Pause, or Precipice

Stirred, Not Shaken *(Sorry Mr. Bond)*

Observations and Commentary
by a Portfolio Manager

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The Wall Street adage of "Sell in May and go away" could not have described any better the behavior of the financial markets, both here and globally, in the month just ended. Increasingly investors became concerned over the global implications of anemic economic growth, high unemployment, and abscessing financial conditions, indigenous to Europe, and the result of long standing governmental spending policy. Through April of this year, global markets and most asset categories had witnessed almost meteoric investment performance from the lows of March 2009. Investor's guarded optimism was improving and corporate earnings, for the most part, were continuing to generously exceed analyst and market expectations. Overall, it hardly seemed like the time or the conditions for the market to form "travel plans".

Early into 2010, the financially and economically weaker members of the ECB (European Central Bank), symbolically viewed in the form of poster child Greece, became recipients of increased market scrutiny and eroding investor confidence. In the past, their financial imbalances had been overlooked, and to some degree, psychologically "paid for" by an accepted rate of economic growth. Previous issuance of sovereign debt had always financed the long standing bad behavior of deficits and entitlement spending. Moreover, the seemingly perpetual and excessive level of these deficits, as a percentage of GDP, appears to be in clear violation of the guidelines for ECB membership. Paradoxically, as economies around the world started to recover in 2009, the Euro had strengthened against most major currencies, achieving almost cult-like status within the global investment community by year's end. However, by 2010, it was becoming increasingly clear that the pace of economic growth in these member countries was well behind that of the global economy, and most specifically, that of the US. A critical realignment of currencies was not only warranted, but from an investment point of view, quite necessary. It was this first domino, which was about to fall, that would set off a series of events leading toward the current global financial market correction and May's multi-decade historic performance.

The Euro, once promoted as the new global reserve currency of the future by certain "enthusiastic" endorsers, not to mention overly shortsighted portfolio managers, now moved in nervous reaction to the unfolding "Greek tragedy". Far more ominously and with broader implications, in the minds of investors, the currency's fall appeared to represent a growing admission. The multi-generational model of European big government and it's hardly Spartan attitude of spending excess and social benefit largesse was possibly in trouble. Against a backdrop of slow, almost anemic, economic growth, even by European standards, fiscal reality came swift and harsh. Euro selling, first felt temporarily in January and February, resumed with a sense of renewed intensity beginning in late April. Financial markets around the world reacted to the almost daily decline in the currency. Previously accepted investment assumptions and asset correlations, known to some as the "carry trade", immensely successful in 2009, were now invalid and forced to unwind. Domestically, the US dollar strengthened and the Treasury markets rallied sharply, beneficiaries of global liquidity inflows.

Throughout May, as the Euro weakened, asset sales in former market leaders accelerated. In all probability it was forced selling by highly leveraged, strategy-based market participants, which served to punish the previously overindulgent commodity markets and their related equities. Blind disciples in the "hard currency" belief, and those investors with views of unending Chinese commodity demand, losing the confidence of their convictions, soon added to the selling pressure. Additionally, evidence was building that prime banks, lenders to the hedge fund community, were quickly reducing their margin loan exposure, demanding immediate action by their clients. Quite often, this mandate forces many leveraged market participants to sell the most liquid names in order to rebalance their portfolios. This phenomenon goes far in possibly explaining the seemingly inexplicable fall in many of our equity market's strongest corporate names. Many of whom had little or no connection to possible European economic slowdown, commodity demand, or the Greek (and their cousins) sovereign debt crisis. What had started out as a badly needed correction of misplaced investor confidence in the Euro currency, was now global in nature and broad in impact. The failure of a misguided and highly short-sighted set of investment strategies, focused on a currency supported and commodity-based central theme, had become the next series of investment related dominos to fall. A spreading series of swift, corrective asset liquidations was to make May 2010 one of the worst market performances since the days of Kennedy. I am talking John here, not Ted.

As the month of April moved into May, investor confidence was falling for the sovereign debt in a growing list of countries, whose future solvency was now being questioned. Markets nervously assessed the potential global economic impact from these nations, as they, under the threat of sovereign default, would be forced to author a series of government initiated austerity measures. These new policies were seen as immediately unpopular by a European citizenry used to decades of government benevolence. Greece became the scene of almost daily protests and occasional riots. Financial market participants became worried about the combination of an economically weakening Europe, and a strengthening dollar. Domestically, the American economy, already struggling to grow against the weight of high unemployment, and gradual attempts to reduce government "stimulus", did not need additional headwinds in the form of reduced exports. Furthermore, in Asia, there were reports that Chinese monetary policy was about to become more restrictive. Better balance between the rate of economic growth, the possibility of an existing bank-fed real estate bubble and early signs that inflation was on the rise, was seen as necessary. In the minds of equity investors, the corporate earnings of US multinationals, commodity producers, and global financial entities were viewed as potentially vulnerable. However, to the observant, within the market's almost daily turmoil, there were some interestingly positive side effects being produced. Some of which could eventually lay the groundwork for the next leg of an advance in a market uptrend that started in March 2009.

The recent surge in demand for US Treasuries, especially longer dated maturities, served to lower the borrowing costs for two key entities of the domestic economy. Our government's own version of European style deficit spending and entitlement largesse (quite ironically at a time when we may be witnessing the global investor no longer tolerant of such a model), had necessitated weekly borrowings of record debt issuance, now ironically, at falling interest rates. Separately, the potential home buyer, with government based tax incentives having expired in April, could be seen as reenergized in light of anecdotal reports surfacing in recent weeks of 30 year, fixed rate mortgages under 5%.

Commodity prices, recipients of nervous user selling in light of emerging global growth concerns, and, all but extinguished "investor" demand, fell in most categories, from industrial metals to the various forms of fuel. The consumer, along with other key economic entities, users of fuel in its many forms, may very well benefit almost immediately from this economic equivalent of a tax break. Seasonally, as our country heads into the time of year when gasoline demand tends to increase, prices have been reported, countrywide, as having fallen, in an almost unheard of occurrence. Additionally, for commodity-reliant manufacturers, the benefits could be seen not only in the potentially lower cost of power, but the lower cost of the materials needed in the production process.

Corporate balance sheets, in aggregate, for American companies, have reached levels of liquidity and strength not seen in decades. They are well supported by cash on hand as a percentage of total market capitalization, relatively low levels of long term debt, and a strict eye toward cost containment. With the evidence of a stubbornly high unemployment rate and anecdotal reports of a general reluctance to hire additional labor, even in the face of improving economic demand, productivity could remain at levels not usually experienced by an economy exiting a recession. This factor, along with falling borrowing and commodity costs, could result in corporate profit margins that potentially surprise to the upside. In these past few weeks our equity markets have fallen broadly, in part the result of baseless selling due to portfolio liquidation. Yet it is important to realize that there been no shortage of individual companies who have raised their earnings expectations and guidance for the months, and even year, ahead.

The stronger economies in Europe, such as Germany, with their large economic exposure to exports, should on some level, benefit from the weaker Euro. Whether or not this will help offset the potential impact from the ECB's weaker members remains to be seen. In similar but opposite fashion, strength in the US dollar could certainly negatively impact our future competitive ability to export, and in turn, put added pressure on our economic expansion. The recent corrective move downward in the equity prices, especially those of domestic multinationals, certainly would indicate the markets have more than assumed that possibility. However, it could also be possible that in light of the increasingly acute investor nervousness, equity prices have yet to reflect the growing list of potential economic and corporate earnings positives mentioned above.

The market turmoil which began in late April and consumed all of May, and perhaps, even most of June, one day could be recorded by history as officially no more than a correction. Quite often, the occurrence of these events has signified a shift in the key investment themes that are reflective of the various stages in a recovering economy. Rarely do these shifts occur quietly or gracefully. Specifically, recent market action would appear to suggest that the liquidity driven leg, courtesy of almost unprecedented Fed accommodation, of the market's strong upward move in 2009 and early 2010 could be at or nearing an end. As the reality of an economy moving toward an actual, self-sustaining path emerges, new investment themes will emerge and the asset prices will move accordingly. It will then mark the beginning of a new market phase.

In 2009, the higher risk, high beta, and aggressive growth-oriented investment themes, beneficiaries of a liquidity driven market, proved to be the dominant performers. One possible indicator that this market could be entering a more economically sensitive phase, potentially one with slower than expected growth, has been the recent bad behavior of the former market leaders. Future outperformance could be marked by equity holdings in companies representing more predictable levels of growth and well managed balance sheets. Dividend paying stocks, almost universally shunned in 2009, currently appear to be quite attractive, sporting generous yields when compared to 10 year Treasury rates, and the underlying corporate debt yield of the individual entity. Corporations generating continuing high levels of free cash flow may increasingly seek ways to return that cash to the investor. Stocks of these companies, with increasing dividends and stock buybacks, could be viewed as quite attractive. In a slower growth, perhaps more uncertain investment climate, corporate bonds, along with preferred stocks may prove be a good diversification tool in an investor's overall asset allocation strategy

Therefore, in the mind of this portfolio manager, a correction does not necessarily a bear market make. While these events, over the life of an investor (and a portfolio manager), never feel good, or give one a sense of euphoria, they do serve as constructive and opportunistic occurrences, for the observant, not to mention the "brave". It can certainly be appreciated that investors, with the emotions felt in 2008, and early 2009, still fresh in their minds, believed that the markets in late April and all of May, had once again betrayed their investment trust. May's equity market "flash crash" did little to assuage these emotions (though this phenomenon did happen once before in 1962). However, investors with a realistic sense of risk, are well served, and over time, reasonably rewarded, by attempting to look past doubts that, in the end, proved too negative, and fears of the unknown, proved unfounded. While my emotions in this pause of the past few weeks have clearly been stirred, my investment convictions are far from shaken.