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Quarterly Investment Outlook

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Wanted: Political Will for the Next Stage of Recovery

In our most recent Outlook we forecast a recovery for the US economy that would be slow, uneven, and not very pretty. To date, that forecast has proved to be correct. As we move into 2011 we've seen a renewed decline in housing, a resurgence of inflation, a newly reshuffled Congress frozen in gridlock, deteriorating sovereign credit quality both in Europe and the US, and a natural disaster in Japan of epic proportions. Throw in the upheaval in the Mid-East that threatens oil supply and you have the makings of a long, cruel economic winter. Yet, while the news of the world remains grim, key economic indicators point to a solid surge of growth in the US and Canada as well as developing economies around the world. This could explain why the equities markets have taken on a "What, me worry"? attitude with the major indices nearly doubling in the two years following the market crash. Stock prices have climbed a formidable Wall of Worry. We'll offer our thoughts on why and what might be on the other side of that wall.

State of Recovery in the US

Many economists seek to explain current conditions in terms reserved for the traditional recoveries of the past 30 years. Others see this one differently and describe it as fragile and illusory. They see the data supporting a recovery but describe it as living on borrowed time and borrowed money. Time will tell. We see this recovery as anything but traditional and agree that it will be challenged by the weight of a moribund housing economy, an extended consumer who must de-leverage, and a home-grown sovereign credit crisis that threatens public employees and bond-holders alike. That said, the data tells the story of an economy that has avoided the deep-freeze of a collapsed financial system and clawed its way back to life. The numbers don't lie: Industrial Production, Manufacturing and Services, Employment, and Consumer Confidence tell us the US economy has rebounded from the brink.

That could explain why, following the multi-generational market low of March of 2009, the equities markets have been on a tear. The advance has been fueled by the resurgence in corporate earnings and a lengthy string of monthly data releases pointing to a sustained recovery of the US economy. In our view, the market reflects the rebuilding of confidence in the US economy even while absorbing the prodigious number of body blows that populate the headlines on an almost daily basis. This isn't the first time the stock market has climbed a Wall of Worry but we think this one is wider and higher than usual. In our view, the question of whether that confidence persists into next year and beyond hinges on what occurs in the next quarter or two.

The proliferation of money and credit, courtesy of the Fed, has played a part in driving economic growth. It's also served to roust fixed income investors and whet their appetite for stock market risk. Quantitative Easing (QE1 and 2) has provided both Wall Street and Main Street with the cheap credit needed to bridge them through what is expected to be an extended period of de-leveraging. What happens in the absence of QE is the question investors are asking as decision day for the Fed approaches. As of today, current conditions point to a stronger US economy. Whether that disappears along with Quantitative Easing will become apparent in the very near future. This recovery may not be fragile and illusory, but there is concern that its underpinnings have instilled a sense of false confidence that could blow away like so many paper dollars.

Defining Success and Creating Expectations

As professional investors, we sometimes have to separate success for the economy from success in the markets. In most instances, a healthy economy begets a healthy stock market. However, for some brief periods success for the economy may weigh on the markets rather than support them. Why? Because recovery of the economy isn't an event but rather a *process*, one that at times can challenge equity investors. Since the meltdown, the economy and its markets have been the beneficiaries of an unprecedented expansion of credit and money supply. QEs 1 & 2 is part of a tactical response by the Fed to the crisis that befell the economy. It is not a long-term strategy. As we've seen throughout the Rest of the World ("RoW"), where inflation appears, central banks tighten credit. The US should be no exception. This present recovery *process* was designed to replace deflationary pressures with moderate inflation. The Fed has been successful in doing that.

That being the case, we think the Fed's next step in the recovery process should include ending QE and returning monetary rates to their "normal", pre-crisis levels as many countries throughout the RoW have done. While normalization of rates implies good news for the economy, it could temporarily spell trouble for the stock and bond markets. History provides precedents indicating that inflation doesn't kill a bull market, higher interest rates do. In our view, the *magnitude* of rate increases, not the direction, is a stronger influence on the markets. Acting preemptively avoids having to play catch-up in the future, lowers expectations for big hikes, and increases the odds for a correction rather than a full-fledged bear market.

With QE2 set to expire on June 30, the likelihood of higher treasury rates increases and could pressure the Fed to raise its key rates. We're not talking Armageddon here. A glance back to 1977-1981 yields an example of a stock market response to the worst of times, a stream of rate hikes that remains unmatched in our lifetime. The Fed took the Discount rate from 5.75% to 14% and Fed Funds from 6.25% to 19% as bond yields shot to record highs. Yet stocks managed to claw their way 31% higher as long-bond investors suffered. Why? We think investors eventually bought into the Fed's unwavering intent to fight high inflation with higher interest rates. Of course that period was book-ended by two bear markets: one at the beginning, with the Fed sending mixed signals and another at the end due to uncertainty over whether the battle had been won. It had and thus began a 20-year bull market in stocks and bonds.

We think a similar period lies ahead but without the sky-high interest rates. We see it as an opportunity for the Fed and fiscal policy-makers to make some tough choices and do the right thing. Unfortunately, it will require self-discipline from the Fed and political will from Congress. Chairman Bernanke should fire the first shot and allow QE2 to expire without a successor. Congress should heed the advice of the Deficit Commission, putting everything on the table, entitlements, taxes, programs, and mount an attack on the deficits. While not necessarily stock market friendly, these would be constructive for the economy in the long-term and should go a long way toward moderating inflation and maintaining our access to low-cost capital in the public debt markets. More importantly, it will establish a policy of responsibility and preemptive action that could create positive expectations for stock investors. A little pain now could pay big dividends for the economy and its markets in the future.

We see this as the beginning of the next chapter in the recovery process and think current events and monetary policy moves could trigger a stock market consolidation of perhaps 4-6%. We view that as contributing to the longer-term health of a bull market that has further to ride on the wings of a resurgence in corporate earnings and the US economy. Failing to act responsibly now creates the threat of seeing the US economy surrender its dominance. A growing dependence on the kindness of our lenders could be debilitating for both the US and the RoW since it's difficult to see global growth remaining on track without the leadership and participation of the world's largest economy. We and the world will be watching these next few quarters for indications as to whether the US leads or follows the global economy into the future.

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