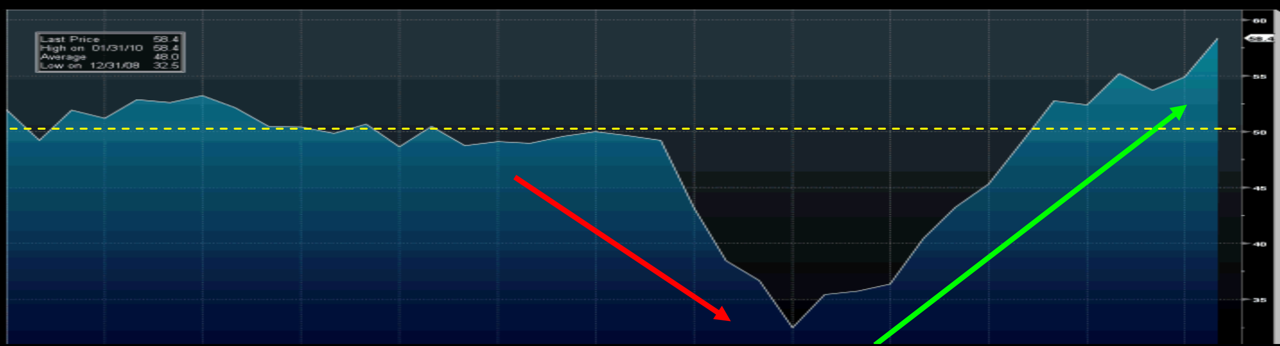
The model for economic recovery is simple: Government stimulus pumps cash and incentives into the system, which encourages private consumption and investment, which creates jobs and income. Because people have repressed spending during the lean period, pent-up demand exists and, as folks begin to spend again, confidence rises and the handoff from government to the private sector is underway, aided by the "multiplier effect". For recessionary periods dating back decades, this model has proven mostly effective. But a recession stemming from a financial crisis, particularly one as long and deep as this one, is different from the garden-variety. Banks can't (or won't) lend, leverage must be extracted from the system, and households must save to rebuild lost wealth, thus diminishing the size and breadth of the recovery.

It is our opinion that the financial markets currently reflect much of the recovery cycle; the "easy money" has been made. Credit spreads have narrowed considerably, exhausting profit opportunities that existed a year ago across many sectors of the fixed-income markets, leaving very low yields for investors. Global equities have appreciated sharply from their lows of March 2009 and, while not rich in price, they're no longer cheap either. Most portions of commodities and real estate are also fully priced, reflecting much of the economic recovery that consensus currently expects. From here, the markets are more likely to trade in a range-bound fashion until the sustainability of this recovery, or lack thereof, becomes more apparent.

In the near-term, we expect economic expansion to continue, with inventory replenishment driving the cycle forward, even job *creation* is likely to materialize over the next few months. Despite generally upbeat data, the financial markets are likely to vacillate between rising economic output and legitimate concerns regarding the private sector's ability to wean itself from public-sector stimulus. In such an environment, security selection will prove more prominent in investor results with quality rising in importance over the poorer quality securities that typically excel during the early stages of a market recovery, and was certainly the case in 2009.

Economics

Indeed, economies around the world are recovering. Accelerating growth in much of Asia has spread to portions of the Americas and Europe. Our set of leading economic indicators began revealing the recovery cycle early last year and they remain constructive today, having moved from early recovery into expansionary territory. The following is one of our favorites, the ISM Manufacturing Survey, a nearly real-time signal of economic trends that is released each month. The surveys are indicative of *relative* activity, used to capture inflection points and changes in momentum rather than measuring *absolute* levels of activity. They do, however, contain an important historical relationship to absolute levels of economic activity as highlighted by the yellow dotted line that has historically predicted the demarcation between absolute economic expansion (above the line) and economic contraction (below the line) as measured by the Commerce Departments Gross Domestic Product (GDP) reports that are released each quarter, after the fact.



U.S. ISM Manufacturing Survey
01/31/07 – 01/31/10

* Bloomberg

The ISM Surveys (Manufacturing, above, and the Services Survey, not shown) illustrate the sharp recessionary decline experienced during 2008 to levels never experienced by the Index in its history, and also show the strong recovery into what has proven to be economic expansion as noted by the two consecutive quarters of positive real-GDP growth reported by the Commerce Department. Other "early" indicators of economic activity are reinforcing the ISM Surveys recovery: industrial production levels are rising; capacity utilization has stabilized; consumer confidence and retail sales have improved; the stock and bond markets have appreciated; and even the residential real estate market is looking less bleak. The data set out of much of the developed world has displayed similar results, and those in the developing economies have generally experienced even greater strength.

This supports our near-term thesis, that the prospects for economic expansion (and even job creation) remain in-tact for much of 2010. Monetary policy from most central banks around the globe is likely to remain accommodative, supporting economic growth with low-cost credit. This will be particularly true in the U.S. where officials have telegraphed an extended period of low rates and are unlikely to act in front of a very influential mid-term election cycle. Fiscal stimulus is still leaking its way into the global economy and we are mindful that last year's U.S. stimulus package is designed to have its greatest impact in 2010. There are even certain economies, like China's, that are moving to restrict capital by slowly raising rates and raising lending requirements, but those moves are likely to be short lived, in our opinion.

Equally as important as expansionary policy decisions, the inventory replenishment cycle should continue to provide positive support to economic growth. The liquidation of inventory from warehouses and store shelves was a significant contributor to the sharp declines in economic production and served to exacerbate the hibernation of end-market consumption. From extremely depleted conditions, the replenishment of inventories, on their own, will add to growth over the next few quarters; any increase in consumer spending and capital investment will be a bonus. As employers cut to, and perhaps into, the bone during the downturn, we expect to see some job growth materialize as companies bring back employees for marginally higher production of goods and services.

We are encouraged by the economic growth underway and believe it can be maintained for a few more quarters, but as expansionary policy begins to fade and inventories rebound, we are less optimistic that the private sector will be able to sustain the economic growth trajectory. Massive public debt will loom over much of the developed world, which will be a huge burden on the growth opportunity. U.S. consumers are unlikely to boost discretionary spending in any meaningful way as they remain saddled with excessive debt loads, are facing the prospects of higher tax burdens, and remain woefully underemployed if not unemployed. The international consumer is the wild card, where traditionally higher savings rates offer an opportunity for consumers in Germany, Japan and emerging middle classes in China and Brazil, to support global growth through greater consumption.

For now, we are maintaining our global growth thesis and expect to see positive activity out of the data for at least the next two quarters. But leading indicators will be the clue when growth begins to succumb to the mounting headwinds of public debt, higher taxes, and a generally jobless recovery unfolding in the U.S. – still the dominant source of end market consumption in the world. The leading indicators will peak in advance of these pressures becoming obvious, so a shift in tactical investment strategy should materialize in tandem with indicators like the ISM Surveys as they begin to roll over.

Fixed Income

The fixed income markets are tied to the hip of the economic conditions, given the role that central banks around the globe play in establishing interest rates on the short end of the yield curve through monetary policy action. Further out on the curve, market participants price in the impact of monetary policy in the context of inflation; in other words, will expansionary policy lead to inflationary pressures? We don't believe that traditional inflation, where prices rise because of the scarcity of goods and services, is a likely problem for the developed world. Excess capacity exists across a wide swath of the global economy, whether measured by manufacturing capacity or excess labor. The abundance of the two most significant cost inputs will keep a lid on traditional pricing pressures. The developing economies, particularly those rich with natural resources, are more likely to experience rising prices and will require appropriate policy action.

Monetary inflation, where the value of currency is influenced by fiscal irresponsibility, is a greater threat in the future. The developed world is strapped with massive debt and gaping budget deficits, from the U.S. to Europe and Japan. There is a limit to how much credit can be accommodated before it is reflected in the value of currency. The decline in the value of the U.S. dollar, and consequently the rise in commodity prices and gold, serves as example. The story of global debt will have a profound impact on global currencies and lead to consequences that are hard to conceive at present, but fixed income yields will certainly reflect the pressures that are building and in some cases are likely to break.

The economic growth story has translated into a steepening yield curve, a normal reaction to the anticipation of rising inflation threats that typically come with recovery. It has also resulted in tightening credit spreads between poorer-quality issuers and the benchmark U.S. Treasury Note. But the absolute level of yields has remained stubbornly low, particularly in the U.S. where Treasury yields are little changed from those experienced over the past few years, absent the depths of the credit crisis. The following graph depicts the yield on the 10 Year US Treasury Note over the past three years.

* Bloomberg

One of the most liquid securities in the world, the 10-Year US Treasury Note, tells a story, and in our opinion, it speaks to the deflationary pressures that come from excess capacity around the globe, and reflect the muted growth trajectory that accompanies economies saddled with debt, particularly those struggling with government and consumer debt loads. Probably more than any other security, the range-bound yield of the 10-Year US Treasury Note exemplifies the extraction of leverage from the global economy.

The credit markets have witnessed exceptional recovery from their darkest days of a year ago. Prices of municipal bonds, high-grade corporate bonds, and especially lower-quality credits, have appreciated so significantly from their lows that valuations, as measured by yield spreads relative to U.S. Treasury securities, are challenging. On the other hand, our outlook on the economy over the longer-term doesn't suggest that yields are certain to rise, at least not as significantly as some believe. We might suggest that yields priced off of a 10-Year US Treasury above 4% may prove to be a good buying opportunity. At present, we continue to emphasize shorter-maturity bonds over longer-maturity issues, with the exception of inflation protection bonds (TIPS) that can be purchased with mid-term time horizons.

Equities

Stocks are one of the best discounting mechanisms of future economic activity, and their performance in 2009 correctly anticipated the improving environment of accelerating economic growth and robust corporate profits. The following chart represents the S&P Global 1200 Index price change during the previous three years. Despite the strength of equities in 2009, most remain well off of the highs established over two years ago and speak to the importance of protecting capital during down markets.

* Bloomberg

That stock prices remain well below their 2007 highs also speaks to the fact that economic activity, although growing, has yet to approach the absolute levels achieved more than two years ago. Indeed, top line revenue growth has been meager so far in the recovery, strong corporate profits have been the result of severe cost cuts made during the downturn. As noted above, stock prices on the whole fairly reflect the economic growth prospects by our estimation, not expensive, but no longer cheap either. At this stage, we are emphasizing companies with strong balance sheets, a proxy for those companies that are likely to gain market share during the coming quarters. We do anticipate revenue growth for market leaders, which should flow through stable margins (margins will be difficult to expand from here) and generate reasonable profits, but earnings multiples are likely to resist expansion as the markets begin discounting a decelerating growth trajectory in the broader economy. Cyclical earnings are likely to peak during the first half of 2010, while those companies that are less sensitive to economic cycles will remain more stable through the balance of the year.

Beyond our moderately optimistic near-term view that economic prospects are on solid footing, our longer-term thesis is less constructive regarding the growth trajectory in the developed markets, specifically the U.S., Western Europe and Japan. Many of the developing economies offer greater opportunities and lead us to be more enthusiastic about companies that are domestic to those higher growth regions and to those global companies that have oriented themselves to participate as leaders in ways that are very meaningful to their bottom lines.

Conclusion

The U.S. and global economies are recovering from an economic trough that has been more severe than most and has required exceptional expansionary policy action by government and central banks. The aggressive fiscal and monetary action are stimulating positive economic activity and we expect the inventory replenishment cycle to provide a meaningful lift to the growth profile over the next few quarters. However, once stimulus programs and inventory restocking begin to fade, we don't expect the private sector to be prepared to carry the torch and we fear another decelerating environment to sub-par growth. This outlook places a lid on how far fixed income yields can rise, and we would anticipate buying opportunities emerging prior to and lower than the current consensus. The stock markets appear fairly valued, and while the indices are likely to remain generally range bound, the opportunities to select high quality companies that are gaining market share are quite attractive by our estimation. Hard assets, those in the commodity and real estate spaces, are likely to present buying opportunities early in 2010 as well.

The year 2010 will likely be about the transition from economic recovery into a sub-par growth outlook in the U.S. and other developed economies, one that will frustrate job searchers, policy makers, and investors that have not recalibrated their expectations. Investors who think globally and concentrate on quality are likely to experience better results.

We are grateful for the opportunity to bring you the View from the Pier and, as always, we welcome your questions and comments.

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