

## Commentary and Outlook May 2010

In view of the extreme decline in the stock market on May 6 and 7 and substantial recovery on May 10, volatility and fear have demonstrated their potential to discount negative and potentially negative fundamental developments rapidly. Nevertheless, we believe that inevitably equity prices reflect underlying fundamentals even if they are dramatically disconnected for what are often relatively brief intervals, thus we present our comments in the context of a longer-term investment horizon.

Equity markets recovered strongly in mid-quarter after an average 8% decline to finish with mid-to-high single digit total returns. Small capitalized stocks and REITS were especially strong in the quarter. Bonds had positive total returns in the quarter, although interest rates on intermediate and longer term maturity issues increased in March.

The rebound in equity prices since early March 2009 could be viewed as a nearly equal and opposite reaction to the sharp sell-off in late 2008 and early 2009. The enormous liquidity provided by the Federal Reserve, as well as the economic stimulus program contributed to investor confidence. We have discussed our respect for mean reversion in prior letters since the crash as the reason that we maintained a long-term strategy, despite widespread concerns that markets would behave differently after such a dramatic, near failure of the financial system and the easily identified negative factors of Federal, state and local government deficits and mounting debt, enormous future liabilities of Social Security and Medicare (especially discounted at today's very low interest rates), prospectively higher taxes, increasing mortgage defaults and their self-reinforcing negative impact on housing prices, the deleveraging consumer, high structural unemployment and underemployment, potential sovereign debt default and a host of other problems likely to confront the country for years to come. However, evidence is mounting that it may well be that the economic contraction and equity market decline since late 2007 prove to be a severe cyclical phenomenon, not a structural decline arrested temporarily by fiscal and monetary stimulus.

It now seems quite clear that the equity market advance anticipated the economic recovery that began in last year's third quarter and that has continued through early 2010 in what might be characterized as a "V" shaped trajectory that could be viewed as symmetrical with the sharp falloff in the economic downturn. Since the March 2009 bottom, rising equity prices have been met with derision and disbelief. In retrospect, the evidence points strongly to the advance in stocks as mirroring the strong recovery in the business cycle. The first quarter corporate earnings reports saw 80% of S&P500 companies that have reported results that exceeded estimates, the most in 17 years.

Of course, the durability of economic recovery is still in doubt with many, although the equity market's ability to date to recover from modest corrections suggests that it may well continue.<sup>1</sup> Although warned regularly about the waning impact of the economic stimulus program, more than half of the Federal funds have yet to be disbursed. Of course, the transition to private sector demand will be tested as the Federal program does wane in the course of the next year. Residential housing remains a major concern and may weaken after showing signs of improvement with massive aid from the Federal Reserve and the government's incentives that have largely ended.

There has been a clear bias in the popular financial news and commentary media to accentuate negative economic factors, especially unemployment. It appears that many want far more evidence of a recovery before they will assume risk, which is certainly understandable, as it is normal for people to be anchored to behavior that will avoid painful outcomes. Most people in the investment community acknowledge that an economic recovery began

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<sup>1</sup> We are quick to note that this is correlative thinking, but the correlation of stock market advances after recession declines is quite strong.

last summer, but many highly intelligent investors and commentators remain quite concerned that the economy will stop growing and even contract again as inventories are rebuilt and the economic stimulus program peaks. Such concern, or risk aversion is not surprising after such a wrenching destruction of wealth from late 2007 through early 2009. Concern about the possibility of another downturn, or “double-dip” recession has been recently reinforced by Martin Feldstein’s statement that the declaration of a recovery is premature.<sup>2</sup> This may be slowly changing as individuals and companies repair their balance sheets as evidence of corporate revenue growth is presented in quarterly earnings reports. Optimistic sentiment might be evident beyond the equity market gains in the recently positive flow of funds into equity mutual funds after well over a year of net redemptions, but after a year of a substantial rebound of over 60% that should not be surprising. Indeed, in the past, the equity market has typically advanced before economic recoveries and its trajectory has just as typically presaged the degree of economic strength. We certainly appreciate the still risk averse climate and fragile confidence, but there is a relatively long list of positive economic indicators showing improving trends including: the aforementioned positive earnings surprise in first quarter 2010 earnings reports, the index of leading indicators, industrial production, ISM non-manufacturing survey, real GDP that has advanced at a higher pace than the recovery from the 1981 recession, inventory restocking trends, trade deficit, the employment index, initial jobless claims, adjusted non-farm payroll employment, ADP employment change, ISM manufacturing employment, CPI, PPI, PCE core price index, Federal Reserve Board comments about keeping interest rates low for “an extended period,” retail sales, consumer spending, and the number of loans past due falling. The prospect that corporate earnings continue to be above general expectations is another potential positive. What might concern us most about the near-term direction of equity is if the bias in the popular financial media and the oft-seen commentators became clearly optimistic. So that while the domestic economic landscape is unlikely to return to the largely debt-financed surge it experienced through 2007, it is restructuring while shouldering the prospective burden of higher taxes and large public sector debt and contingent obligations of Social Security and Medicare as well as prospectively higher energy prices.

There is very little discussion about potentially positive restructuring of the American economy that may occur. One of the bright spots is the strong financial position of large domestic public corporations that were very quick to reduce costs in 2008. This coupled with the wider adoption of information technology has increased the productivity of corporations and has permitted managements to address risks far better than in the past. Add to this the lower external value of the dollar in the past year against a trade-weighted index of currencies, despite its strength versus the euro since the Greek default risk became daily news in the first quarter, and there is reason to be optimistic about US prospects for export growth. We note that large multi-national, US-based corporations derive the majority of their earnings from international markets and increasingly from emerging market countries. Of course, the Eurozone may well impede global growth. Adding to the potential of US corporations is the prospect of increasing capital spending after years of decline. Capital spending actually declined below depreciation last year for the first time since data on that series has been recorded.

Emerging market equities continue to represent an excellent opportunity for long-term growth, although we believe that their performance since their low point in November 2008 has corrected much of the undervaluation and that they are now fairly valued, especially relative to large capitalized multi-national company stocks. Both broad equity sectors represent strongly financed enterprises that can capture growth in the faster growing regions of the world.

As we expressed in our last letter, we are concerned that higher interest rates, which seem inevitable should the economy continue its recovery, may well surprise many who moved assets from late 2008 through early this

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<sup>2</sup> Martin Feldstein: Harvard University, George F. Baker Professor of Economics; President Emeritus, National Bureau of Economic Research, which is the organization of economists that determines US business cycle expansions (recoveries) and contractions (recessions).

year into bond funds as they sought safety and income from their depleted retirement accounts. Therefore, we believe that shorter durations in fixed income accounts are warranted as we move through this year.

Inflation has remained benign and may remain low until capacity is more fully utilized globally. Commodities have reflected the economic recovery since last summer and in the case of oil can be expected to exact a toll on consumers. Additionally, the prospect of higher taxes and healthcare costs are likely to temper growth. However, it appears that the risk of increasing inflation rates will rise as the economy recovers given the enormous monetary and fiscal stimulus globally during the past two years. As we have discussed in past letters, equities are the most powerful long-term inflation hedge, despite what may well be short term weakness if commodity prices surge and interest rates rise meaningfully. Investors can expect the Federal Reserve Board to increase short-term interest rates as employment increases and economic growth continues. Cash equivalent interest rates will increase accordingly. However, the after-inflation rate of return on cash equivalent investments is very unlikely to match that from equities over time, if history and mean reversion are a guide.