COHO PARTNERS, LTD.

2010 Annual Commentary

We enter 2011 with a higher degree of optimism in the cyclical recovery of the U.S. economy than we have felt since the summer of 2007. Improving consumer sentiment has led to a pickup in spending and improving small business confidence. At the margin, we are now seeing improvements in job creation that may lead to stronger than anticipated employment growth in the early part of the new year. In turn this increasing demand should lead to increased growth in credit created by financial institutions and foster a modestly accelerated pace of economic growth for the year. The questions remain, however, as to the durability and magnitude of this expansion and the continued dependence on broad-based intervention by the government in the capital markets and the economy in borrowing from future growth to fund current consumption. Modest economic growth, though improving, may do little to make major reductions in the tremendous excess capacity of labor and housing in a continued environment of high public and private debt levels.

At this time last year we disagreed with the consensus of economists and the forecast for a v-shaped recovery. Our concerns centered upon the fading in the second half of the year of much of the fiscal stimulus and the lack of sustainable underlying demand. While much of the focus was centered upon Federal Reserve exit strategies of prior economic stimulus, we felt the opposite would occur and that interest rates and inflation would not be a concern. Indeed, we noted that “forecasting 2010 would be highly predicated upon the actions of the administration and Federal Reserve.” We underestimated how prescient that comment would be.

Through August this appeared to be precisely what was unfolding in the economy as data clearly indicated an economic slowdown was at hand. With the spectre of increased taxes amid the expiration of the Bush-era tax cuts on the 2011 horizon, the talk of a “double dip” in the economy increased. Reflecting these concerns, the S&P 500 was down over 6% for the year and the yield on the 10 year U.S. Treasury had declined from 4% during the bloom of Spring to below 2.5%.

At this point Chairman Ben Bernanke employed another tool from the Alan Greenspan toolbox during his speech at Jackson Hole, Wyoming. The announced goal was to expand the balance sheet of the Federal Reserve via the purchases of Treasuries and other debt instruments thus lowering interest rates. Quantitative Easing 2 (QE2) could conceivably even be followed by additional stimulus. In essence, Bernanke was targeting the stock market and other assets in hopes of re-kindling the animal spirits. The goal of this increased "wealth effect" was to stimulate consumer spending which, in turn, would lead to increased hiring and business spending. On this point the early returns have been positive. Combined with the administrations apparent move to the center and passing of the recent payroll tax cut and Bush-era tax cut extensions, the market has concurred. The residuary impact of a jump in interest rates and pronounced rise in commodity prices may impose an unintended consequence on the economy that has yet to be determined.

For now, however, the risk-trade has resumed and the markets have enjoyed a 20% rally from August lows. For the full year the S&P 500 and Dow Jones Industrial Average posted generous returns of 15% and 17.5% respectively, about half of which occurred in December alone. International developed markets as represented by the MSCI, EAFE index fared less well with a full year return of 8.2% while the MSCI Emerging Markets index continued to lead the way with a 19.2% return. After outperforming equities through the first three quarters of the year, a broad based sell off in bonds commenced in the final two months shaving about 2% from returns on the Barclays U.S. Aggregate index leaving the full year return at 6.5%.

This fixed income decline was most pronounced in Treasury and Municipal bond markets though for distinctly different reasons. Rather than fears of rising inflation, we feel the increase in 10-year Treasury rates from 2.5% to 3.3% at the end of the year reflects increased prospects for faster economic growth and find this to be evidenced by a commensurate decline in the cost of Credit Default Swaps (CDS) on U.S. debt.

Municipal bonds in aggregate suffered one of the largest quarterly declines ever with the Barclays Municipal Bond index off 4.1%. Yields on longer term AAA-rated bonds jumped over 1% during this period reflecting the sunset of the governments' successful Build America Bonds (BABs) program. This federal initiative subsidized 35% of the cost of financing for state and local agencies and had represented over 30% of total municipal borrowing. The heavy issuance as municipalities rushed deals to market overwhelmed short term demand.

Signs of economic strengthening have been evident in varied economic barometers. Both the Institute of Supply Management (ISM) manufacturing and service numbers are now in excess of 57 indicating continued solid expansion while Industrial Production is back to levels of the 4Q of 2008. A year ago we had postulated that the peak growth of this economic cycle might have been reflected in the 4Q 2009 reading of 5.0%. While this still may be true, our view of a declining 2nd half growth rate has been contradicted and we now anticipate 4Q 2010 GDP to approach 4% bringing the full year to about 2.8% (though about 65% is accounted for by inventory replenishment).

Consensus GDP estimates for 2011 are rising towards 4% though we view 3.0% -3.5% as more likely. Upside to this is possible though as the economy is now at levels whereby the drag of housing is lessened as residential investment is now only 2.5% of GDP versus 6% in 2006 and the largest consumer spending declines are probably behind us.

While we do anticipate a modest rise in the inflation figures, they are more due to the anniversary of very low headline readings than a strong and permanent increase. The PCE index (the preferred inflation gauge of the Federal Reserve versus the CPI) rose 0.5% in 3Q 2010, the lowest in the 52 year history of the report. While we have seen an eruption in the cost of food and energy (another negative consequence of high deficits and dollar debasement), there is no commensurate pickup in wages and housing, which are the greater components of rising costs. Domestic price pressures have been very modest. We do not see that changing in 2011.

Employment, housing and state and local government fiscal crises and their interdependence remain the most critical short (and perhaps longer) term concerns and highlight the fragility of our baseline growth projections. For the year, the unemployment rate modestly declined from 10% to 9.4% while the broader U-6 rate of under employment nudged down from 17.4% to 16.7%. These are historically lagging indicators and we feel we are finally on the cusp of increasing payrolls as the initial jobless claims (a strong coincident indicator) show marked improvement in the recent two months. We fully expect job growth to now average over 200K per month in the early part of 2011. It is likely that we will need much higher numbers to really make an impact in the levels of excess capacity in labor. Estimates are for about 150K new entrants into the job market from population growth and current statistics indicate there are 14.5M unemployed (of which over 6 million have been out of work over 6 months) and another 8.9M working part time for economic reasons. While we are increasingly optimistic on private payroll growth, we must not ignore that State & Local governments represent 15% of total employment and will remain in contraction.

As weak as the headline data may have been, however, the underlying details were actually worse. Two startling statistics continue to catch our eye and need to improve before we can be confident that we are moving in the right direction for the longer term. The first is the Employment to Population ratio which we view as a far better gauge of labor market conditions than the unemployment rate. This figure recently declined to a cycle low of 58.2% in November (down from almost 65% in 2000), a number also breached in the mid-1970's in the early stages of the influx of women into the workforce. Many of these people will look to enter the work force as the job market improves and may perversely increase the unemployment rate as the employment picture gets better. The other concerning statistic noted is that during the recent period of modest job growth we have seen the net loss of 1.6M full time positions replaced by part time positions. As companies continue to be vigilant on expenses, the use of "perma-temps" will continue.

Despite the weak jobs picture, wages and salaries and disposable personal income has improved over 3% on an annual basis and alongside a modest drawdown in savings to a 5.7% rate have supported a pickup in consumer spending of over 3.6%. The decreased use of credit card debt remains the most striking aspect of the consumer deleveraging. The American Research Group estimates that credit card use during the holidays was down 50% from one year ago levels and was at the lowest level in the 27 year history of their tracking. Total consumer debt is now down for three consecutive years and total credit card debt outstanding is back to the levels of 2004. Improving consumer debt levels are apparent in the improvements of Household Debt Service ratios and Financial Obligations ratios (debt payments as a percentage of disposable personal income) back to levels of 1995. Some economists believe the consumer is now much more comfortable with current debt levels and thus able to increase spending. More likely, however, is the continued bifurcation in this data with higher income consumers with larger stocks gains (wealth effect again) accounting for the majority of these increases. We also need to note the potential residuary impact of the Federal Reserve actions in this area. With wages now accounting for only 58% of GDP (down from 62% in 2008) there is much slack. As we look to maintain current consumption, deficit spending and dollar debasement will increase prices of commodities in dollar terms. Thus, wage gains will likely lag the increases in commodities over time and real incomes may suffer.

Try as we might, we cannot seem to find many positives in the housing market and believe we are in the early stages of a second leg down in prices. This is apparent in the recent Case-Shiller home price data which shows national home prices down four consecutive months and now only 4% above the lows of April 2009. In a nutshell more than 13% of mortgages are delinquent or in foreclosure; more than 22% (almost 11M) mortgages exceed the values of the home and total inventories (including estimates of shadow inventories not on the market) approximate a 24-month supply. According to the Flow of Funds data, total Household Real Estate in the United States has declined from $22.7T in 2006 to $16.5T. Owner's equity as a percentage has declined from 80% in the 1950's and 60% as recently as 2006 to less than 39%! As it is estimated that over 30% of homeowner's do not possess any mortgage, the math indicates that those that do have around 13% equity in their home. Core Logic estimates that another 5% decline in home values would leave an additional 2.4M homeowners underwater. Optimists note that existing and new home sales and starts have bottomed. Realists note that they are at or near 50-year lows. Here again the recent actions of QE2 have had an undesired impact as the backup in mortgage rates has lifted the average 30-year fixed rate from about 4.2% to almost 5%. With supply increasing and demand impacted by rising rates, we will need greater than expected employment growth to offset this imbalance. Left to free markets, we have little doubt that further declines are baked in. However, we are living in strange times.

State and local budgetary may end up being the second biggest risk behind housing in the outlook for 2011. Currently state and local governments represent about 12% of GDP and 15% of total employment. According to the recent reports from the National Conference on State Legislatures, states face budget gaps of over $65B in fiscal year 2011 and pension deficits of more than $1T according to the Pew Center on the States (studies by Joshua Ruah of the Kellogg School and Robert Novy-Marx of

University of Rochester triple this estimate). In 2010, Federal stimulus monies supplied about 32% of funds for state budgets who in turn funded about 40% of local budgets. With much of this stimulus rolling off, tax hikes, increased user fees and major service cutbacks (such as snow removal in New York) will be regular headline news. While we feel that talk of municipal bankruptcies have been overblown, there is little doubt that the structural imbalances will lead to drastic cuts, layoffs and compromises. As mentioned, the expiration of the Build America Bond program may have a major negative consequence to municipal funding if not re-introduced. All told, this will be a great area of concern and one that is sure to cost the tax payer much more.

While we continue to attempt to maintain our 30-year consumption over savings and investment binge, we cannot ignore the accumulating debt and the impact it may have over time. With about $1.3T deficit and over a 90% government debt/GDP ratio, we are moving perilously close to the level at which funding these debt payments crowds out investment and eventually becomes unmanageable. As this is not a 2011 event, we will of course kick this can down the road. The sovereign issues of more imminent concern will probably come from abroad though it may not be in just the most obvious places.

The debt issues in the Eurozone are well documented but still bear review. According to the Bank of International Settlements, the PIIGS (Portugal, Ireland, Italy, Greece and Spain) countries collectively owe over $2T to European and U.S. banks ($353B to the U.S.). Of this, about $1.5T is due in 2011. Greece, Ireland and Portugal collectively represent about 7% of the Eurozone. While some believe this current concern is manageable, as the contagion moves to Spain (which represents 12% of the Eurozone), it may no longer be. Remember as we look towards export growth as a driver of GDP, this region represents over 25% of U.S. exports. An additional area of downside risk less publicized is in the Asian region where China has increased Reserve Requirements six times in 2010 to slow down growth. As central banks move forcefully to curb inflation, these economics may struggle much more than is expected and that may be indicated by the recent 10% decline in these stock markets.

Corporate America continues to appear to be in strong shape. According to the Wall Street Journal, though debt levels are at all-time highs of $7.3T, corporate cash is also at all-time highs of $1.93T. High debt levels are mostly due to the terming out of longer term debt at generationally low rates. This has opportunistically reduced the interest expense and improved margins. The improvement in corporate stability is highlighted in the speculative grade default levels which Moody's Investor Services states have dropped to 3.3% in November from 14.7% in 2009. The high levels of cash are also benefitting shareholders as stock buybacks are now up for five consecutive quarters and Standard & Poor's calculates that 255 S&P 500 companies have raised their dividend payouts in 2010 versus 157 in 2009. Lower interest expense and lower labor costs have helped increase productivity to a level where corporate profit margins are estimated to be at record highs of close to 9%, fully 50% above historical norms. These improved margins helped generate earnings growth in the S&P 500 of over 25% in 2010 and we are now looking at consensus estimates of over $92 in earnings for the index in 2011, a record high. Wall Street strategists appear giddy and eager to slap a robotic multiple of about 15 times that number and generate a target price return in excess of 10% or greater.

So here we are with record fiscal and monetary stimulus; a Federal Reserve that appears to want to engage and even support speculation; an administration that is moving more towards the markets desired center (and may even consider corporate tax cuts); an improving economy; and corporations with record profits and profit margins. Sentiment indicators in the markets are moving towards extremes and even money from Main Street is starting to move into the equity markets. There is a developing and strong bullish consensus on Wall Street. I even just read that venerable Wall Street analyst Laszlo Birinyi has projected the S&P 500 will hit 2,854 on September 4, 2013 (not sure if he meant morning or afternoon).

So why are we less sanguine? Is it because it has taken record amounts of stimulus to just generate north of 3% growth? Perhaps due to having 14.5M unemployed that at a job growth rate of 250K per month (which has only once even been approached during any Presidential term) will still leave us at over a 7% unemployment rate in 4 years? Maybe a housing stock that is still overpriced yet at perilously leveraged levels with fourfold normal inventories? Or is it record levels of public and private debt and our increasing reliance on government intervention? How about perilous fiscal concerns in state and local government? Surely a global financial system facing increasing sovereign defaults? We could say yes to all of these and many other concerns. However, it would be difficult to find a period in history where there were not storm clouds present (though perhaps not as many).

It is rather that the price for clarity is usually high valuations and markets offer the best opportunities when the future looks bleak. However, now we are paying a price for apparent victory when the game is still in the very early stages. We have an overbought, highly bullish, rising yield market environment that is apparently assuming that profit margins (perhaps the most mean reverting of all statistics) that are a full 50% above historical norms can continue uninterrupted. Maybe it can in 2011. A lot must continue to go right and the cheap valuations of two years ago are no longer there for the markets as a whole, making the desired hurdle rate more elusive. The one growing consensus with which we firmly agree is in the strong relative valuations of high quality companies and the continued focus on demand defensive business models with attractive yields and cash flows. To paraphrase one of our favorite commercials, “stay defensive my friend”.