September 27, 2010

View from the Pier

The model for economic recovery is simple: Government stimulus pumps cash and incentives into the system, which encourages private consumption and investment, which, in turn, 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, with a little boost from the "multiplier effect". Rising tax revenues replenish the government coffers to complete the recovery circle. For recessionary periods dating back decades, this model has proven mostly effective, or so it has seemed. But excessive government spending, easy-money policy, lax regulatory oversight, and the accumulation and use of extraordinary amounts of debt, can all go astray, directing capital to unproductive and inefficient uses. Such was the case for far too many years, resulting in a recession that stemmed from a financial crisis of excess debt relative to asset values, one that is proving long, deep, and quite different from the previously-experienced, garden-variety recessions. In the end, this recession was caused by excess leverage that permeated all aspects of the economy and financial markets, and the path to recovery will require an extended period of de-leveraging, thus diminishing the size and breadth of the recovery.

A process of de-leveraging, whether by financial institutions, governments, consumers or local businesses, is almost by definition a sacrifice of current consumption. It requires more of one's income to be dedicated to debt repayment, leaving less for consumption and investment. It should be obvious then, that those financial institutions, governments, consumers and businesses that carry excess debt will have less to spend and economic growth will suffer as a result. We do not have a supply problem, we have plenty of goods, services and available capital, what we have is a demand problem, and that won't change until assets and liabilities get better aligned for households, businesses, and governments.

As we stated this past January, "[T]he 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 those job searchers, policy makers, and investors who have not recalibrated their expectations. Investors who think globally and concentrate on quality are likely to experience better results." This has mostly been the case. Indeed, the pace of economic expansion has slowed considerably in 2010, particularly across those economies where excess leverage has caused the most havoc, namely the U.S., Europe and Japan. Those economies that maintained relatively healthier balance sheets have not been immune to the deceleration of recovery, as most depend on the higher income per capita economies as export markets for their goods.

We don't expect the de-leveraging process to be completed any time soon; it is our belief that it could be years before economic growth potential is realized, as it simply takes time to work through the above-mentioned excesses. This isn't to suggest that the world's economic outlook is overly dire, but rather that growth is very likely to be muted and bumpy. The short-term prospects for economic growth in the U.S. are fair, shaky in Europe, and stronger in Latin America and Asia, ex-Japan. 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.

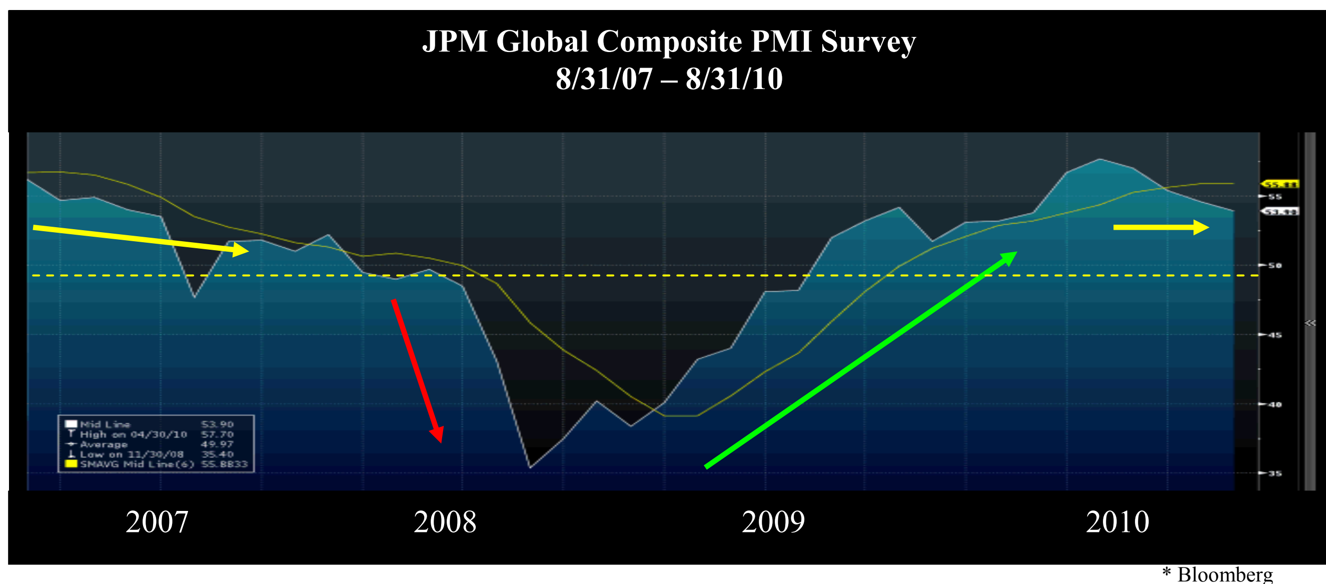
Of rising concern, as we first noted nearly two years ago, is the concept of devaluing currency as a means to increase exports and pay down debt. We suggested at the time and repeat today that a global race to devalue currency may be at play within the developed world and contains a risk profile very unfamiliar to most market participants and policy makers. The concepts of currency intervention and quantitative easing are relatively new to U.S. investors, but must now be factored into portfolio management strategy and the assessment of risk.

The challenges facing the sustainability of the current expansion have not been absent in the minds of investors. Volatility has been high across all financial markets throughout 2010, as investors have digested the constant flow of conflicting economic data and a lack of clarity around monetary and fiscal policy decisions from around the globe. The FTSE All World Equity Index has vacillated around a wide trading range, currently up about 4% year-to-date, on historically light trading volumes and near constant fund *outflows*. Conversely, bond markets have experienced strong fund *inflows* as investors have demanded the perceived safety and income that fixed income securities may offer. The Barclay's Aggregate Bond Index has gained nearly 8% so far in 2010. Active management and discipline in one's research and investment process remain critical.

Economics

Economies around the globe generally remain in recovery and continue to expand, but the rate of expansion is clearly decelerating and the duration and scale of this recovery is in question. The return to growth that started in much of Asia and later spread to portions of the Americas and Europe has slowed in much the same order. Our set of leading economic indicators

began revealing the recovery cycle early last year but appears to have peaked during this past spring and has slowly deteriorated since. The following is one of our favorite indicators: the JPM Global Composite PMI 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 quarterly Gross Domestic Product (GDP) reports that are released after the fact. It is the real-time nature of the PMI surveys and their rich data set that make these reports so valuable and the equity markets have a very high historical correlation with the PMI surveys, moving nearly in lock step.



* Bloomberg

The JPM Global Composite PMI Survey illustrates the sharp recessionary decline experienced during 2008 to levels never before experienced by the Index, and also shows the strong recovery through 2009 and into the first part of 2010. It is important to note that the early part of the green-arrow section represents economic contraction (still below 50), but the financial markets were quick to assess the trend that the economy was moving into positive growth and investors were able to anticipate recovering and growing corporate profits. As we have often discussed, the market is a discounting mechanism that anticipates future news, which is why stocks begin to rise well ahead of actual good news. The opposite is also true.

Global GDP reports have confirmed the recovery predicted by the PMI surveys. By way of example, the US economy posted real-GDP growth of -2.6% for all of 2008, but rebounded to 1.6% in 3Q09, 5.0% in 4Q09, 3.7% in 1Q10, and 1.6% in 2Q10. Portions of Asia have reported stronger GDP results while most of Europe has experienced slower growth. But what are the PMI surveys now suggesting about the future? The past few months, as represented on the far right part of the graph, cause us to question the durability of the current expansion as the trends now point toward the demarcation line that separates economic expansion from contraction.

By historical standards, the real-GDP recovery experienced by the developed world (U.S., Eurozone, Japan) has been considerably more tepid than past business cycles. The brief strength exhibited during 4Q 2009 and 1Q 2010 did not provide enough confidence for new capital investment and/or hiring, and has resulted in a prolonged and elevated level of joblessness across these geographies. While much greater growth trajectories have occurred in the developing world, particularly China and India, those regions remain very dependent upon their ability to export to the developed countries for sustainable expansion.

Recent PMI surveys, as illustrated in the graph above, began rolling over in May of this year, sooner than has generally occurred in past cycles. Of particular concern, the new orders component of the surveys have declined at a more pronounced pace, as have backlogs which are a key metric within many services industries.

At the heart of the problem in the U.S. is the number of unemployed and under-employed, nearly 20 million Americans, or approximately 17% of the American work force. Many of the unemployed ranks are now counting joblessness in years not months, and the prospect for returning to work remains dismal as weak economic activity does not require job growth or capital investment. This is particularly true within the blue collar trades, many of which are tied to either manufacturing or residential

and commercial construction. Unfortunately, the real estate markets appear to be getting worse, not better. It is a vicious and reinforcing cycle that deflates the value of all assets.

For the pace of economic expansion to be experiencing mediocre performance is of little surprise to us. As readers of the View are familiar, we have long suggested that the developed-world economies would suffer sub-par growth rates in the years ahead, faced with the one – two punch of aging populations and extraordinary debt levels. The former produces societies that are lopsided users of an economy with fewer contributors. The latter results in less private sector discretionary spending and governments bloated with social program promises that will be hard to maintain. Those economies that share this unfortunate combination currently represent approximately 51% of global economic activity, a heavy weight for the other 49% to support, particularly when many in the latter group are dependent on the former as export markets.

On the other end of the demographic scale are many smaller economies with enormous potential. They typically contain much younger populations and are generally free from the burdensome credit problems facing the developed world. In many ways, China is the poster child of this rapidly developing world, but there are many such geographies, including India, Brazil, and Indonesia, all with large, mobile populations that are young and rising in the ranks of education. It is likely that this month China will surpass Japan to become the second largest economy in the world, lagging only the United States in pure size. This contrast of large, aging, indebted, slow-growth economies and those that are younger, hungry for higher living standards, and ready to make their mark in the world, is very important for investors to recognize.

In the near term, we expect the global economy to more-or-less tread water, with developing economies expanding at reasonable rates while the larger developed economies struggle with austerity measures, anemic employment growth, and weakened financial systems. This is not the dreaded double-dip so often referred to in media circles these days, but is also not a growth trajectory that will feel particularly good; unfortunately, weak economic expansions that drag on tend to leave a lot of people behind.

Fixed Income

The fixed income markets are tied to the hip of 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 mature economies of the U.S., Europe, and Japan. 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. Further, the household debt burden will reduce overall demand, particularly for discretionary goods and services, thereby reducing the risk of inflationary problems. The more adolescent economies that are growing and experiencing rising standards of living, will demand greater volumes of natural resources and basic necessities (better food, shelter and energy resources), and are more likely to experience rising prices which will require appropriate policy action to contain inflationary pressures. This dichotomy of weak demand for discretionary items and strong global demand for necessary items, is likely to lead to a scenario where the things we *need* will cost more and more, while the things we *want* are more apt to cost less and less.

Monetary inflation, where the value of currency is influenced by fiscal irresponsibility, is of 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 of 2009 translated into a steepening yield curve, a normal reaction to the anticipation of rising inflation threats that typically come with recovery. It also resulted in tightening credit spreads between poorer-quality issuers and the benchmark U.S. Treasury Note. But yields have declined in recent months as the sustainability of the economic expansion has lost steam. This is highlighted in the following graph that depicts the yield on the 10-year U.S. Treasury Note over the past three years. The depths of the credit crisis are obvious in 2008, but yields across the curve are in danger of revisiting those historic lows and, in our estimation, should serve as a warning.

* Bloomberg

One of the most liquid securities in the world, the 10-year U.S. Treasury Note, tells a story and, in our opinion, it speaks to the deflationary pressures that come from excess capacity around the globe, and reflects the muted growth trajectory that accompanies economies saddled with debt, both government and consumer. But it also illustrates the extreme measures that central banks, in this instance the U.S. Federal Reserve, may take to pump money supply into an economy to generate activity. Recent monetary and public policy comments hint of extraordinary measures that are being contemplated to this end. While in the near term, monetary activity may support lower yields, bond buyers should beware of the dangerous consequences that can materialize from such action.

An additional matter to which we are attentive within the fixed income markets, relates to the fiscal dilemmas of state and local governments, which are confronting declining tax revenues and the need to cut important services. We expect continued pressure on state and local budgets to create isolated concerns regarding select municipal debt ratings, with a larger risk that municipal debt markets become less liquid. The challenges facing many municipalities must be monitored carefully.

Lastly, all of the above also reinforce to us the importance of looking globally for opportunities, as bonds issued by countries with fiscally-sound economies, stable currencies and attractive yields can enhance cash flows and further diversify risk.

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 and highlights the sideways action witnessed so far in 2010, highly correlated with peaking economic growth trajectories and investors taking a wait-and-see approach to the sustainability of the current cycle.

* 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, they are neither expensive nor cheap. 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.

At present, we believe earnings estimates for 2011 remain too high given our outlook for meager revenue growth opportunities that come from a sluggish economy. Expectations regarding economic growth, namely GDP estimates, have been coming down in recent weeks, and we expect earnings estimates are likely to follow suit as we head toward year end. This process is likely to pressure stock prices despite them not being overly expensive, and that may lead to more attractive entry points. As has been the case for some time, we continue to emphasize those companies participating in the higher-growth regions of the world.

In the near term, markets can certainly deviate from their fundamental valuations. Talk of further quantitative easing by central banks and additional rounds of stimuli from governments can drive equity prices higher as investors hope those measures are successful in reviving economic activity. They would be the wrong measures, in our opinion, as the problem is not the quantity of money available but rather the velocity of money – the speed at which money changes hands, that is the real culprit.

Conclusion

The U.S. and global economies remain in expansionary status, but the recovery has lost momentum much sooner than recessions of decades past. A more muted economic growth trajectory is the result of the excessive debt levels that have induced a de-leveraging process, which comes as little surprise to us. The recovery experienced to-date required exceptional expansionary policy action by government and central banks, but as stimulus programs and inventory restocking begin to fade, we don't expect the private sector will be prepared to carry the torch and we fear an extended period of sub-par growth to be the norm. The financial markets will struggle with a bumpy economic path, pushing the pendulum from fear to greed and back again many times through the course of the de-leveraging process. Policy makers are not likely to show the patience that may be required during this period and their action(s) will push and pull the economy in unintended ways. We are neither optimists nor pessimists at this time, just believers that our repayment of debts past will require time and an acceptance that the trend line ahead is flatter than we'd like. If we are able to navigate this fragile period back toward improved financial health for our institutions, governments, consumers and businesses, then we can once again harness the ingenuity, entrepreneurship and potential of the global economy and the financial markets will reward investors for their allocation of capital.

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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