3Q 2010 Commentary

""Nevertheless, balance sheet policy can still lower longer-term borrowing costs for many households and businesses, and it adds to household wealth by keeping asset prices higher than they otherwise would be."

Brian Sack, Head of New York Fed's Market Group

Lather, Rinse, Repeat

Did you ever sit down to watch a movie and, part of the way through it, realize that you have seen it? You want to turn it off but are still not sure how it ends? Well, investing in the current environment is similar and becoming increasingly precarious. While it has been clear that macro events rather than fundamentals have been driving the markets for much of the last two years, the domestic economic news is now seemingly inconsequential in impact to the actions (or anticipated actions) of the Federal Reserve. On September 21st in an FOMC statement, Bernanke shifted the previous stance of the Fed in saying that the FOMC, "*is prepared to provide additional accommodation if needed to support the economic recovery and to return inflation, over time, to levels consistent with its mandate."* While focusing upon low levels of inflation, Bernanke was really stressing the disappointing levels of economic growth.

Following these comments, legendary hedge fund manager, David Tepper, posited on how to invest in the current climate while on a CNBC appearance in late September, "*Sometimes it's just that easy.... What did the Fed just tell me? What did they say? They want economic growth. And they said, We want economic growth, and we don't even care -- not only do we not care if there's inflation but we want a little more inflation. Have they ever said that before?... They want the market up. So, what am I-I'm gonna say, No, Fed, I disagree with you?...*

We have shared our views in many communications that the "Greenspan put" has really never left the capital markets but rather morphed into the "Bernanke put". The quote at the top of the page admitting the attempt of the Fed to manipulate asset prices above their fundamental values is disquieting to say the least. After years of encouraging risk-taking and forcing savers and investors into more risky assets, the Federal Reserve is seemingly telling us that attempts to spur economic growth through more traditional methods are not translating. Rather we will try to reignite “animal spirits” and potential future market bubbles and “hope” that this illusion of increased wealth via higher asset prices brings back economic growth. Why not? It worked so well the last time.

We do not necessarily disagree with Mr. Tepper’s view over the short term. However, the underpinnings of this position are extremely fragile and the rationale for a confident, more aggressive posture for investors does not exist until and unless the transmission mechanism of monetary policy to the structural issues of housing, employment, and debt succeed in creating sustainable demand. On those collective issues, we are not yet optimistic.

It is difficult to categorize the housing market as anything more than dismal. While many view the Case-Shiller pricing data showing 3.2% year over year gains and the recent seeming stabilization of home sales positively, these must be viewed in context. Despite record low mortgage rates of 4.3% and the highest housing affordability (according to the National Association of Realtors) ever, sales of new and existing home sales are down fully 68% and 41% from the peak of 2005 and just off historic lows. In the simplest terms, there still remains a tremendous and increasing imbalance between the supply of total homes for sale and current demand. The National Association of Realtors reports the combined total inventory of new and existing homes for sales to be 4.189M with an annualized rate of sales of 4.418M. This is a near record supply of 11.4 months and compares with an average of about 5 months during healthy markets. David Rosenberg of Gluskin Sheff estimates there to be over 3.7M additional vacant homes held off the current market while Core Logic sees more than 2M additional homes currently in default and a total of 11M homes (23%) underwater on their mortgages. They further conclude that we may expect about another 5M homes to be foreclosed upon over the next 2-3 years. We would concur with estimates for an additional 5%-10% further decline in national housing prices.

This potential double dip in housing may impact states and local municipalities even more than it does banks which possess a much stronger capital position. State & Local government spending has been about 12% of GDP and accounts for about 15% of national employment. However according to Meredith Whitney Advisory Group, expenditure growth from 2000-08 has totaled 60% while receipts have only grown 45%. This has created a projected budget gap for 2011 of $121B. This may get worse as municipalities tend to feel the consequences of recessions and recovery later due to the lagged impact of tax collections. The impact on public pensions is now well chronicled as the potential next shoe to drop. One of the unintended consequences of maintaining such low interest rates may be to increase the funding problems of these plans by increasing the actuarial liabilities.

Though job losses have clearly abated, monthly job growth through September has averaged less than 100K jobs and has not kept pace with population growth which is estimated to require approximately 125K new jobs per month just to maintain the current unemployment rate. This statistic alone speaks to part of the structural concerns with employment and shows how the unemployment rate of 9.6% still dramatically understates joblessness. We are still 7.7M jobs below the level of employment when the recession started. If adjusted for the number of discouraged workers that are no longer counted in this metric, the unemployment rate would be over 11.5%. The Household Survey, for example, reports over 430K newly employed people in August and September combined. It also notes that there is an increase in part-time employment over that same period of over 940K implying that over 500K full time positions have been replaced. A data point that is underpublicized but one we find interesting is the Employment-Population Ratio maintained by the Bureau of Labor Statistics. There is no fudging this data point as it simply computes the percentage of working age population that is employed. This ratio has enjoyed a secular increase from the mid-1970's to over 63% at the start of the recession reflecting the social change of more women in the work force. It has now dropped back to just over 58%, a level last reached in 1984 and also seen in 1974.

While the extension of unemployment benefits to as long as 99 weeks has continued to help consumers and spending, it also may have contributed to the lack of labor force growth and has served to keep the unemployment rate below our target of 10%. We still maintain this level will be breached in early 2011 as job prospects increase and more people exceed the maximum duration of unemployment benefits and enter the workforce. Prospective economic growth below 2% will continue to weigh on hiring and with over 41% (over 6.1 million people) of the total unemployed out of work for more than 27 weeks, structural employment risks increase. This long term jobless issue continues to worsen and as skills and confidence deteriorate eats at our social and political fabric. The lack of mobility in the labor force due to the housing market adds to this frustration.

For 25 years from the early 1980's into 2007, the ease of credit access through technological and financial innovations succeeded in giving us the illusion of moderating the business cycle. Recessions were indeed shorter in duration and milder in magnitude. However, what was masked during this period was the mountainous increase in debt relative to GDP from 165% in 1982 to over 370% in 2007. Household debt grew by the same percentage and the growth in total Household Net Worth was largely based on leveraged asset price increases. This has clearly reversed during this recession and the shrinking of the balance sheet has continued in 2010. Federal Reserve estimates of total Household Liabilities (which include all debt-mortgages, credit cards, auto and personal loans) are down over $200B year over year ($82B of which was in credit cards) at the end of the second quarter and over $430B from the peak of early 2008. Household Net Worth declined in 2Q 2010 by $1.5T and is now down over 20% from the peak.

Whether this deleveraging represents the start of a new era of consumer frugality or just banks writing off credit card debt is not completely known but there are certainly some hopeful signs to be found. Delinquency rates on credit cards are at the lowest levels in three years. Debt service ratios (measures of required debt payments on mortgages and consumer debt to disposable personal income) compiled by the Federal Reserve Board declined a record amount in the second quarter and now stand at 12.1%, a level last seen in 1Q 2000. The tragic flip side, however, can be found in the new Census data released showing that fully 45M people (14%) and 1 out of 5 children are currently living below the poverty level with 2009 representing the largest single year increase ever. The U.S now possesses the 3rd worst poverty rate of the developed nations according to data from the Organization of Economic Cooperation and Development (OECD). The social cost continues to rise and according to the Wall Street Journal nearly 50% of U.S. households currently have at least 1 person receiving federal benefits. This compares to 29.3% in 1983.

With this continued weak structural economic data serving as the backdrop and more noisy short term data and the support of the Fed in the foreground, the market clearly concurs with Mr. Tepper's logic. We have just experienced the best September for the major U.S. averages since 1939 with a gain of 8.9% and 9.4% for the S&P 500 and Dow Jones Industrial indices respectively. This brought the quarterly gains over 11% for each and moved the 2010 returns into positive territory at 3.9% for the S&P 500 and 5.2% for the Dow Jones. The MSCI EAFE International index up 16.5% exceeded these returns during the quarter benefitting from a Euro that rebounded strongly from a first half decline. Emerging markets continued to stand on their own and the MSCI Emerging Market index gained 18.1% for the quarter. This strong move followed weakening U.S. economic data and Sovereign debt concerns in Europe during the June through August period. Anxiety during this period resurrected strong fears of a "double dip" and precipitated a modest 7% market correction in mid-summer. This period also included revisions to 2Q GDP for 2010 lowering the initial 2.4% reading to 1.7% annualized growth. More importantly the release included revisions to the prior three years and showed the peak to trough GDP decline to be far greater (4.1% over six quarters) than had previously been thought.

However, modest signs of economic growth and better news did start to materialize in early September commencing with a stronger than expected Institute of Supply Management manufacturing (ISM) index reading of over 56.3 (a reading over 50 indicating expansion). This continued with better than expected reports on jobless claims, the August non-farm payroll report, and Case-Shiller housing price data. Additional positive news was the release by the Bank for International Settlements (the primary regulatory body for global banking) of Basel III which addressed increased capital requirements for banks that were much less restrictive than feared. Finally, there was also the official determination by the National Bureau of Economic Research (NBER) that the recession (technically) ended in June 2009.

When viewing these reports in totality, we continue to maintain that our previous base case for a very slow growth environment is still in place. We projected in our annual commentary that the peak economic growth for this cycle would occur in the fourth quarter of 2009 due to the confluence of both stimulus and inventory rebuilding during that period. When we review the four quarters of recovery which so far has averaged 3%

GDP growth, we note that real final demand (which excludes the cyclical and temporary impact of inventory accumulation) has averaged less than 1%. The history of post-recession periods averages 4% real final sales indicating just how weak this recovery has really been. A durable economic recovery requires sustainable consumer demand. The normal drivers of GDP growth during economic expansions are growth in credit-sensitive areas of housing and durable goods such as autos. In addition to long term concerns in these areas discussed above, stimulus programs such as the Homebuyer Tax Credit and Cash for Clunkers may have already brought forward short term consumption thus reducing future spending in these areas. Additional concerns regarding the expiration of the Bush tax cuts may also be bringing consumer spending forward into 2010 with the consequence of increasing growth risks in early 2011. We are now witnessing the fading of these tailwinds and continue to project below consensus GDP growth to average 1.5% for the second half of 2010 and into 2011.

With inflation rates below the Fed's comfort zone and annualizing about 1% on the core CPI (1.2% including food and energy), yields in the Treasury market have reached historic lows on short to intermediate maturities with the 10-year and 30-year yields not far off the 2008 trough levels at 2.5% and 3.7% respectively. The bond market sees deflation yet we are inundated with talk of a "bond bubble". The Federal Reserve is on the precipice of additional easing estimated as high as another $1T in the latest reflation attempt. We have long suggested that inflation was not a concern but rather viewed the excess capacity and continuing unwinding of a secular credit bubble as deflationary. We still do. While this view of lower rates and very strong bond returns has held true, we are now at levels that give us pause. The demographics of an aging baby boomer that has been burned 3 times in the last decade may continue to support the fixed income markets and for now we are in agreement. The Fed will continue to target interest rates and keep them low thus also supporting high quality fixed income. However, the majority of the returns in these areas have already been made.

A perhaps intended consequence of the continual efforts throughout the developed world towards quantitative easing is the debasement of the currencies. This currency war has, of course, favored non-dollar and hard assets with rising commodity and precious metal prices. Gold is no longer an inflation hedge but viewed more as the only reliable currency and has grown to a nominal high of over $1300.

While liquidity has recently driven the markets higher, there is no disputing that earnings growth over the last year has been very impressive and justified a large portion of the advance. Operating earnings on the S&P 500, which troughed on a calendar year basis in 2008 at $49, rebounded to $57 in 2009. Consensus estimates for 2010 are for a 45% gain to $82 with a further 15% gain to $95 in 2011. The major catalyst for this turnaround has been in productivity as profit margins have rebounded to 8% with analysts forecasting improvement to 9% for 2011. On this basis, valuations may appear to be quite reasonable at no more than 12 times forward earnings.

However, decomposing how that figure is arrived at may expose some inconsistencies. Profit margins are at the same levels at which they stood prior to the financial crisis which already represented over a five decade high. Margins are mean reverting and have averaged just over 6% through most of the last 3 decades. The recent explosion in margins has clearly been due to reduced labor costs. As we have discussed, while hiring remains weak labor is stabilizing. Productivity for 2Q declined 1.8%, the first such decline in 4 years with unit labor costs rising 1.1%. Our expectations are for Real GDP to come in around 1.5% with inflation less than 1.5%. This means that nominal GDP (a proxy for revenues) growth will be less than 3%. In the face of rising input costs and moderating productivity with low top line growth, we do not see such optimistic earnings as being likely to occur. We look for 2010 S&P EPS to come in around $80 with a modest rise to $84 for 2011. If margins were to contract as they should over time, these numbers are more at risk. In summary, we will need an increase in top line growth for further earnings gains and employment and housing will remain critical to that.

Census data indicate that over the next decade, approximately 12% of our total population will turn 65. The theme of an aging baby boomer population will certainly have implications for reduced consumer spending and lower levels of household formation and demand for homes. It will also impact changes in investing with a continued movement from capital gains towards desires for income. This has certainly been a contributing cause of the high inflows into fixed income over the last two years. In a low interest rate environment, a supply/demand imbalance creates an even stronger case for above average dividend yields with a focus on companies that continue to maintain and grow these dividends. We continue to find increasing value in such high quality companies.