Market Commentary
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Taking Issue with the Vice President

Some have taken to calling this post-crisis period the Great Recession while others simply refer to it as a debt deflation. Either way it's a Very Big Deal.

By Maxwell E. Bublitz, CFA, *Chief Strategist*

Yes sir, Mr. Vice President, this is indeed a big…um, deal. And no, we're not referring to passage of the healthcare bill. Thanks to the recent media dogpile, most readers are by now fully aware that Joe Biden awkwardly dropped an F-bomb when describing Obamacare. While some may take issue with his rather earthy synopsis of the bill, we're actually more concerned with his trampling (and, frankly, trumping) our very own description of the whole post-crisis financial clean-up effort.

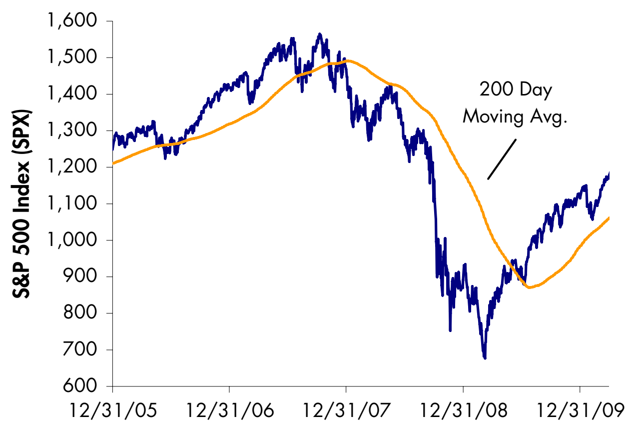
Over the last couple of years we've used these pages to explain that the United States is necessarily and inevitably locked in a struggle to figure out how to deal with the aftermath of the bursting of the enormous bubble in private sector debt. We've described that the unprecedented debt binge had been formed over decades by highly inter-connected economic, social and political cycles and that each cycle had been energized by – and ultimately, fed upon – the others, until the unsustainably toxic brew finally exploded in 2007.

Some have taken to calling this post-bubble period the Great Recession, while others refer to the extended process of balance sheet repair needed after such a long and explosive confluence of cycle as a debt deflation. In last quarter's Market Commentary we took our own shot at a name; we called it a Very Big Deal (VBD). So you can see why we get a little sensitive when we hear the VP go all *Tommy Boy* on our pet phrase[1]. But we'll have to get over it, we suppose, and simply chalk it up as yet another example of Joe being Joe.

We continue to be puzzled by those who refuse to accept the lessons of history and by the many misguided attempts to compare today's VBD with the more frequent and common types of cyclical economic downturns seen since the Great Depression. History is clear about what happens when there's a massive debt deflation created by a financial crisis; 1) governments need to step in for the retrenching private sector, 2) balance sheet repair acts as a massive headwind to economic growth, and 3) the deleveraging process takes five-to-seven years to work through the system… at best.

[1] Remember the scene in the movie *Tommy Boy* when Tommy pretends to be JoJo the idiot circus boy and uses a dinner roll as his pet. He ultimately tears the roll apart.

Figure 1. S&P 500 Index
December 31, 2005 - March 31, 2010



Source: Bloomberg

This time around, policymakers have belatedly responded with a VBD of their own, which we've taken to calling The Great Reflation Experiment; a globally coordinated monetary and fiscal response on a never-before-seen scale. Initially, the idea was simply to stave off a Great Depression 2.0, and the massive policy stimulus appears to have broken the downward spiral in asset values *[See Figure 1]* and economic activity. The next phase of the global lab experiment is to trigger a healthy, self-sustaining revival of confidence and spending; and that's where things get a bit more complicated.

We've long argued that since the direct methods of monetary and fiscal stimulus were blocked by a form of financial constipation that develops naturally out of the collective efforts of individual self-preservation, policymakers were actually forced to take a less direct route to revive dormant animal spirits. Traditional stimulus measures that work during the more typical kind of economic downturns, fail to do so when a not-so-common debt deflation creates a liquidity trap. What many felt was supposed to be a direct path to jump-starting economic activity, has rapidly morphed into an experiment in reigniting a little of the appetite for risk in the capital markets that had been so thoroughly trashed during the panic of late 2008 and early 2009. And so far so good; risk premiums did indeed come down in most markets as a result of stimulus being redirected to the capital markets.

So while the giant Petri dish we call The Great Reflation Experiment can be deemed successful to date, that success has not been achieved directly through traditional macroeconomic

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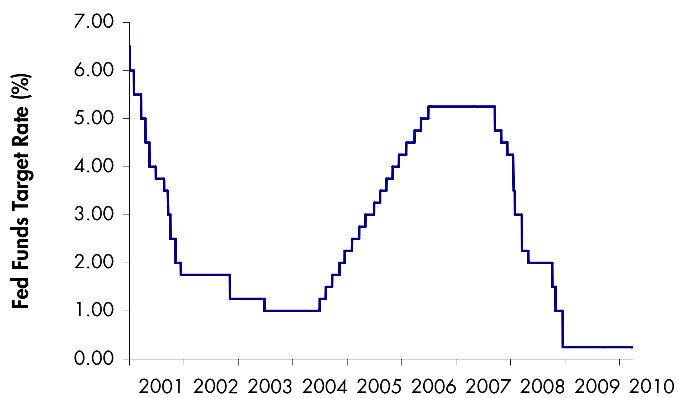
channels. It has been achieved indirectly, by helping to revive animal spirits through the partial repair of the left side of consumer's badly damaged balance sheets, via higher prices for risk assets. Initially, these moves to higher prices were highly-correlated with one another. Wide swaths of assets, including stocks, commodities and most non-government bonds all rose explosively and in seeming lockstep as market efficiency healed as well. Many of these assets were purchased with money borrowed in a weak currency, such as the U.S. dollar, which became popularly referred to as the reflation trade. The success of the reflation trade and the attendant high correlations – dollar down, risk assets up – held through most of 2009.

Even though the appetite for risk seems to be improving, under the surface many of the drivers of that appetite began slowing, if not reversing, during the first quarter of 2010. Weakness in money and credit trends signals that deleveraging remains a major headwind for the economy. Liquidity has been eroding lately, not improving as one would expect this far into a recovery. MZM turned negative on a year-over-year basis during the first quarter and M2 is cratering. Other leading indicators of monetary traction, such as the money multiplier (M2/the monetary base) and velocity (GDP/M2), remain in steep downtrends. Further evidence of monetary constipation can be seen as growth in bank lending continues to hit post-WWII lows, with the weakness being broad-based across all major categories. Outside of traditional lending channels, hopes that the once mighty Shadow Banking System (SBS) might be revived, remain just that; hopes. At best, the SBS will remain but a shadow of its former self for a long time, and may signify a permanent alteration to the era of consumer spending.

The Fed has been operating under a framework consisting of two sets of policy tools, one set of liquidity measures and one set of monetary policy measures. Most of their recent activity has been focused on unwinding the emergency liquidity measures, and officials have gone out of their way to suggest these moves, including the discount rate hike, don't signal anything regarding monetary policy. Easy money in the form of the Fed's near-zero interest rate (N-ZIRP) and Quantitative Easing (QE) policies, helped break the downward spiral in asset values and economic activity in March of 2009, and we have gotten some clues from Fed officials recently on their thoughts on exiting those strategies. Nevertheless, we don't expect the Fed to shift from its N-ZIRP *[See Figure 2]* until late this year at the earliest, although we wouldn't be surprised at more hikes in the discount rate.

On the fiscal front, the federal government has stepped up its borrowing in the short term – to 10% of GDP – to counteract the drop in private consumption and investment. Over the next few years, however, credible programs to control public-sector debt ratios will need to be established, or else the markets will do it for them… and it won't be pretty (see Greece). We are facing the prospect of having to make huge adjustments to our standard of living… the end of Saturday mail is only the beginning. Inevitably, we should expect higher taxes, higher interest rates, reduced government services, delayed retirements, slower growth and further down the road, higher prices for imported goods.

Figure 2. Federal Funds Target Rate
January 1, 2001 to March 31, 2010



Source: Bloomberg

In a sense, policymakers are attempting to yet again artificially extend the debt super-cycle that we've written about in past Market Commentaries, by having the public sector take over for the retrenching private sector. Every cyclic problem over the last few decades has been dealt with by adding to the secular mountain of debt. This time, we've simply shifted from a position of too much private debt to too much government debt. And remember, governments don't create income or wealth; they merely redistribute it. By further extending the debt super-cycle, it is likely that excess sovereign debt will be the next chapter in this credit crisis, and the country doesn't yet appear to be ready to deal with it, as evidenced by the highly questionable timing of Obamacare.

Tensions are mounting. We've often said that there is a significant difference between economic recovery and expansion, and we continue to believe that while we may be in a statistical recovery, many are not – and won't be – feeling it. The financial crisis, deficits as far as the eye can see and a general distrust of Washington are leading social mood to take a turn for the worse. Even as we await word from the National Bureau of Economic Research (NBER) that the official end-date of the recession could be back-dated as far as last summer, consumer confidence remains deeply entrenched in recessionary levels. This is hardly a surprise given the destruction in wealth and the deepest recession since the 1930s, but the economy cannot register a meaningful revival without marked improvement in consumer confidence. As the key driver of that confidence, a healthy labor market becomes all the more important given the lingering weakness in home prices and the expected hike in taxes.

There have been some statistical hints that the labor situation could be showing signs of improvement, like the drop in the headline unemployment rate from 10.1% in October to 9.7% in

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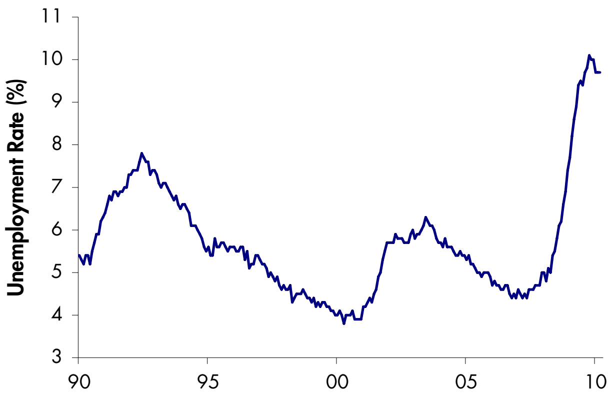
Figure 3. Unemployment Rate
As a percent of the labor force - seasonally-adjusted
December 31, 1989 - March 31, 2010



Source: Bloomberg

January and February *[See Figure 3]*. But that drop was due in large part to a drop in the labor force as the labor participation rate fell. Stepping back a bit, the same numbers of people are employed today as there were 11 years ago, and this is after the working age population grew by 29 million people over that time. The best you can say about the labor market is that firings are stabilizing, while hiring remains anemic.

On the housing front, the recent rebound could be short-lived as many of the artificial incentives are getting set to roll off at a time when five million Americans are still in the foreclosure process and eighteen million housing units sit empty. After the stimulus is withdrawn, and the current "shadow inventory" of homes begins to hit the market, expect another leg down in prices. This could further fan the flames of social anger as the mortgage modification and foreclosure abatement programs to date have been seen by many as simply a ploy to allow banks to hide bad loans.

Despite reports of continued low and falling consumer inflation, wage gains have been growing at an even slower rate. Not only will this have negative socio-political consequences, but it is also quite deflationary. While sharp divisions remain in the inflation/deflation debate, even at the Fed, it's our view that disinflation remains the fact, while inflation remains the fear. The good news is that inflation expectations have come down, the bad news is that there isn't much room left between lower inflation and outright deflation. Therefore the best we expect is a muted statistical recovery, and as we stated earlier, it won't feel like a recovery.

Given the depth of the recession, the biggest surprise so far has been that the Great Reflation Experiment hasn't produced a more robust bounce in economic activity. Sure, the economy grew at a downwardly-revised 5.6% rate in the fourth quarter, but fully two-thirds of that "growth" came from a reduced drag from inventories. Final sales were revised all the way down to1.7%, which does not bode all that well for future inventory restocking. Both the level of GDP and employment are still below levels prevailing 28 months ago when the Great Recession began. During the more typical economic downturns seen since WWII, both the level of economic activity and employment would be at all-time highs. We continue to expect 2.0% growth in GDP this year, well below potential.

We stated earlier that many of the drivers of the increased appetite for risk were slowing and/or reversing, and this can be seen in the series of rolling peaks in the various markets comprising the vaunted reflation trade. These rolling peaks have led to a breakdown in the unsustainably high correlations seen since the early 2009 lows. The dollar troughed in late November and broad commodity indexes peaked in December, credit spreads and many foreign stock markets peaked in January, while most U.S. equity indexes were making new highs as the first quarter was coming to an end. As global currency markets continue their competitive devaluation race to nowhere, the dollar's flight-to-quality rally in the first quarter should be seen as a counter-trend move. We continue to view the dollar as a fundamentally weak currency whose main attribute is that during times of stress, like the spreading sovereign debt crisis in Europe, it is viewed as the best horse in the glue factory.

The continued rally in the domestic equity market has a grinding, short-covering feel to it. Given our thoughts on the deterioration in social mood in the U.S., it should come as no surprise that individual investors are skeptical of the liquidity-led rally and remain on the sidelines; not surprising given two 50+% draw-downs in the last decade. Any sign that the economy is successfully transitioning to a self-reinforcing recovery could, ironically, both attract retail investors and mark the end of the liquidity the rally has fed upon. While embracing trends in place since March of 2009, we continue to believe the rally in domestic equities is cyclical in nature, within a longer-term bear market, and remain concerned about how the markets will respond when the artificial liquidity-spigot gets tightened.

The big story in the bond market as the quarter came to a close, aside from longer-dated Treasury yields probing the top of multi-month trading ranges, was the related action of swap spreads turning negative. While our analysis suggests the increased demand to pay low floating rates and receive higher fixed rates is in part a natural outgrowth of the effects of QE and the substantial carry derived from historically steep yield curves (as seen in Japan in the 90s), we must remember that the inner cogs of the financial system have been so distorted by government intervention that its become increasingly difficult to grasp the full meaning of such things as negative T-bill rates and negative swap spreads. We've gone on record saying that we expect the Treasury yield curve to be higher and flatter in a year's time, but that has become such a consensus call recently, it makes us think that the curve might need to become steeper first, if only to create a "pain-trade" and a little more market balance.

Either way, it is not clear to us that the narrative of the financial crisis is being properly written. It is either colored by a poor knowledge of history, or it's being manipulated by those with questionable agendas. The economic, social and political issues are, as we've said, a VBD. Yes, the Great Reflation Experiment did stave off financial collapse, but that in no way implies that the U.S. and global economies will be made whole. It remains to

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Quarterly Review

The first quarter of 2010 closed with equity indices sitting at cycle highs. A 10% sell-off in the beginning of the quarter, sparked by China tightening and sovereign debt concerns, was erased by continued strong global economic readings. Positive macro developments included benign inflation readings, improved manufacturing production, solid retail sales, and further signs of house price stabilization. However, while the unemployment picture has stabilized, the rate remains uncomfortably high. Meanwhile, investors kept a watchful eye on Washington as health care overhaul and federal budget discussions dominated the airwaves. Most import to our growth oriented equity investment strategies, we again saw corporate profit expectations revised upward, although the breadth of upward revisions slowed. We kept our growth cyclical and reflation positioning largely intact for the balance of the quarter.

In addition to the ever changing economic and political events, there were technical developments to consider this quarter, with two worth highlighting: a strengthening US dollar and rising yields. From December '09 through the end of this quarter, the US dollar increased by over 10% versus a basket of major foreign currencies as yields on longer dated maturities reached 12 month highs. Both developments ignited debates over the implications. Is the dollar strengthening because the economy is improving and the threat of deflation has diminished, or is the US dollar simply the best house in a bad neighborhood? We think both. There is clear evidence of the recovery gaining momentum, but sovereign risks remain elevated. Similarly, is the steepening yield curve reflective of expectations of an economic recovery or simply due to the Fed artificially anchoring the low end of the curve? Again, we think both. Economic recovery acceptance is gaining momentum, but short term rates are artificially low. The debate between the duration of cyclical strength and the effects of secular headwinds continues, an attractive environment for opportunistic investors.

Equity COMMENTARY

By Doug S. Couden,
Director of Equity & Senior Equity Portfolio Manager

Market Outlook

We expect the equity market to transition from a higher growth, low rate environment to moderate growth, higher rate environment. Traditionally, the strongest return phase of a cyclical rally happens when rates remain low as growth accelerates. The 70%+ return in equities from the lows of 2009 attests to the strength of these phases. As the yield curve flattens, returns remain positive so long as growth remains, but to a lesser degree. The recovery still should have the support of accommodative government policy and low rates, in our view. Therefore, we see the economic recovery continuing and view the intermediate outlook favorably as the underpinnings of the cyclical bull market remain intact. Tactically, our portfolios continue to have a global cyclical bias primarily due to stronger sales and earnings growth expectations and relative valuation.

Because profit revisions are so closely tied to economic prospects, we spend a lot of time analyzing the current cycle. There are notable differences in sector and factor performance during early expansion, or early contraction, phases. Currently we see the cycle as transitioning from an early expansion phase to a mid cycle phase. Portfolio adjustments were subtle this quarter but will accelerate if we see the transition gaining speed. We wouldn't expect market volatility, which is now approaching its lowest reading in almost two years, to remain subdued during this transition. An active portfolio management approach will be crucial. With secular challenges keeping us in a low nominal growth environment, we expect the divergence between "winners" and "losers" to widen. We will continue to focus on well capitalized market share leaders with strong profit outlooks to differentiate themselves from the pack.

The investment professionals here are an experienced, stress tested group that always has our clients' best interest at heart. We will continue to work hard and remain consistent in our investment philosophy of isolating those higher quality companies that can sustain profit levels above their peer groups. We are happy to share our thoughts with you in greater detail and welcome any questions and comments you may have. Thank you for your continued support.

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be seen how much private debt, the root cause of the crisis, will be reduced. And it remains to be seen to what extent escalating public sector deficits can be brought under control in a timely way. The recent sovereign debt crisis and its incipient global spread have been contained for now, but won't be going away. These are highly uncertain and likely very volatile times. But we can be certain of one thing: this is an environment that will provide plenty of opportunity for active managers. Opportunity born of change, nurtured by uncertainty, and laid bare by volatility. These changing times demand that our investment decisions be built on a solid foundation of fundamental research. They demand that we be prepared to take advantage of opportunities that inevitably arise when price deviates from fundamental value. And because each of our clients has unique needs, these times demand that we create, manage and administer a portfolio that meets those specialized needs. Our firm's disciplined approach to rational decision-making, when combined with the integration of research, trading and portfolio management, ensures that we will remain ready to respond to the dynamics of an ever-changing marketplace.

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