

## The Answer Is Blowin' In The Wind

*And in the third quarter, those winds freshened considerably*

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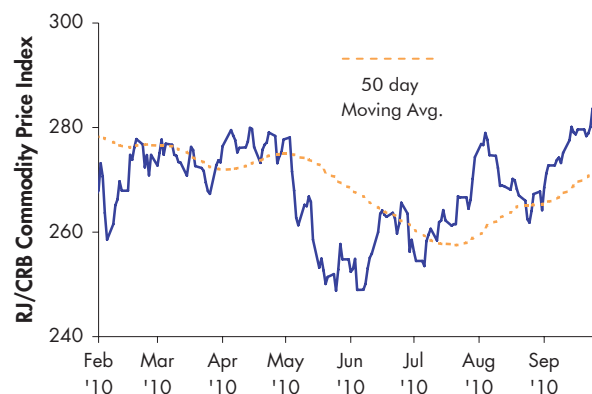
In our last few *Market Commentaries* we've made the case that the economy and the markets were being buffeted by two opposing and historically significant trends. For the sake of simplicity, we've taken referring to them as secular headwinds and cyclical tailwinds. By secular headwinds we mean the longer-term primary trend of a structural debt deflation, the result of a global financial crisis created when credit excesses that had been building for decades finally exploded. You'll also recall that we tagged the cyclical tailwinds with a proper name, The Great Reflation Experiment, representing the shorter-term post-crisis cyclical reflationary effort of policymakers trying their darnedest to alter the profound financial, political and social manifestations of the primary trend. Even though we use these shorthand phrases to summarize the prevailing macro currents, there's nothing abbreviated about any of them. And in the third quarter of 2010, the winds of change freshened considerably.

*The drip, drip, drip of disappointing demand, the hallmark of a secular debt deflation, finally began to exact its psychological toll.*

That we call the cyclical reflationary effort an experiment is simply our way of stating that the outcome is anything but certain. Indeed, the scale and scope of the policy responses almost guarantee an incredibly wide range of potential economic and financial outcomes, a fact that unfortunately gets jammed down everyone's throats on a daily basis by a growing number of ideologues pitching whatever pet theory serves their immediate purpose. So in an effort to get our heads around the wide array of possible outcomes, we began clumping them into three broad scenarios, *successful handoff*, *turning Japanese*, and *failed handoff*, with handoff being shorthand for the public sector handing back to the private sector the responsibility for being the main driver of economic growth.

Before we get to the subject of handoffs, let's back up a bit. We contend that the financial and economic recoveries from the March 2009 panic lows have been driven in large part by the unprecedented cyclical reflationary efforts. In last

Figure 1. RJ/CRB Commodity Index  
February 1, 2010 to September 30, 2010



Source: Bloomberg

quarter's *Market Commentary*, however, we explained that it was becoming increasingly clear to us that for those cycles of economic and market recovery to continue, there would need to be a corresponding extension of the reflation cycle... in fact, their continuation depended on it. This was anything but consensus opinion at the time, and how those opinions changed turned out to be the story of the third quarter. Stock and commodity markets posted double-digit gains for the quarter [See Figure 1], the Treasury yield curve bullishly flattened by over 30 basis points (bps), while the Dollar Index fell by more than 8½%.

Minutes from the June 22-23 meeting of the FOMC best encapsulate consensus thinking as the quarter began. The minutes clearly show that their primary concern was how to shrink the size of the Fed's balance sheet as part of an "exit strategy" from Quantitative Easing (QE). There was zero discussion about any need to shift policy to a) keep the balance sheet from shrinking further, which in fact was implemented a few short weeks after the meeting, and has come to be known as QE-Lite or b) to actually expand the size of the Fed's balance sheet. The now widely-expected QE2 wasn't even a twinkle in Chairman Bernanke's eye as the third quarter began.

So how did the cyclical winds shift 180 degrees in mere weeks, from planning for the Fed's balance sheet to shrink at the start of the quarter to planning for it to expand? The answer, my friend, is blowin' in the wind... and something we've written about often. The drip, drip, drip of disappointing demand, the hallmark of a secular debt deflation, finally began to exact its

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## The Answer Is Blowin' In the Wind... (cont. from page 1)

psychological toll. After falling from a seemingly healthy 5.0% in the first quarter of 2010, GDP fell to a below-potential 1.7% in the second quarter, and that weakness appears to have carried over into July and August. We'll get first estimates of the actual numbers beginning in late October, but leading indicators of economic activity [See Figure 2] re-approached recessionary levels in late July, fanning fears of a double-dip. Business and consumer confidence turned down, labor market improvement stalled, and the housing market appeared poised for another downturn.

This increased expectations of the least likely of our three broad economic and financial outcomes, the failed handoff scenario, long the favorite of the world-is-coming-to-an-end crowd. As you'll recall, it's the scenario where the private sector just can't take the handoff back from the public sector – meaning they can't take back the role as the driver of economic growth – due to the weight of their own debt. Since the public sector has to retain that responsibility, the resultant soaring level of public sector debt ultimately renders fiscal policymakers impotent, the global economy shrinks back into recession, there's massive deflation, markets collapse... and well, you know the drill.

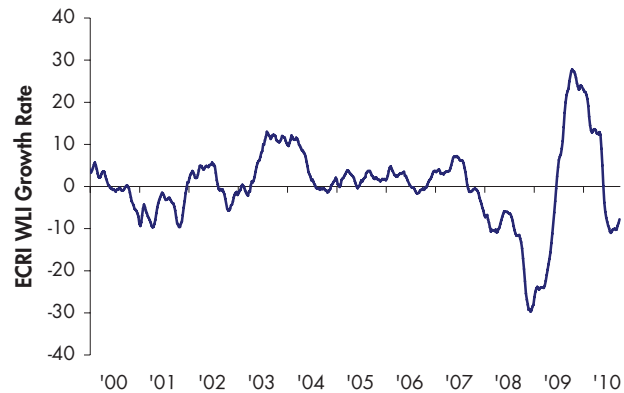
The failed handoff scenario remains our least likely, but at a 20% probability, not something to dismiss as impossible. We continue to believe, at least for the intermediate term, that policymakers will keep at the handoff until they make it. That's really the story of the last two Fed meetings and the story of Bernanke's Jackson Hole speech; to reassure everyone that monetary policy options are not exhausted and that they're going to keep at it. And it's the story of recent discussions about additional fiscal stimulus measures such as an extension of the Bush tax cuts. Policymakers of all stripes are going to keep working at it until animal spirits revive.

The economic and financial bounce off the March 2009 lows was largely driven by what we can now call QE1, and was enacted primarily as a jolt to animal spirits. We believe that QE2, in whatever form it's going to take, should be viewed as another attempt to jolt those animal spirits, and thus further extend the post-crisis economic and financial bounce. So as the quarter comes to an end, it isn't a question about whether QE2 is coming, but how effective it will be. After all, if QE1 was all that successful, then why would we need QE2? Good question, since the direct benefits to domestic demand will likely be marginal, thanks to those still-gusting secular headwinds. But policymakers believe that additional stimulus could indirectly help the economy by boosting consumer and business confidence for a while via the wealth effect as risk assets appreciate. In addition, one of the manifestations of QE1 was to produce a significant selloff in the U.S. dollar, and with it came a corresponding bounce in the net export component of GDP. [See Figure 3]

Like it or not, we remain firmly entrenched in a world of competitive currency devaluation (CCD), as countries compete to make their goods more attractive (read: cheaper) on a global basis by devaluing their respective currencies... whether explicitly or implicitly. Japan recently jumped back on the bandwagon, perhaps signaling that CCD is entering its silly season. Could CCD become this era's form of the protectionism, which was so integral to The Great Depression?

**Figure 2. ECRI Weekly Leading Index**

January 1, 2000 to September 24, 2010



Source: Bloomberg

Most recent available data as of publication date

Brazilian Finance Minister Mantega thinks so, and neatly summed up the risks recently, "We're in the midst of an international currency war... this threatens us because it takes away our competitiveness."

Speaking of Japan, our turning Japanese scenario has gotten a lot of attention lately. You'll recall that it's the one where there are numerous, sloppy attempts to hand the economic growth engine back to the private sector, driven by policy errors arising from overly-optimistic officials who have withdrawn stimulus prematurely because they felt they had successfully defeated the forces of secular debt deflation. As seen in Japan over the last 20 years, these repeated handoffs and subsequent fumbles produce fitful, feeble growth and chronic bouts of deflation.

Even though the rhetoric surrounding the turning Japanese scenario has ratcheted up recently, it is that very focus that gives us the comfort to keep our probabilities of such an outcome at 30%. Our "Bigger Boat" theme from the last *Market Commentary* picked up steam over the last quarter, becoming mainstream. And once again, many on the street are scrambling to downgrade their economic forecasts. Yes, the rapidly souring political environment should concern everyone. And yes, there is still a lot of balance sheet repair to be done in both the financial and consumer sectors. No doubt that serious headwinds remain. But we do see some underlying improvement. Money and credit growth, while still weak, may be showing signs of life. The capital markets have unfrozen, fiscal drag looks as if it will be postponed for a while, and the monetary environment will stay accommodative for quite some time.

Our base case economic scenario remains the successful handoff, where recovery is sustained enough for the public sector to gradually make the handoff back to the private sector, and then go about the business of putting the fiscal house in better order. Even though it's our most likely scenario,

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**Figure 3. U.S. Dollar Index**  
January 1, 2009 to September 30, 2010



Source: Bloomberg

at a 50% probability, it's hardly assured. We label the handoff successful, but attach a serious caveat. Thanks to the secular headwinds, growth will be markedly subpar for a long time. We continue to believe that even though both the housing and labor markets are in the process of forming a bottom, they'll likely get worse before they get better. Make no mistake about it, the economy is still very fragile and susceptible to shocks from various sources, including growth scares, sovereign issues, and banking concerns. This was never destined to be a straight-forward recovery. We continue to expect domestic GDP to average around 1½ - 2.0% over the next twelve months with a lot of volatility (and revisions). In an attempt to emphasize the economic volatility, if the mid-point of our GDP forecast is 1.75%, it wouldn't surprise us to see quarterly deviations around the mid-point to match or even exceed that 1.75%.

Stepping back a bit, after being initially slow to respond to the financial crisis, the Fed has done a pretty good job of helping to pull panicked risk spreads back toward the Treasury curve and anchoring them there through QE1 and their various lending facilities. With QE2 they're looking to pull down the entire Treasury curve now that risk spreads are better anchored to it, thereby pulling down broad borrowing rates with it. The statement after the September 21st FOMC meeting marked an important shift in the burden of economic proof needed before such drastic monetary measures will be undertaken. At previous meetings, Fed policymakers operated under the assumption that the economy was recovering at an acceptable pace, and that incoming data would need to disprove that assumption if policy would have to be changed. Well, that's exactly what happened in July and August; the economy slowed meaningfully as policymakers became increasingly concerned about the risk of deflation and the sorry state of the labor market.

The bottom line is that the economy is clearly not growing at a level that is acceptable to the most influential members of the FOMC, and it's now incumbent on the data prior to the Fed's fourth quarter meetings to show that economic activity is significantly picking up steam. If not, Fed policymakers are set to kick off QE2 after the fall elections. We believe that the initial effort will be the first of what could potentially be a multi-step process largely dependant on economic data. Rather than the shock-and-awe approach taken with QE1 during the panic of the first quarter of 2009, we expect the more open-ended, surgical strike approach espoused by St. Louis Fed President James Bullard. The risk of either approach, of course, is that like any drug, stimulus will have less and less effect over time. Either way, it now seems that the front end of the curve is anchored near zero for as long as the eye can see, much to the chagrin of a couple of members of the FOMC, and we now expect 10 year Treasury yields to remain below 3.0% for the remainder of the year. Coupled with the extension of the Bush tax cuts, you end up with the melding of monetary and fiscal reflation efforts; a tax cut funded by money creation. Combined with the Tea Party-led expectation of Democrats losing the House this fall, this may bode well for risk assets over the near-term. We would caution, however, that this confluence of expectations surrounding future events is setting up for a classic *buy the rumor, sell the news*.

Another way to look at QE2 is as a way to boost inflation expectations at a time when a deflationary mindset is gaining traction. Policymakers would prefer to rekindle animal spirits a bit and loosen up the still-constipated banking system by heading off the expectations of persistently falling prices, because they understand that those expectations can become self-fulfilling. Since we believe it will be difficult for real GDP (ex-inflation) to get much above 2.0%, we'd prefer they explicitly raise the inflation target above the current 1½ - 2.0% target, so they could at least help elevate nominal growth (real GDP plus inflation) north of 4.0%. After all, we live in a nominal world where such things as pay checks and company earnings aren't adjusted for inflation. Unfortunately, the Fed appears to prefer taking a less explicit path, and deflation fears will likely remain in the headlines for the rest of the year.

So where does that leave us? The cyclical tailwinds ebbed in the third quarter and began to be overwhelmed by the relentless flow of secular headwinds. As a result, economic data deteriorated to the point where confidence began to wane that the public sector could actually hand back to the private sector the responsibility for being the main driver of economic growth. Policymakers now seem poised for another round of The Great Reflation Experiment, further extending the reflation cycle that began on March of 2009, and suggesting that it might be a bit premature to count this economic cycle as dead just yet. We certainly don't claim that the economy will have much oomph over the next twelve months, and we remain concerned how the political wildcard might distort it. But the cyclical tailwinds are clearly about to stiffen, so look for gusting volatility on all

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## Quarterly Equity Market Review

The 'risk-on' – 'risk-off' nature of asset markets continues, with the former winning out this quarter. Double dip fears were assuaged by stable economic reports and the oversold position of mid-year reversed. We wrote last quarter that a moderation in economic growth was more than being discounted and valuations continued to be supportive of gains, provided economic results stabilized. As investors digested a string of better data (industrial production, housing starts, leading indicators, etc.) fears subsided and risk tolerance increased. Meanwhile, a belief that sluggish economic data combined with high unemployment would put additional pressure on

### Equity COMMENTARY

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policymakers to act boosted investor confidence and opened the door for additional easing from the Fed (the so called "QE2"). This development later in the quarter propelled stocks to their largest September gain in over 70 years and helped most equity indices finish the quarter with strong double digit gains.

Cyclical economic volatility in the presence of secular (deleveraging) headwinds makes for volatile trading, and this quarter was no exception. As the quarter progressed, earnings estimates were revised slightly lower, and only two sectors (Technology and Industrials) had positive revisions. The stock market continues to be driven by macro forces with many technical considerations (the yield curve, currency movements, geopolitics, etc.) impacting equity returns, often en masse. Correlations amongst equities (and other asset classes) remain elevated. Company specific fundamentals routinely get overlooked in markets like these, often times presenting opportunities. We kept our growth cyclical and reflation positioning largely intact for the balance of the quarter. Tactically, our portfolios continue to have a global cyclical bias primarily due to stronger sales and earnings growth expectations and relative valuation. Small caps bested large caps and growth outperformed value this quarter.

## Equity Market Outlook

The market does not have conviction on the direction of the economy, and that will keep volatility high. Many of the recent positive economic surprises simply reflect improvement from previously lowered expectations as opposed to a dramatic improvement in data. However, with a backdrop of extremely accommodative monetary policy and attractive valuations, we would expect the stock market to grind higher. So long as growth remains positive, companies should continue to post reasonable profits. Handicapping the level of growth is a challenge given the many crosscurrents affecting the financial markets. We want to keep it simple and focus on those pockets of relative fundamental strength - this, in turn, leads us to global growth cyclicals. Emerging economies are growing 2-3x the rate of developed economies. Many of our holdings have revenue streams tied to the continued success of these emerging economies.

In the near term, we expect some consolidation, with upcoming earnings reports and election results providing catalysts. In the 12 midterm election years going back to 1962, the S&P 500 has on average risen 2.4% in the two months prior to the election and gained 7.5% in the three months following. Of course, given the returns of the third quarter, one has to wonder how much has already been discounted.

Longer term, we think we are on track for moderate, yet sustainable growth. We feel "growthier" sectors should garner a premium as revenue gains slow and growth becomes scarce. While the debate between the duration of cyclical strength and the effects of secular headwinds continues, the subsequent volatility has and will continue to provide an attractive environment for opportunistic investors.

We will do our best to take advantage of this dynamic. 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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fronts; financial, political, and social. Unfortunately, it isn't likely that we're even half way through the secular storm season. How policymakers choose to deal with that fact can never be certain... it seems that we keep ending up in some sort of twisted economic Petri dish. No doubt, these are highly uncertain and 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.