



Antecedent Analysis and Strategy Counsel
From Enthusiasm Wanes to Uncertainty Reigns
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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.

In our previous **Antecedent Analysis and Strategy Counsel**, which we titled *Enthusiasm Wanes*, we concluded 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 are that they will continue to worsen.”¹

From when I penned this prognostication to the end of January 2010, the S&P 500 appreciated 7.8%. Much has changed since September 2009 and our portfolio is evolving in response to new and different incentives. While fundamentals continue to worsen, Singer Partners believes that the pace of deterioration has abated. Over the coming year, in response to emerging opportunities, Singer Partners will shift fund risk composition from market risk to relative sector, industry and thematic risks. While the undervaluation of equity markets continues to provide opportunity, the opportunities we expect to arise from relative risks have increased.

Fundamental values for global equity markets range from roughly 20% to 70% above current index levels, a little less than those prevailing on September 3, 2009. Despite continued equity market strength, valuation suggests more than adequately compensation for incurring market risk exposure. Canada is atypical, having dodged much of the financial crisis and demonstrating surprising resilience in the energy sector. Other countries that upheld higher capital requirements for financial institutions, such as Brazil, similarly dodged much of the direct crisis impact. Conversely, values for sovereign bonds remain below current prices. Credit opportunities that were extreme earlier last year have faded. We remain positively disposed to corporate credit exposure, but valuation is less compelling. Moreover, corporate credit loads on equity markets and affords considerable yield at the same time.

One dominant consideration has changed from our last **Antecedent Analysis and Strategy Counsel** and influences our analysis at this time:

- Fiscal Policies

Fiscal Policies: People Respond to Incentives - If They Can

Subsequent to the 2008 credit contraction, 2009 evidenced relatively certain and certainly adverse government policies. These policies prevented stronger economic and equity market performance than was actually experienced. Now, 2010 hails relatively uncertain and selectively adverse government policies. More fluidity in Washington and Whitehall means new and changing policies and new and changing investment opportunities.

¹ “Enthusiasm Wanes,” Brian D. Singer, September 3, 2009, www.singerllc.com.

Behind these opportunities is a tendency toward populism in difficult political times. Both Labor and Democrat parties in the U.K and U.S., respectively, have witnessed positive opinion dissipate, recently turning to disapproval. Populism seems motivated by critical upcoming elections in each country. Gordon Brown was the first to see his popularity fall and the first to turn to populism, most publically with respect to banker compensation.

In 2008, Barack Obama and a plethora of Representatives and Senators sailed to victory on a craft built of voter discontent over policies pursued by prior legislatures and administrations. In politics, it often seems to be the same as it ever was. Following defeats in the New Jersey and Virginia Gubernatorial elections, the Democrats were stunned by the election of a Republican Senator in Massachusetts, a seat held by the Democrats since 1953 in a distinctly blue state.

The Obama administration has moved from ushering large social safety nets through Congress to pushing populist measures. Following Gordon Brown's lead, the populist rhetoric is anti-Wall Street and pro-Main Street. Obama declared that, "We want our money back. We want our money back! And we're going to get your [taxpayer] money back - every dime, each and every dime." Simultaneously, the Administration utters the "jobs, jobs, jobs" mantra as if transcendental meditation can will jobs into existence.

This is not tea-party populism auguring for government steadiness and restraint. Tea-party populists believe that economic life is hindered by a public policy wildcard, the fact that new legislation, whether good or bad, alters the profitability of prior investment decisions. Supporting this view, the National Federation of Independent Business (NFIB) December 2009 report on Small Business Economic Trends stated that, "The other major concern is the level of uncertainty being created by government, the usually [sic] source of uncertainty for the economy. The 'turbulence' created when Congress is in session is often debilitating. . . . There is not much to look forward to here."²

No, this is Obama populism, compounding an unusually rancorous Congressional session with piecemeal populism that stokes fears of instability. Consider the potential variations of health system reform. Currently, the market teeters on the edge of roughly bimodal outcomes - on the one hand, procedural maneuvers to pass the system-changing Senate bill via House approval and budget reconciliation, avoiding the new-found lack of a Democrat Senate supermajority, and, on the other hand, something closely approximating no change. Obama and his lieutenants signal both a willingness to push for large scale healthcare reform and a new focus on jobs and budget deficits.

Energy policy waffles between consideration of emission taxes that reduce emissions, but stifle potentially beneficial R&D expenditures, and directed subsidies that focus on one technology this week and another one next week. These taxes and subsidies may be good or bad, clearly opinions vary, but the need for clarity and conclusion are paramount for the recovery to take hold.

At this juncture, even the Bush tax reductions, scheduled to expire over the course of the coming year, are variously being considered for extension and modification. It appears that the Administration supports a capital gains tax increase from 15% to 20%, but Congressional resistance to raising taxes in a weak economic environment make this recommendation uncertain.

² *Small Business Economic Trends*, National Federation of Independent Business, William C. Dunkelberg and Holly Wade, December 2009, p.3.

While there is no change from our thoughts expounded in the September 2009 **Antecedent Analysis and Strategy Counsel**, U.S. monetary policy remains the overwhelming uncertainty for which the Fed's response may extraordinarily reward debtors, via inflation, relative to creditors. The uncertainty of the Fed's relative response to its dual objectives of supporting employment and suppressing inflation is already a yoke on asset prices. Since the U.S. Treasury is the largest debtor and Congress is striving to augment its oversight of monetary policy, Singer Partners is very concerned. Any significant threat of diminished Fed and monetary policy independence will be catastrophic to asset prices and, ultimately, societal wealth. Global capital markets will struggle under the strain of additional central bank uncertainty.

The wearisome lack of details or resolution derived from Congressional partisan commotion and populism has adverse implications for the economic growth that underpins asset returns. Businesses responding to surveys reveal a reluctance to invest, to hire or to spend on durable goods. The NFIB survey indicates that, "Capital spending is on the sideline. Plans to make capital expenditures over the next few months fell one point to 16 percent, revisiting the 35 year record low."³ Household surveys expose similar concerns. The Michigan Survey of Consumers indicates that "37% of households plan to postpone purchases because of uncertainty about jobs and income, a figure that has not budged since the second quarter of 2009, and one that remains higher than any previous year back to 1960."⁴ Moreover, loans will only be originated with lending institution confidence about the future.

While the theater of politics makes great fodder for pundits and prognosticators, markets have heightened concern over fiscal developments globally. Critically for the European Union, Portugal, Italy, Ireland, Greece, and Spain have garnered the unflattering PIIGS moniker. The fiscal situations in these countries have deteriorated during the recent recession, which ended unrestrained investment and consumption booms in each case. However, as part of the Eurozone, these countries' monetary policies determined by the European Central Bank and they cannot unilaterally cheapen real exchange rates (a maneuver that has been available to the fiscally-challenged US and UK in the last two years). Thus, the PIIGS have fewer degrees of freedom by which their economies can counter relative real economic differences. Expanding deficits, high debt-to-GDP ratios (well beyond those required by the growth and stability pact) and continuing economic weakness highlight this inflexibility and offer a deeply unpalatable menu of choices for the most afflicted; severe fiscal austerity, bailout via unknown mechanisms, or default. In response, the Euro has weakened against the U.S. dollar and U.K. pound.

Conclusions

As previously, we remain long equity markets in response to discrepancies of prices generally below fundamental values. Conversely, remain short sovereign bond markets.

Policies from Washington implemented and proposed in 2009 adversely impacted equities and US dollar. Serious inflation and tax fears depressed asset prices and the US dollar. The equity rally could have been much stronger. The recent loss of a Democrat supermajority in the Senate alleviated these fears, but a populist Presidential response creates a more fluid situation for 2010. New policy developments create new investment opportunities.

Singer Partners is slightly more positive now than we were late last year. Last year, relatively certain and certainly adverse government policies stymied economic growth and hindered equity market performance. This year, some of the certain adversity has dissipated, but in its

³ *Small Business Economic Trends*, National Federation of Independent Business, William C. Dunkelberg and Holly Wade, December 2009, p.3.

⁴ "Uncertainty and the Slow Recovery," *The Wall Street Journal*, by Gary S. Becker, Steven J. Davis, and Kevin M. Murphy, January 4, 2010, p A17.

place has crept the selective adversity of populism. As populist trial balloons are floated and either accepted or rejected, opportunities will develop within individual equity markets. As stated in the NFIB report, "Uncertainty [sic] is the enemy of the real economy as well as financial markets."⁵ In response, Singer Partners will responsively increasing the risk that our funds incur through sector, industry and thematic exposures relative to that of market exposure. This does not mean that Singer Partners is decreasing its market exposure risk, only that the relative risks are increasing and thereby decreasing the relative contribution of market risk. Total portfolio risk is expected to increase somewhat.

Equity market volatility has declined since the market trough in March 2009 and has been fairly muted in the last half of 2009. Market participants are skittish and volatility spikes are likely in 2010. Evidence of this skittishness can be gleaned from such indicators as the steep skew of below-market equity options and the relative pricing of concave high yield bonds and convex convertible bonds, among others. Skittishness is likely to contribute to capital market volatility and Singer Partners expects volatility to be higher in 2010 than experienced in late 2009. Since we have relatively high equity market exposure, our and our clients' resolve will be tested by this expected volatility increase. Singer Partners feels that this volatility will be rewarded as we set our sights on a horizon that is beyond this period of uncertainty.

⁵ *Small Business Economic Trends*, National Federation of Independent Business, William C. Dunkelberg and Holly Wade, December 2009, p.3.