

Commentary and Outlook, January 2011

In 2010 the global economy and financial system continued recuperating from their near disintegration of late 2008 and early 2009. As we entered 2010 concerns persisted about the sustainability of economic recovery domestically with the nearly incomprehensible amount of private and government debt, the still fragile residential housing market and the government's contingent liabilities of Social Security, Medicare and Medicaid obligations. The Greek debt crisis in the spring was followed by the "flash crash" of May 6 and a significant flight to the perceived quality of US Treasury securities through July. The prospect of broader sovereign debt defaults in the European Monetary Union countries of Ireland, Portugal and Spain last spring and summer caused many to forecast the end of the Euro, which actually strengthened from early June to the present. Concerns about a "double dip" in the domestic economic recovery remained prominent even as corporations were reporting record profitability achieved by the cost cutting—and accompanying high unemployment—were reported. The Federal Reserve Open Market Committee's announcement in August that it would embark on another round of bond purchases (dubbed "Quantitative Easing 2", or "QE2") by creating money buoyed financial assets and commodities through year-end in dramatic fashion. Recall that the equity market indices domestically were negative on a year-to-date basis through August as the S&P 500 was down 4.6%, but rallied to end the year with a 15.1% total rate of return. The enactment of tax rate extensions as the year ended and a moderation in the economic and tax policy leaning of the Administration, which has discussed reducing corporate tax rates, has given some hope for a less rancorous tenor in Washington. Given the large uncertainties in the economy, continued Federal Government policy uncertainty is not conducive to long-term economic decisions by corporations or individuals. As if investors needed another problem to focus on, the elevated discussion of municipal bond defaults caused significant declines in prices of all tax-exempt bonds from mid-November onward. As discussed in recent quarterly letters, concerns about another significant decline in equity and certain bond prices that decimated portfolios in 2008 and early 2009 remain at the fore and the preference for liquidity, even if cash equivalents and short term bonds have very low yields, remains quite high.

There continues to be much debate about the implications of the FOMC's quantitative easing bond purchase program that has not lowered interest rates. Printing money is the only short-term lever available to policymakers given the resistance to further fiscal stimulus beyond the recent tax rate extensions. Of course, it is easy to argue that further borrowing will not solve the problems created by too much debt, but the political, social and economic consequences of capital starvation at this vulnerable point in developed country economies are too difficult to accept. Indeed, the can is being kicked down the road and the ultimate resolution of debt burdens must be considered in investment and economic decisions. That it falls upon the Federal Reserve system, itself under intense legislative scrutiny, to execute a policy to increase the probability of full employment may in the future be seen as a very positive factor supporting an economy recovery that although modest in its pace, may become self-sustaining. The implications for price inflation remain a concern when and if the economic recovery quickens, especially as commodity inflation increases primarily as a function of demand for physical commodities by rapidly developing nations that now comprise about 40% of global Gross Domestic Product. We note that such rapidly developing countries, or emerging market countries, have inaugurated more restrictive monetary policies to quell price inflation in sharp contrast to the expansionary monetary policies of the United States and the European Monetary Union that continue to skate along the edge of deflation in the important residential housing sector.

The 90% recovery of the S&P 500 for nearly two years since the March 9, 2009 bottom leaves the equity market near fair value after what we believe was a very deep cyclical decline against a backdrop of long-standing structural problem of debt and its implications. Our last letter discussed the notion of low growth and high unemployment and debt levels for many years, described by the ubiquitous spokespeople from PIMCO as the "New Normal." We believe that such a concept, while very accessible and appealing is the polar opposite of what "New Economy" adherents believed a decade ago. Just as the New Economy theory that held that business cycles were a relic lead people to assume too much risk, adherents of the New Normal have assumed too little in the past two years, believing that a return to meaningful economic growth, profitability and opportunity were naive expectations.

The structural problems of unemployment and debt have lead many to believe that another deep decline will occur, although the Euro debt crises, the domestic residential housing wows and now the concerns about municipal bond defaults have not been strong enough to cause a meaningful decline in equity prices. Perhaps the liquidity that the FOMC with its QE2 has stemmed another downturn and its end will coincide with another downdraft in stock prices. Certainly, there has been no shortage of such warnings in the financial news programs and publications. Perhaps the advance in equity prices since August represents an overdue upgrade of expectations and renewed confidence in the prospect of a sustained economic expansion. Such a situation could be viewed as a normalization of perceptions. Corporate fundamentals are positive and earnings expectations in the low double digit range, after a spirited recovery from 2009 lows, provide a solid underpinning for equity investments. As noted in recent quarterly letters, emerging market equities remain attractive on a long-term basis, but domestic companies offer a competitive combination of valuation, financial strength and earnings growth. As ever, there is little question that the equity market's rapid advance such as that since August will consolidate and test optimism with periodic declines. The monthly pattern of total return of the S&P 500 Stock Index in 2010 tested optimists:

<u>Jan</u>	<u>Feb</u>	<u>Mar</u>	<u>Apr</u>	<u>May</u>	<u>June</u>	<u>July</u>	<u>Aug</u>	<u>Sept</u>	<u>Oct</u>	<u>Nov</u>	<u>Dec</u>	<u>2010</u>
-3.6%	3.1%	6.0%	1.6%	-8.0%	-5.2%	7.0%	-4.5%	8.9%	3.8%	0.0%	6.7%	15.1%

While equities are attractive, the nearly 30-year bull market in bonds is quite susceptible to an end as financial liquidity is gradually absorbed by stronger economic activity. This may well occur even if non-commodity price inflation remains quiescent given high unemployment and still low capacity utilization. Until and unless unemployment declines meaningfully and inflation increases, it appears likely that the FOMC will maintain its policy of low short-term interest rates, but that does not mean that longer term interest rates will not increase enough to produce very low to negative total returns for holders of such bonds.