



Antecedent Analysis and Strategy Counsel
Enthusiasm Wanes
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Antecedent counsel is provided as internal guidance to our portfolio managers and analysts. This counsel is not a forecast and has a longer time horizon than our commentaries. We use this guidance to inform our fundamental analysis, having measurable impact on our model inputs. Antecedent counsel should assist our clients in understanding our analysis and strategies.

As October of 2008 ended, I opined that despite high volatility and the potential for future losses, investors should seize upon low equity prices and take risk:

“Today, most investors and market pundits seem worried about the latest 10% wiggle in the market. Rather than decry a 15% to 20% drop in net worth as an investment failure, realize that, unless one is prescient, this is simply a part of investing and taking risk. Those with long investment horizons, a sense of fundamental value (as opposed to the fool’s errand of predicting what someone will pay tomorrow), and an appreciation of investment risk should realize that now is the time to retain or take risk; not when friends approve of investment decisions over a cocktail. Now is a rare opportunity to invest - seize it before it disappears.”¹

From when I penned this opinion at the end of October, the S&P 500 has risen 23%. The good news is that we do not believe that the market has reached prices that we deem consistent with underlying fundamentals. The bad news is that fundamentals have deteriorated, and all indications show that they will continue to worsen.

Four dominant considerations influence our analysis at this time:

- Valuation
- Generational Risk Aversion
- Monetary Policy
- Fiscal Policy

Valuation

Fundamental values for global equity markets range from roughly 25% to 75% above current index levels. Despite equity market strength since March, valuation suggests significant opportunity for incurring market risk exposure that is more than adequately compensated. Canada is atypical, having dodged much of the financial crisis and now demonstrating surprising resilience in the energy sector.

Conversely, values for sovereign bonds are below current prices. Credit opportunities that were extreme earlier this year have faded, but we should not be misled by recent price appreciation. The credit crunch of 2008 inflated credit spreads to such extremes that even after recent spread narrowing, values remain above prices. Moreover, corporate credit simultaneously loads on equity markets and affords considerable yield.

¹ “Irrational Apprehension,” Brian D. Singer, October 27, 2008, www.singerllc.com.

Generational Risk Aversion

Children of the Great Depression ensure future comfort by risk aversion and saving. Their investment portfolios often reflect the same degree of risk aversion and material security as evinced in their everyday lives. Observing our parents shows that the lessons of the Depression were so visceral as to shackle the thinking of its survivors from cradle to grave. We suspect that the current crisis will leave some of the same imprints, albeit significantly muted.

The credit crisis of 2008 will scar investors for decades. *The Wall Street Journal* has described investors questioning equities and the long-standing 60% equity and 40% bond rule-of-thumb that guided portfolio diversification for decades. Committees and boards around the world will likely codify some form of risk aversion in investment policy statements. Once laid down, these policy statements likely will influence investor behavior through the next significant equity bull market.

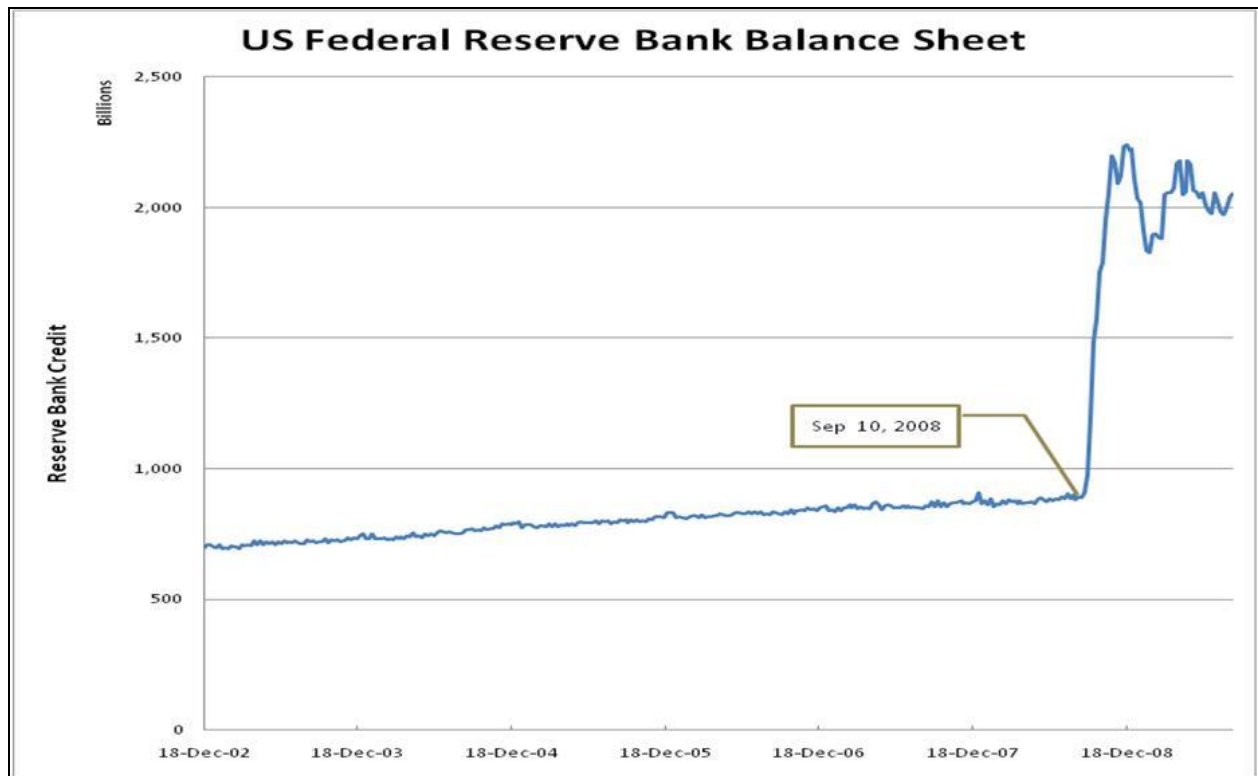
Risk aversion could be incorporated into our valuation models by boosting the risk premia used to discount future cash flows. However, we prefer to maintain valuation purity and use equilibrium, long-term risk premia estimates. Our accommodation of long-term risk aversion occurs in the behavioral component of our investment process.

Monetary Policy

Narrow monetary aggregate growth is strong in the US, UK and Euro area. Broad money growth is somewhat less strong. In the US, broad money growth is high but off its 8% yoy peak. UK broad money growth reached a peak of 20% and is now down to a relatively high rate of 12%. The Euro area has witnessed broad aggregate growth drop from over 12% to a more sustainable rate of 4%. Japan's broad money growth of 3% is relatively high, up from about 1%. China stands out, with growth spiking up to 30% after ranging from 15% to 20% since 2003.

Bank lending growth, on the other hand, has collapsed in the US, UK and Euro area, and recently contracted in the US. It has softened in Japan. Again, China stands out as a huge outlier; bank lending there has exploded to 30% yoy from 15% in 2008. Talk of an asset price bubble in China appears supported by fundamentals. In fact, recent asset price strength in the face of softer consumer price strength is reminiscent of the recent credit crisis that befell the US.

US, UK and Euro area reserve expansion has been more than offset by declining velocity as banks sit on reserves and bank credit remains tight. The financial crisis and credit bust significantly affected these economies. In the US, "Helicopter Ben" Bernanke has proved quite the pilot; his helicopter has unloaded trillions on the economy. The world's premier scholar of the Great Depression, Federal Reserve Chairman Bernanke was the best man for the job. Too little liquidity exacerbated the Great Depression, and Bernanke scripted the appropriate response to similar systemic stress, helping to prevent another catastrophe. However, the Fed's balance sheet's expansion beyond \$2 trillion will likely lead to inflation.



Bernanke may have been the best man to prevent a catastrophe, but he has not scripted his counsel for unwinding such an explosion of bank reserves. Bernanke knows that the Fed's balance sheet must contract as credit begins to loosen. Monetary policy affects prices with a long lag; therefore, when the first green shoots of economic growth appear and Bernanke screws tight the liquidity pump, it will likely be too late to preclude at least some inflation.

We can guess that Bernanke will have to execute monetary contraction in a political pressure cooker of resistance. Bill HR 1207: The Federal Reserve Transparency Act of 2009, currently circulating through the House of Representatives, empowers the Government Accounting Office to audit Fed decisions. Subjecting Fed decisions to legislators' scrutiny would clearly impinge the system's independence. While HR 1207 is unlikely to gain much traction in the Senate, it provides advance warning of the forthcoming political pressure with which Chairman Bernanke will need to contend.

Until then, we expect disinflationary, perhaps deflationary, pressures to persist with inflation expectation in the offing, supporting longer dated yields. It is inappropriate to predicate strategies on disinflation; rather, we must look beyond this period of unknown tenure to position for inevitable inflationary tendencies.

Fiscal Policy

The New New Deal that already encompasses a \$787 billion stimulus package, of which "only" \$144 billion has been disbursed to date, is helping to shore up the US financial system in the short run but will ultimately affect the economy and equity prices adversely. Doubling the national debt over the next five years and transferring labor from the private sector to the public sector is no panacea.

A public sector credit overshoot is replacing a massive private sector credit overshoot. Currently, the private sector imbalance is unwinding, and the public sector is taking on a debt load that affords flexibility and forestalls economic pain. However, this flexibility is also causing an economic shift from the private to the public sector.

While all men may be created equal, all jobs most certainly are not. Profit motivates private sector employees, ensuring that private sector labor remains robust and creates secondary jobs. Public sector jobs lack the same degree of efficiency and productivity. The Institute for Market Economics research confirms that government spending at a level greater than 25% of the GDP causes a decrease in economic growth. It takes private sector profit motivation to do the “bad” of destroying outmoded economic activities that frees resources for superior alternatives.

Moreover, government spending and the requisite taxation required to support it smothers private sector productivity. Government spending and taxing appropriates productive capacity away from the private market. Total government spending in the US has risen from the 25%-30% range in the 1950s and 1960s to above 35% since 2005. The Obama administration, in helping to push this percentage above 40%, is making the bad situation they inherited worse.

The stealth destroyer of asset returns is taxes. Our analysis suggests that the Bush tax cuts passed in 2001, if they had been permanent, would have contributed roughly 35% to the value of equities. The lack of permanence muted the impact to approximately about 10% to 15%. Thus, allowing the tax cuts to expire likely erases 10% to 15% of equity value. In fact, since the market already expects the Bush tax cuts to expire, it has likely already been a weight on equity prices. Looking ahead, our concerns are higher marginal tax rates on the wealthy and other tax burdens to pay for stimulus packages and health care.

Regardless, a major headwind blows in the face of economic growth and equity market opportunity. Our intent is not to comment on whether federal, state or local programs are desirable or effective. Rather, we simply observe that too many or too large programs choke the system and impair economic and living-standard growth.

Conclusions

If inflation emerges, it is not likely to do so until a couple years after central banks begin to tighten monetary policies. Given our expectation of anemic growth, political pressures could delay any tightening until after the inflation genie is out of the bottle. In the interim, risky assets are likely to find short-term support in stable inflation and expectations of monetary stimulus and future inflation. Yield curves are likely to stay steep for the near future, as expected inflation persists and realized inflation is postponed.

Compounding our fear that inflation may emerge disruptively, recent discussions from Jackson Hole indicate that central banks are considering preempting financial system risk. The future of monetary policy seems on the cusp of change. If this thinking persists, the price rule that guides most central banks may be joined by an asset price rule. A Hyman Minsky model is one that central bankers are considering. This model is predicated on Minsky’s hypothesis that a price rule leads to financial market and economic stability. However, this stability sows the seeds of its own demise. Stability incentivizes more risk taking and, ultimately, instability.

Central bankers reflect the same generational risk aversion as the rest of society. If inordinate fear of an asset price bubble guides their policies, it is less likely that equities and other real assets will reach the higher end of normal price variation ranges.

More than just risk aversion should concern us. Fundamentals, especially of developed economies, are deteriorating. After the private sector credit bubble, real consumer spending is likely to be subdued. As the public sector credit bubble unwinds, real government spending will be constrained. Rather than follow the typical pattern of consuming (dis-saving) in our old age, developed country populations are likely to save more than would otherwise be the case. Typically, this saving would spur future productivity as the capital stock expands. This time, however, the productivity enhancement that we would expect to arise from this saving is less likely to accrue to developed economies. Developed world savings are more likely to finance developing world capital stock expansion. This capital stock will be supported by growing working age populations and increased saving in developing economies. Consequently, emerging market earnings growth stands to benefit relative to that of developed markets.

The public sector debt burden creates other issues. Rather than tax or constrain spending overtly, high public sector debt incentivizes an alternative central bank response: press the “reset” button and inflate the debt burden across society. In the long term, debtors win and creditors lose. Perhaps now is not the time to unwind leverage.

While we feel that equities in the US, and in the UK and Europe, are priced 25% to 75% below the values justified by underlying economic fundamentals, we anticipate that the upper end of range-bound markets will be somewhere near these values, and the lower end will not be far below current price levels. Moreover, we believe that this macro investing environment is likely to prevail for many years.