

Investment Outlook & Commentary Second Quarter, 2009

The recent G-20 summit, billed by hopefuls and cynics alike *The [New] Committee to Save the World*, launched a few initiatives, including a \$1 trillion boost to the International Monetary Fund for increasing financing to third world nations. More importantly and symbolically, it solidified on a world stage its members' commitment to borrow, print and spend as much money as possible to halt and reverse a massive global recession.

After some 500 policy initiatives launched globally over the past six months, collectivism and coordination may be the next theme in bailout mania with many policy makers feeling that nations tending to their own corners of the Crisis may not be enough. A global New Deal of sorts may be underway after the G-20 coordinates further a collective financial bailout.

It's hard to imagine how much more the United States government could do with the last six months alone proving beyond a doubt the U.S.'s willingness to abandon all fiscal responsibility to re-inflate the economy and its financial system. Then again, we've identified airborne "kitchen sinks" thrown from Washington only to learn how drastically we had underestimated its arsenal—especially when its agencies work together and get creative.

The Federal Reserve lowering interest rates to zero was supposed to be the kitchen sink. *Wrong*. Then allowing banks and fake-banks to swap toxic assets for cash was the kitchen sink (the Fed had previously allowed institutions to pledge only risk-free U.S. Treasuries for cash). *Wrong again*. The Fed then pledged to directly lower longer term interest rates by buying up to \$1.2 trillion in longer term Treasuries—that was the kitchen sink, as was Treasury's \$700 billion TARP¹; \$1 trillion TALF² program; and the \$1 trillion PPIP³. *Wrong wrong wrong*.

We shudder to think of the fiscal and monetary risks Washington (and now the world) is taking. The consequences of today's policies—even if they're successful in "saving the world"—will surely be front and center at a later time. Right now, however, we also have to recognize what all the squandering is also doing: it's likely putting a floor under the market.

¹ The Troubled Asset Relief Program (TARP) is a \$700 billion program by Treasury to purchase assets and equity from financial institutions to strengthen the financial system.

² The Term Asset-Backed Securities Loan Facility (TALF) was created by the Federal Reserve to support the issuance of asset-backed securities collateralized by credit card loans, auto loans, student loans, and certain small business loans. The Fed pledge to loan up to \$1 trillion to support holders of TALF-eligible assets.

³ The Public-Private Investment Program for Legacy Assets (PPIP) is designed to provide liquidity for low quality and illiquid mortgage securities held on financial institution's balance sheets. Under the plan launched jointly by the Fed and Treasury, up to \$1 trillion in equity and debt financing will be given to private capital to buy legacy toxic assets from troubled financial institutions.

The worst of the banking crisis seems behind us, and the economy, from the perspective of output and jobs, is decelerating in its slide. (Markets generally turn long before the employment picture improves) Most experts and pundits are finding their estimates for various economic and housing-related indicators too dismal.

For a time, we feel we can focus on how cheap many great companies are for prospective investors. You may have noticed we've been buying again—mostly companies with leading business models, strong balance sheets, and consistent generators of cash, the kinds you'd expect of us. And they are cheap...not just relative to the market as a whole, but also cheap when compared to other asset classes.

Just look at the dividend yields sported by many of the companies you own. We feel good about those dividends holding up even as many other companies slash theirs (another reason you buy strong companies who earn in large excess to the dividend they pay their owners). In addition, yields from many companies are higher than that of investment-grade bonds.

Lately, stock investors have received some good news regarding taxation. After promising to increase the capital gains and dividend tax rates from their current 15% to 28% and 40%, respectively, President Obama now plans to increase both to no higher than 20%. This will keep dividends a choice income source, especially as income tax rates increase.

More than our rising bullishness on certain equities is our aversion to U.S. Treasuries. After years of declining interest rates and a massive flight to quality during the current Crisis, Treasuries have outperformed all other asset classes and have clobbered stocks over a myriad of time horizons. In retrospect, an investor has done better rolling 10-year U.S. Treasuries than holding the S&P 500 over the past one, five, and ten years.

Going forward, it should be a different story. Investors years from now may look back and recall not just the housing bubble, but also the subsequent bubble in Treasuries. With zero interest given for shorter maturities and historically low yields offered for longer ones, investing in Treasuries may prove a terrible idea once inflation returns.

We have increased our holdings of Treasury Inflation Protected Securities (TIPS) that present a more attractive proposition than traditional Treasuries. On the surface, TIPS' yields are even lower than traditional Treasuries. However, that discount to Treasuries at the current moment is substantially less than it would be if the market believed inflation was in our not-too-distant future. Herein lies the opportunity: should inflation rise, TIPS investors get compensated on a one-for-one basis versus changes in inflation (as measured by CPI).

Normally, investors expect inflation and oftentimes fear inflation will be higher than expectations. TIPS can carry a premium as investors are willing to pay up to hedge unexpectedly higher inflation data. Today, deflation is front and center, and investors by and large doubt inflation's return. Inflation doves argue inflation is a virtual impossibility given the unemployment rate is 8.5 percent and climbing and wages being frozen or lowered.

Perhaps. However, at some time inflation will return, just when is anyone's guess. Perhaps exactly when inflation returns may not matter all that much. That's because TIPS present an asymmetrical return proposition for investors. If inflation returns, TIPS' principal amount will increase until maturity, and investors will receive the bond's par value (100) plus any accumulated inflation.

Should deflation persist, a TIPS investor gets back no less than the original 100 par value. That means over time, assuming the investor buys a newly issued TIPS or a TIPS that has an adjusted-principal value of around 100, the TIPS investor is virtually assured to at least maintain his/her investment's purchasing power (using CPI-measured inflation to define purchasing power).

Deflation may actually result in an *increase* of purchasing power since investors will receive small, but positive, interest payments, plus par at maturity—even as overall prices for goods and services fall (deflation).

In this low yield environment, TIPS, like Treasuries, are nothing to get excited about. But given that TIPS investors pay almost nothing today for inflation protection, buying TIPS instead of Treasuries or even cash equivalents may prove good sense.

Even as nearer-term risks like widespread bank failures and economic depression lessen and we begin putting more of your investments in select equities, we must express our growing apprehension of structural changes in Washington and power centers around the world.

Start with the “junking up” of fiscal and monetary resources. Deficits, particularly the U.S.'s, have traditionally been of little concern to us. The size of the U.S. deficit relative to the nation's output seemed manageable, even reversible given the nation's growth potential. Today, we may be in the midst of a fiscal inflection point with deficits poised to multiply rather than simply grow. In addition to monstrous bailouts, a new secular growth phase in government begs the question: how is government going to pay for itself?

We have ideas on where it will go for revenues, and we anticipate new and higher taxes will cause headwinds for economic growth. The markets' reaction at that time could be decidedly negative.

The Fed's contribution to the rescue—by running its printing press—poses perhaps a more immediate and profound risk to investors and consumers. The Fed's Balance Sheet is exploding. Last year, the Fed's Balance Sheet was roughly \$800 billion, the result of relatively stable growth over decades. Today, it's over \$2 trillion and soon on the way to \$4.8 trillion with the Fed's latest initiatives. The approximately 600% jump in the Balance Sheet will mean a corresponding jump in paper money floating around the system.

If you believe as we do that inflation is too much money chasing too few goods and services, then the explosion of printed U.S. dollars should raise fear. At some point, after the deflation beast is slain, those excess dollars could find themselves in higher prices for goods and services.

In addition to higher taxes and inflation, the massive borrowing and printing of dollars risks the U.S. dollar's status as the world's reserve currency. At what point do our financiers, especially foreign ones like China that hold trillions in dollar reserves and dollar-based securities like Treasuries, decide to diversify away from the dollar (or even paper money in general)? We don't know, but we're watching the dollar and other indicators like gold for clues.

Lastly, we worry about Washington's capricious and creative interpretation of law. From the Obama Administration's new role as Chairman for the various companies it has decided to aid (Witness: the firing of General Motors' CEO, setting of employee pay, or making companies get its blessing on tactical strategy) to the retroactive changing of deals (Witness: forced mortgage restructuring and changing the rules on TARP including *not allowing* some banks to pay back Treasury and get government out of the board room); rule of law in America is being increasingly perceived as something fungible.

The effects on investment behavior could be significant. While the government is spending trillions to generate buyers' interest in toxic mortgage assets held by embattled banks, it's also signaling that the terms of the very mortgages held within those assets are subject to change. Who would buy mortgages knowing mortgagors may be allowed to pay less than they owe? How much capital will *not* be invested due to fear the rules of the game may be changed mid-hand?

Certainly, the problems and solutions of the day are numerous, complex and extremely difficult. Volatility should continue to be ever-present. A lot of good and bad news will come across the wire, policy mistakes will be made, and opportunities will present themselves to investors, even if for moments at a time.

Through it all, we deeply appreciate your continued confidence and trust as we together navigate some truly historic times.

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