

Commentary and Outlook January 2010

Financial markets continued to discount a recovery in the domestic and international economies in the year's final quarter after recording one of the most rapid advances ever since early March of last year. Various measures of economic activity domestically have implied that the worst of the downturn in output may be behind us, although stubbornly high unemployment and underemployment trends, the large inventory of unsold houses, including those in foreclosure and weakening commercial real estate temper expectations that the domestic economy is on a clear path to sustainable growth. Government fiscal and monetary stimulus continues to underpin much of the recovery and the transition to private demand and financing is unlikely to be smooth. Despite the likely volatility in equity markets as they transition to a focus on revenue growth, it appears to us that equity opportunities over the long term are better than those in fixed income, excepting those that arise among distressed debt, as interest rates are more likely to increase with economic recovery.

Domestic equity market returns in the decade have led many to become more risk averse, in stark contrast to the exit from the prior decade that witnessed all-time highs for broad equity indices and an almost unlimited appetite for risky assets that marked the end of the dot-com boom. Add to the financial dislocations precipitated by profligate use of debt in the decade and the failure of Lehman Holdings in September 2008, the significant geopolitical changes, not least, the risk of terrorism in the United States, and we have all had to confront a variety of challenges that make concerns about "Y2K" as we entered the last decade seem hopelessly naïve today. It appears that this may well be the decade of risk awareness and management, which should create opportunity for those who best understand their tolerance for investment risk. Money flowed into fixed income mutual funds in 2009 and out of equity funds as investors sought more certainty and because short-term interest rates hovered close to zero, as retirees sought income from their depleted retirement fund accounts. When such unanimity prevails the self-fulfilling nature of the trend may reward participants for a while, but ultimately will lead to disappointment, or at least that is what history suggests.

Risk awareness and aversion are also front and center in the current Financial Crisis Inquiry Commission's investigation of the financial meltdown. The Commission has noted recently that the financial system remains vulnerable. Recall that the government's investigation into the stock market collapse of 1929 resulted in a number of meaningful changes designed to stabilize the financial system, prominently including the formation of the Securities and Exchange Commission and the enactment of the Glass-Steagall Act that established the FDIC and prohibited banks from owning other financial companies. The prohibition against banks owning other financial companies was lifted in November 1999, and it is now clear that the major financial institutions operated with insufficient capital as they conducted increasingly risky operations to bolster earnings, which they saw as their competitive imperative. This should not surprise anyone, as the banking industry is relatively homogeneous. Despite, or perhaps because of the focus on risk, credit spreads in the bond market have returned to pre-Lehman failure levels and the issuance of corporate debt of all grades has resumed in force as corporate managements attempt to replace short term borrowing with longer term maturities. Such an accommodative market has certainly been enabled by the massive inflow of funds to fixed income mutual funds in 2009 that to us reflects investors' desire for more predictable returns on their assets and higher current yields. A preference for reduced risk is also reflected in the persistently strong demand for US Treasury obligations despite low yields. Firmer economic growth will inevitably cause intermediate and longer term interest rates to increase and bond prices to decline, a risk that may well surprise many mutual fund investors and cause them to reconsider the merits of equity investing. The Federal Reserve's intention to keep short term interest rates low for an extended period will change as employment recovers, but it must tread a very careful path given the enormous creation of money during the financial crisis because such liquidity is likely to fuel inflation as confidence of consumers and businesses resumes. Moreover, its quantitative easing, by which it has purchased US Treasury debt and has essentially nationalized the mortgage market through purchased of mortgage-backed securities, while the Treasury has explicitly backed mortgage financing operations, has served to keep intermediate and longer term interest rates lower than they would likely

have been without such demand. We are also mindful of the likelihood of higher taxes at all levels of government to reduce the deficit. Higher interest rates and taxes will temper economic growth domestically. Much will be said about monetary and fiscal “exit” strategies this year in addition to commentary about the structural underemployment, the continuing deleveraging of businesses and consumers and its combined implications for moderating end demand growth.

Regarding equity markets, the decade had two stock market crashes as the S&P 500 lost 46% between 2000 and 2002 and 56% from October 2007 until early March 2009, producing an annualized total rate of loss of 0.95% per year. We are reminded by Professor Jeremy Siegel of the University of Pennsylvania that in the 14 times that stocks have produced negative returns in any ten year interval since 1926, they have produced more than 10% after inflation per year in the next ten years. Of course, the next ten years may be different, but the tendency for stock rates of return to revert to their average has been clear for those with patience. The rebound since early March 2009 offers a stark reminder of such mean reverting behavior, although it did not recover the losses from the peak in October 2007 and remains approximately 27% below that level and that of early 2000. It is important to note that the sharp increase in stock prices since early March 2009 took place well before there were significant indications of an end to the decline in economic output. Indeed, the rate of increase in unemployment was at its highest level as the stock market began its rebound. The underperformance of domestic equities has produced relatively attractive valuations, especially given the higher operating margins of corporations that have been the result of belt-tightening over the past two years. In view of the likelihood of higher interest rates and their tendency to reduce price-to-earnings multiples, a focus on earnings growth will become more important for equity investors, in our view. Companies that can demonstrate growth in end demand and relatively high returns on assets with relatively low valuations are likely to be favored by investors, which is in contrast to the performance of many cyclically sensitive company stocks that performed much better than more stable earnings growth companies in the early stages of the stock market’s recovery last spring and summer. In 2008, 90% of stocks declined and in 2009, 90% of stocks appreciated. It is likely that the spread in returns among stocks will be much wider; suggesting that stock selection will become more important than it was in the past two years.

The prospects for increasing price inflation appear greatest in basic commodities in the energy, metals and agricultural sectors due principally to the demand from emerging economies. The surplus of industrial capacity and labor is likely to keep general price inflation lower than other post-WWII recoveries, however. To us, positions in natural resources and materials present a reasonable hedge against commodity inflation.

The economies and stock markets of emerging countries in the decade have been a positive story and one that is now a major component of global economic growth. Emerging countries now account for approximately 34% of global GDP and they are becoming more consumer-driven. Additionally, as mentioned in prior quarterly letters, the Asian countries, excluding Japan, have been financially sounder than the developed countries that increased their use of debt to finance private and public expenditures. The trend has been validated by investors as the emerging markets recorded annual gains of 10.1% in the decade just ended. To put this performance in context, one dollar invested in the S&P 500 ten years ago would have declined in value to \$0.91 and a dollar invested in the MSCI Emerging Market Index would have grown to \$2.62. Although the transition of emerging countries to more consumption will continued to be marked by volatility, the desire for continued improvement in living standards is unlikely to stop or reverse. One might well ask if emerging market stocks reflect too much optimism, at least relative to domestic issues, particularly given concerns about an overheating Chinese economy and the threat of protectionist policies to global trade. These are valid concerns and are likely to contribute to higher volatility, but are unlikely to market the end of emerging market growth in the long term, in our view.