

Quarterly Investment Outlook

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This is Not Your Average Recovery

Uncertainty, pessimism, and fear are in the minds of investors these days as they scrutinize an economy struggling to recover from the “Great Recession”. The ebb and flow of the equities markets in 2010 reflect a worry that the other shoe is about to drop in the form of another recession that could trigger another market meltdown. We’re cautiously optimistic about current conditions and think those fears are the product of short memories and unrealistic expectations of investors who look to the media rather than analysis for their opinions. A “Great Recession” comes along every 30-40 years so we’re not surprised by the pace and uneven character of this recovery. We’re seeing that not all economies are equal and that some will recover faster than others. That’s why investors should recalibrate their expectations and refocus on where and how they invest for the next several years. The “truth” about this recovery? It’s different and a little bit ugly, but it’s for real and preferable to the alternative.

The Crash: Different, Not Unprecedented

It’s been 18 months since the world nearly ended. We see the near fatal collapse of the global financial system as the biggest economic event in the post-WWII period. The structural break in the world’s banking and finance system threatened to redefine the economic order in the world. When we look back to the period, March ’08 to March ’09, we marvel at both the scale and complexity of what occurred and the simplicity of what caused it. Suffice it to say, we did it to ourselves and no one is blameless. Our collective lack of self-discipline, coupled with greed and a sense of self-entitlement, took us to the brink of Global Depression. Some say we are still there. We don’t agree. Those two divergent opinions speak volumes about what we’ll see from this recovery and the equity markets in the next few years.

We were surprised at how last year’s stock market rally seemingly erased for many investors the memories of what triggered this Great Recession. If one ponders the causes, however briefly, the conclusion is unavoidable: The expansion of the past ten years was built on a lie, actually a number of lies, that had financial institutions, governments, and citizens spending money they didn’t have or didn’t earn. Why would any investor think the damage done in those ten years could be repaired in a brief couple of years? We saw the ’09 rally as an indication of one simple fact: The world was not ending. Many investors viewed that rally as something more: evidence of a traditional cyclical recovery in our immediate future. We see a cyclical recovery ahead but one further out on the horizon and beyond that point where the financial systems of the developed economies have successfully de-leveraged. That will take some time.

This week, NBER (National Bureau of Economic Research) announced that the Great Recession ended in June of 2009. The fact that employment and housing are flat-lining and could remain so for some time supports our view that the recovery in the developed economies will be a fragile one. We remain vulnerable to public debt concerns and uncertainty surrounding the taxation landscape. In our opinion, the term, “Great Recession”, should be one’s first clue in shaping expectations for what follows. This was a structural event that destroyed an unfathomable amount of capital, leaving financial institutions and governments with black holes in their balance sheets. Investors don’t want to believe that it could take the better part of a decade to see the damage repaired, but it might. **The question of how long that takes hinges on whether government will be a help or hindrance to the private sector in revitalizing the economy. The jury is still out on that issue. The November election results will help shape our expectations for an answer to that question and determine our level of optimism for investing in the future.**

Ugly Can be Beautiful When it Comes to Any Recovery

We would describe a classic recovery as having a somewhat predictable, linear, cyclical upturn in the economy accompanied by a stock market advancing on the same trajectory. It's one fueled by confidence and optimism, arising from expansive monetary and fiscal policy initiatives. What we are seeing today is anything but that. The US economy could be described as a little bit ugly as it navigates through a lengthy, slow, uneven resurgence with a stock market treading water in a stew of uninspiring economic data. There is modest growth, less-than-modest inflation, but surprisingly healthy gains in corporate earnings. **We think this recovery is beautiful when compared to the alternative of a double-dip recession.**

By no means are we out of the woods. Global growth has done a lot of the heavy lifting so far. Here at home, we've seen abundant monetary support but fiscal policy has done little to engender much certainty about the future. The TARP program, a good idea, poorly executed, helped stave off the extinction of the auto, insurance, and banking sectors. Reconstructing a regulatory landscape with FINRA was a good first step toward restoring investor and consumer confidence. But we're still left with TBTF (too big to fail) institutions and market structures that resemble back rooms for high-rollers in Vegas rather than orderly trading platforms. The Next Big Thing on this administration's agenda was a puzzler. While employment has stagnated and businesses are tightening belts to struggle through the biggest downturn in the past 60 years, Congress says NOW was the time to revamp the healthcare system AND introduce new tax increases. In our book, these are not steps taken to spur recovery and could only be considered confidence-inspiring to those who don't pay taxes or aren't paying for healthcare insurance.

We see the need for government to play a bigger role in the aftermath of this crisis by providing the capital and sovereign guarantees to bridge the economy through an extended period of de-leveraging. Beyond that, we would hope that the next Congress presses for more *investment* in the engine of recovery rather than the additional spending and repaying of campaign promises to special interests that both parties do so well. It will take prudent leadership and political will to strike an effective balance between expansion and austerity that markets will respond to positively. Maybe that's why we aren't surprised to see the stock market meandering as it is.

Investors are currently doing time in limbo, waiting to see how November's election results will shape fiscal policy for the next chapter in our history. Our worry is not whether we'll see a lengthy cyclical expansion but how long before it happens and what will the US economy look like when it does? This is an episode where it's appropriate for government to step up and act in a crisis. It also appropriate and proper for government to take a step back to its more limited, traditional role when that crisis has passed and allow the private sector to do its work of pushing the economy forward. That time is near.

An Investment Plan for The Next Cycle

China recently overtook Japan as the world's second-largest economy. The US economy is still 3X that of China's but throw in the developing economies in Rest of the World ("RoW"), notably all of Asia, India, Russia, and Brazil, and you can see that winning in the global economy has become a game of numbers and resources. In the wake of the Great Recession, the US and Europe are, for now, riding the coattails of the RoW when it comes to growth. We like what's happening outside the US. That's where we're seeing our expectations exceeded in industrial production, CAPEX spending, and personal consumption. We're intent on capturing growth returns from companies doing business there. We're continuing to increase our foreign exposure, not only directly but indirectly through global companies based here and in Europe. We do like what we see in the US when it comes to value and total return. We're finding a number of large-cap, dividend-paying, low P/E issues that fall into the category of late-cycle performers. We're perfectly happy to position these for investors who are satisfied with a decent dividend yield while they wait for the tide of a broad-based recovery to float these to higher levels.

We need only look at the earnings from global companies for evidence of a healthy recovery taking place and the value of diversifying into the developing economies. We see our mission as being one of connecting portfolios to growth and value wherever that might be. We encourage investors to broaden their investment horizons and look beyond the US economy for the opportunities that usually arise from a more traditional recovery.

**3147 Fairview Avenue E. Suite 300,
Seattle, WA 98102
206.324.9765 / 800.398.9765**