

Commentary and Outlook November 3, 2010

The third quarter began with a sharp advance in equity markets in July followed by a decline in August and ended with an historically large advance in September as the S&P 500 increased 8.9%. The total rate of return for major equity indices in the quarter ranged from 11.3% for the S&P 500 to 16.5% for the MSCI EAFE Index of international developed markets to 18.2% for the MSCI Emerging Market Index. Bond markets were also firm with the Barclays Capital US Aggregate Index advancing 2.5% as interest rates declined further on expectations that the Federal Reserve Bank's Open Market Committee ("FOMC") would renew its purchases of bonds for a second time by creating money, which is euphemistically referred to as quantitative easing or QE2. Non-dollar bond indexes rose in high single digit to low double digit returns as the dollar weakened.

The risk on/risk off nature of financial asset money flows this year has been quite dramatic, underscoring the very short term horizons of equity market participants. The rapid change in investor sentiment hinged on indicators of economic activity, expected central bank response and the continuing problems of too much government debt, especially in the Eurozone. Recall that in the spring many were predicting the demise of the Euro, which actually appreciated 10% against the dollar in the recent quarter. Such dramatic shifts in sentiment can provide those with conviction about the viability of intermediate to longer term profit growth and equity investing, especially when the yields on bonds are historically low with the ten year US Treasury Note now yielding 2.49%, up from 2.36% in early October, but down from nearly 4% in April.

Adding to the uncertainty of investors sensitized to the possibility of a large decline in equity prices such as that of late 2008 and early 2009, is the lack of clarity of Federal regulatory policy and tax policy. Stabilization in fiscal and regulatory policy is desirable, although with the contentiousness in Washington, DC, one can only guess at the prospect of stability. We are compelled to mention a couple of points made by managers with whom we correspond in August as the market declined. The first is from the mutual fund group, US Global Investors and noted that just as hope is not a strategy, neither is hopelessness and the second is from a long-biased hedge fund that noted that it appeared that the most crowded trade in August was the sidelines. We mention these points to underscore the extreme skepticism of potential equity investors and infer from these characterizations, which we believe are an accurate representation of individual and institutional sentiment, that there is an enormous amount of potential buying power for global equities. If the old Wall Street saying that the market climbs a wall of worry has any truth to it, it certainly seems that worry remains at a high level, despite the progress of equity prices since March 2009. There is never a clear path to higher equity prices and the enormous challenges discussed below coupled with low inflation that has not eroded purchasing power of the dollar significantly has made it relatively easy for skeptics to remain on the sidelines in cash equivalents that yield very little. If there is a lesson in history of markets, it is that diversification, although difficult to achieve, is not just possible, but a prudent strategy for those with a horizon that stretches beyond a few years.

It is reasonable to ask if the recent strength in the equity market presages a firmer than expected economic expansion, is a reflection of the expected infusion of money into bonds from the above mentioned QE2, or a combination of the two. In our letter last year we talked about the Wall Street maxim that holds, one should not "fight the Fed." Had one done so since early 2009, it would have led to a generally unprofitable outcome. Despite a clear slowdown in many economic indicators since May, can it be that the expected infusion of money from an additional round of Federal Reserve Bank easing explains the stock market's stubborn advance? Perhaps such an expectation is accountable for part of the rise in equity values, but seems quite clearly to be accountable for the rise in bond prices at the same time as gold has reached all-time nominal high price. It is also possible that the strength in corporate earnings and revenue growth may account for the view that equities are attractive after a decade of disappointments. Although the impact on economic activity related to QE2 is debatable, with a number of economists positing estimates that a trillion dollars of money creation may increase GDP by 0.5% (the FOMC announced on November 3rd that it would purchase \$600 billion of US Treasury securities through June 2011), it appears that corporate earnings are likely to underpin stock market direction even in the context of several quarters and certainly over a several year horizon. Should corporate profits continue to grow, even at more modest rates,

current valuations of many stocks are well below the peaks reached a decade ago, which given the very low interest rates makes equities relatively attractive.

Although the end of the recession was recently declared by the National Bureau of Economic Research, there remain valid concerns that an economic contraction may occur within the next year.¹ There are also arguments that the slow economic growth of the past two quarters is a normal mid-cycle slowdown. Few would disagree with the view that any economic recovery will be tempered by the structural problems of high unemployment and underemployment, the still large inventory of unsold homes and the continued liquidation of consumer debt, just as at least marginal fiscal constraint globally is a prominent concern. The most likely path is that the economy recuperates from its structural problems in an extended period of low short term interest rates at a sustained, but below normal growth rate.

We have commented the propensity of market participants to be anchored in their most recent experience, which prominently includes the non-trivial risk of a significant “tail event” or crash in values similar to that which occurred from September 2008 to February 2009. Given its now ubiquitous inclusion in nearly every investment commentary, especially among televised discussions, the term “New Normal” strongly suggests that it is naïve to expect returns much above the now low yield on bonds in the future. New Normal is a term coined and vigorously promoted by the world’s largest bond manager, PIMCO, and implies that low growth that will be constrained by de-globalization, regulation; higher taxes and prolonged de-leveraging/debt liquidation by consumers will prevail for many years and that the risks posed by government obligations are very real and potentially devastating. Before embracing this very accessible and seductive argument, we observe that returns to equity investors before the increasing use of debt at all levels that began in the 1980’s, were in the high single digit range adjusted for inflation. One might also recall the New Economy notion that surfaced in the late 1990’s and early 2000’s calling for an ever expanding economy free of significant recessions. The New Economy was obviously nothing more than a simple extrapolation of relatively short term data during a fantastic bull market in equities and robust economic growth. The New Normal may, several years hence, be seen as a similarly naïve notion. We would characterize the term New Normal as specious, although some less politic observers have called the notion of a New Normal idiotic and others have dismissed it by suggesting that there is No Normal and that change is the only constant in economic affairs. We think that the latter view is much more instructive and useful in understanding both risk and opportunity.

Price inflation continues to be a more distant risk than we thought in the past year, as concerns about deflation remain with the slowing rate of economic activity since the spring. It is likely that the Federal Reserve will maintain very low short-term interest rates until there is a recovery in employment. Indeed, the FOMC may initiate more aggressive action than the just announced \$600 billion Treasury purchase program to provide credit to the economy. We have noted that the output gap, or underutilization of capacity and the high unemployment rate will restrain price increases, although a lower external dollar value, while stimulating exports will tend to increase the rate of inflation. As we have posited, the potential for material price increases remains should housing inventory be reduced and employment improve over the next several years. A major surprise in the next year or two is the rate at

¹ Excerpt from The National Bureau of Economic Research News Release, September 20, 2010—“The Business Cycle Dating Committee of the National Bureau of Economic Research met yesterday by conference call. At its meeting, the committee determined that a trough in business activity occurred in the U.S. economy in June 2009. The trough marks the end of the recession that began in December 2007 and the beginning of an expansion. The recession lasted 18 months, which makes it the longest of any recession since World War II. Previously the longest postwar recessions were those of 1973-75 and 1981-82, both of which lasted 16 months. In determining that a trough occurred in June 2009, the committee did not conclude that economic conditions since that month have been favorable or that the economy has returned to operating at normal capacity. Rather, the committee determined only that the recession ended and a recovery began in that month. A recession is a period of falling economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales. The trough marks the end of the declining phase and the start of the rising phase of the business cycle. Economic activity is typically below normal in the early stages of an expansion, and it sometimes remains so well into the expansion. The committee decided that any future downturn of the economy would be a new recession and not a continuation of the recession that began in December 2007. The basis for this decision was the length and strength of the recovery to date.”

which housing inventory could be absorbed and the potential for inflation in residential house prices. The potential for physical commodities to increase significantly in price from now high levels is also high given the constraints of materially increasing capacity to meet incremental demand in most important sectors, especially from emerging economies. Although the timing is uncertain, the transition from very accommodative monetary and fiscal policies to those focused on price stability is likely to be dramatic, with higher bond yields.

We have commented regularly of the attraction of emerging market equities and in our last letter suggested that they had approached fair value after a now more than 140% increase from the low in November 2008, despite being about 11% below the all-time high in late October 2007. We continue to believe that emerging market equities represent the best prospects for the long-term growth. It is also possible to capture the potential of emerging economies in large capitalized multi-national company stocks that are valued very attractively after a decade of disappointing performance in share price, if not in profit growth. Both broad equity sectors represent strongly financed enterprises that can capture growth in the faster growing regions of the world.