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By William W. Priest, CEO

July 23, 2009

The Easy Way Out...

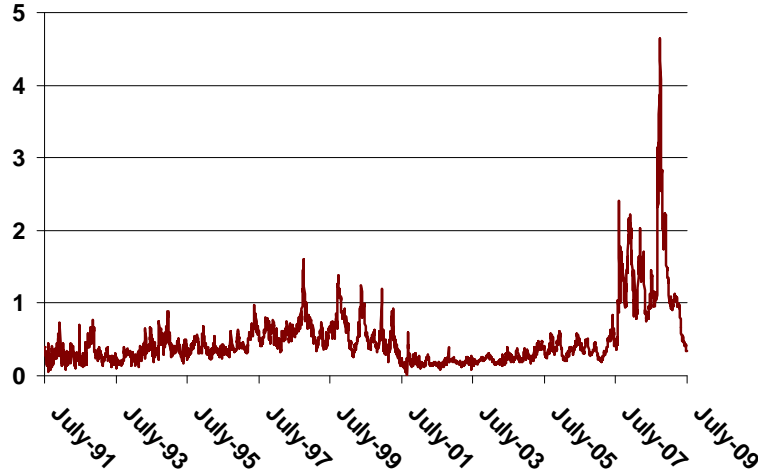
In pondering the recent uptick in stock market performance, I am reminded of a memorable quote from a friend of mine. Ron Bailey, a Brigadier General in the U.S. Marine Corps, has had two tours of active duty in Iraq. Once, when he was still a Lieutenant Colonel stationed overseas, I asked him how he reacts when he finds himself in an unexpected situation in which he and his men are in danger of being overrun. His answer was: “Never take the easy way out. It is always mined.”

These days, when I hear the “green shoots” arguments and expectations that solid economic growth is just around the corner, I find myself alternately heartened by these signs of recovery and haunted by Ron’s sage advice. The National Bureau of Economic Research may shortly announce that the recent economic downturn – an 18 month recession, half of which passed by without us even knowing we were in one – has ended. Furthermore, the third quarter of ’09 should reflect growth in real GDP for the U.S.: an event that usually signals an end to a recession. But, despite these encouraging indicators, I still find myself asking if this crisis is really over. To paraphrase General Bailey: have we taken the easy way out of the most difficult economic problem in over 70 years? And have we endangered ourselves as a result?

To answer these questions, it’s important to take a clear-eyed look at where we currently stand. Today’s predicament is the result of a major liquidity problem that began in August of 2007 when the French bank, Paribas, could not meet redemption demands on certain funds because of security pricing issues. That event triggered a liquidity crisis that led to a solvency crisis that has resulted in a recession worse than anything we have experienced since the Great Depression. The good news is that the liquidity crisis is over (Figure 1), and the solvency crisis, while not yet behind us, is at least better defined. However, the financial system still needs another trillion dollars or so of equity (Figures 2 and 3) to be considered repaired. Furthermore, European banks have not yet come clean about their myriad problems, and a real risk of contagion exists should the Eastern European countries of Latvia, Estonia, and Lithuania fail. The good news is these concerns are well known: the IMF is positioned to address them providing its members actually fund the commitments they made last Spring at the meeting of the G20. (To date, even the U.S. has not funded its commitment.)

Figure 1

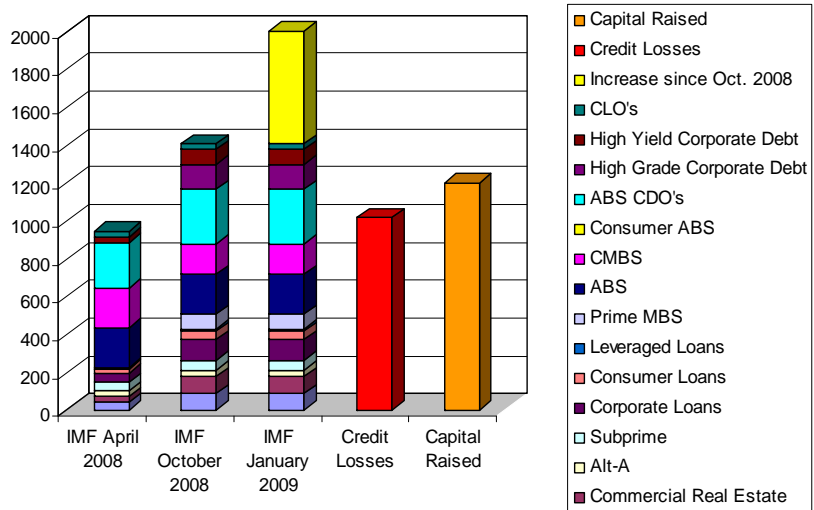
TED Spread (as of July 15, 2009)



Source: Bloomberg

Figure 2

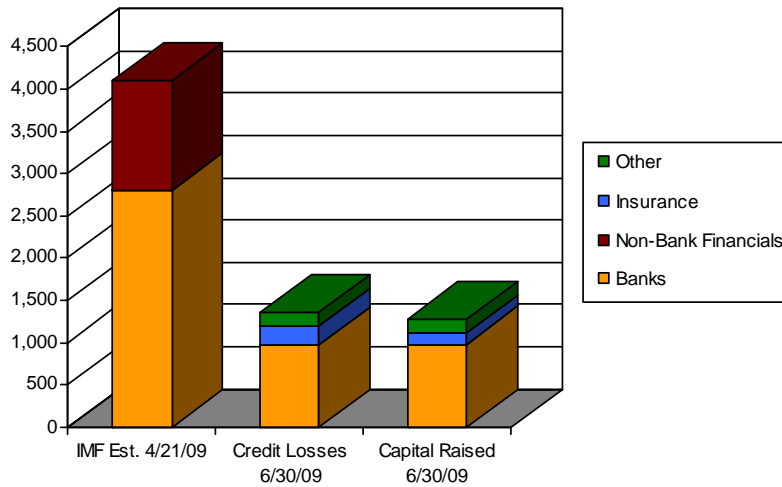
Credit Loss Estimates (as of March 2009)



Source: Goldman Sachs Research, IMF Global Stability Report, April 2008 and Morgan Stanley Research & Bloomberg, ISI Group 2 Conference Board, Bloomberg

Figure 3

Credit Loss Estimates (as of June 2009)

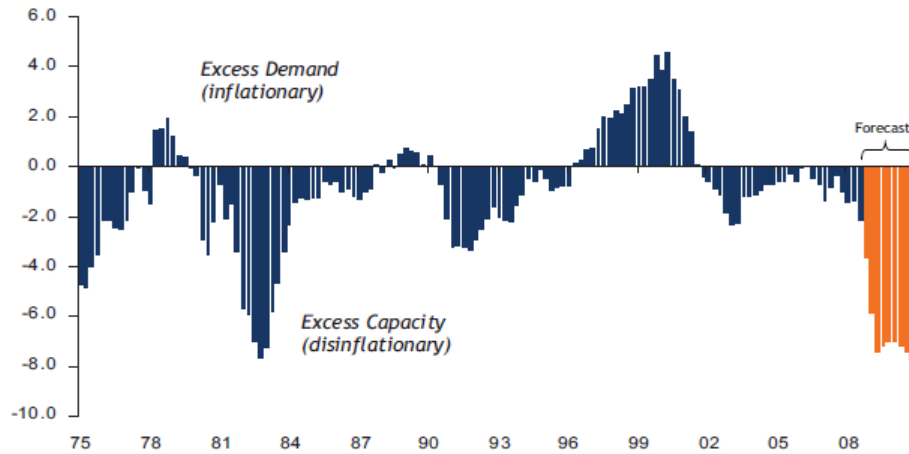


Source: Goldman Sachs Research, IMF Global Stability Report, April 2008 and Morgan Stanley Research & Bloomberg, ISI Group 2 Conference Board, Bloomberg

Since the peak of asset values in October 2007 to the trough early this year, the world's global balance sheet took a hit of over \$50 trillion, more than 60% of which reflected declines in equity stock prices. It is no wonder, then, that the real economy fell off a cliff. With the seizure in the credit markets, the collapse of the shadow banking system, and the deleveraging of the U.S. consumer as his net worth shrunk reflecting declines in 401(k) values and housing, a serious recession was inevitable. Furthermore, U.S. consumer spending peaked at 72% of GDP in 2007 and is now likely to return to a level closer to the 65% of the pre-2000 period, presaging an inevitable GDP shrinkage of \$750 billion. One must also consider today's global output gap, which is larger than at any time since the Depression (Figure 4), resulting in a disappearance of pricing power within most sectors. Globalization has also been negatively affected as global exports as a percent of global GDP will decline this year for the first time in 20 years. All of these signs signal that, in the short run at least, inflation is not a problem; deflation is.

Figure 4

Output Gap to Widen to Record Levels
Output Gap (Actual GDP as a % of Potential GDP)



Source: Federal Reserve Board, Banc of America Securities – Merrill Lynch

All told, what has happened to us is a really big deal. And, unfortunately, there is “no easy way out.” Governments around the world have enacted policies to manage the crisis, both in monetary and fiscal terms. While necessary in the short run, these policies have laid a potential mine field for investors to ultimately navigate. To understand why this is the case, let us step back a moment and look at the enormity of the situation facing policy makers.

The best way to do this is by reviewing the components of economic output and their resulting impact on profits and employment. The following equation illuminates this interrelationship:

$$C + I + G + (X - M) = \text{GDP}$$

GDP, in other words, consists of Consumption (C), Investment (I), Government Spending (G), and the difference between a country’s Exports (X) and Imports (M).

Consider the U.S. In today’s economic climate, C is collapsing and I has shrunk significantly. The variable, (X – M), is positive but it is a small component compared to the other three variables. Therefore, only G can make up the difference or, more realistically, ease the pain of the decline of the other three variables. When monetary policy reduces short term interest rates to zero, fiscal policy is the only tool left. That means deficit spending. This is not the easy way out; it is the only way out, at least in the short run. Perhaps time alone could solve the problem, but only at the risk of much more short term pain than we are already experiencing in terms of falling profits, bankruptcies, unemployment, and wealth destruction.

Let us digress for a moment and illustrate how corporate profits are driven by changes in each of the key variables determining GDP. All of the numbers appearing in Table 1 below are derived from the Federal Reserve's Flow of Funds Accounts of the United States, March, 2009. Once we understand how the model works, the reader can plug in his estimates for each of the four variables and see what the impact on profits would be.

Table 1

Sources of Corporate Profits (National Income Accounts)

	Changes		
	2006	2007	2008
Household Contribution	-22.8	-152.2	-275.3
+Investment	134.3	-90.0	-136.9
+(eXports-iMports)	-43.7	49.5	38.6
+Government	152.8	166.7	207.6
Corporate Profits	220.6	-26.0	-166.0

In Table 1 we provide the annual dollar change in corporate profits for each year from 2006 through 2008. After rising sharply in 2006, corporate profits declined slightly in 2007 with a precipitous drop in 2008. Profits decline for 2009 will be a similar amount.

Household (C) contribution to corporate profit totals shrank dramatically from 2006 through 2008 - from a negative \$23 billion to a negative \$152 billion to a negative \$275 billion. Rising capital spending, both business and residential, effected an increase in corporate profits of \$134 billion in 2006, but declines in capital spending caused reductions in profits for the years 2007 (\$90 billion) and 2008 (\$137 billion). The expansion of the trade deficit (X-M) in 2006 hurt profits but the rise in exports relative to imports added nearly \$50 billion to profits in 2007 and \$39 billion in 2008.

The single largest contributor to corporate profits was government expenditures according to this methodology. The expanding fiscal deficit added to profits in each of the three years from 2006 through 2008 (\$153 billion, \$167 billion, and \$208 billion, respectively). Had government spending simply equaled government receipts in 2008, corporate profit declines would have been catastrophic.

The questions determining corporate profits for 2010 include the following:

1. Will employment levels be higher at year-end 2010 than 2009?
2. Will the average wage per worker be higher?
3. Will the consumer savings rate be higher?
Depending on one's answer to this third question, it is easy to see that the consumer's contribution for 2010 could be flat to slightly up or slightly down. A rise in the savings rate places pressure on spending increases.
4. Will capital spending rise in 2010?

- With operating rates at historically low levels suggesting a poor outlook for business cap-ex and real estate capital spending likely to be lower next year as well, overall capital spending will unlikely be a contributor of incremental profits next year.
5. Exports minus imports should expand; hence, trade should be an expanding contributor to corporate profits next year.
 6. Will government spending exceed government receipts?
Absolutely, and it will be a very big number, for without it any profit recovery cannot happen.

Government spending, therefore, will be the largest contributor to profit growth next year just as it was this year. But it will come at a price. Our debt to GDP ratio will soar to 12% this year and will climb higher in the following 12-month period. A high national savings rate will make this problem more manageable, but the increase in government debt is also a ticking time bomb and a long term growth deterrent. Sustainable growth, independent of government initiatives, is not visible presently.

Notwithstanding this “minefield” of negative trends in the private sector, a recovery of sorts is upon us. GDP in the third quarter will likely be up as an inventory rebuild takes place and the fiscal stimulus kicks in. Supporting comments come from JP Morgan’s June 26th, 2009 Global Data Watch, in which a significant inventory build throughout 2010 and a rise in consumption reflecting the ‘cash for clunkers’ policy are the key drivers in their analysts’ numbers:

“Global manufacturing is poised for a surge that will extend to next year if final demands turns higher...Global industry is projected to retrace one-third of its recession losses by the end of the year, a development that produces roughly 8% annualized growth during 2H09. For the U.S., JPM is predicting a 2.5% GDP growth in Q3.”

If we are to further prognosticate on the timing of a recovery, it is helpful to note that the history of the stock market shows that equity values bottom two thirds of the way though a recession (Figure 5). The March lows, therefore, should hold. Significant progress has already been made in the financial economy: the liquidity problem is now an issue of the past and there has been a rapid improvement in the cost of the capital from the point of view of issuers. The latter is reflected in Figure 6, in which the BFCI¹ serves as a measure of the cost of capital. The BFCI started falling in August of 2007, flattened out for a period, and collapsed when AIG and Lehman failed (a 12 standard deviation event!). However, it has improved dramatically in the past few months to pre-Lehman levels and then some. Think of the BFCI as proxy for the cost of capital. After rising

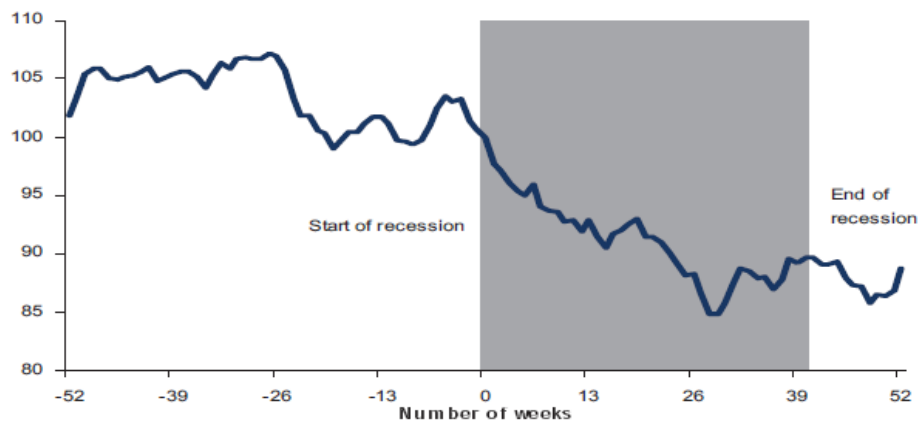
¹ The Bloomberg Financial Conditions Index combines yield spreads and indices from the Money Markets, Equity Markets, and Bond Markets into a normalized index. The values of this index are z-scores, which represent the number of standard deviations that current financial conditions lie above or below the average of the 1992-June 2008 period.

sharply from the summer of 2007 through December of 2008, the cost of capital began falling at a rapid rate this year as the credit markets opened.

Credit spreads have shrunk dramatically, and quality companies like Microsoft have taken advantage of these favorable conditions by raising debt even in the absence of an immediate need for capital. For certain companies, debt was so cheap relative to equity that, if they did nothing but issue debt and repurchase common stock, value would be created for shareholders.

Figure 5

Stock Market Bottoms 60-70% of the Way through a Recession
*S&P 500 indexed to 100 at start of recession**



*average of 1969-70, 1973-7, 1981-82, 1990-91, and 2001 recessions; shaded area represents recession period

Source: Banc of America Securities – Merrill Lynch

Figure 6

BFCI Index (as of July 15, 2009)

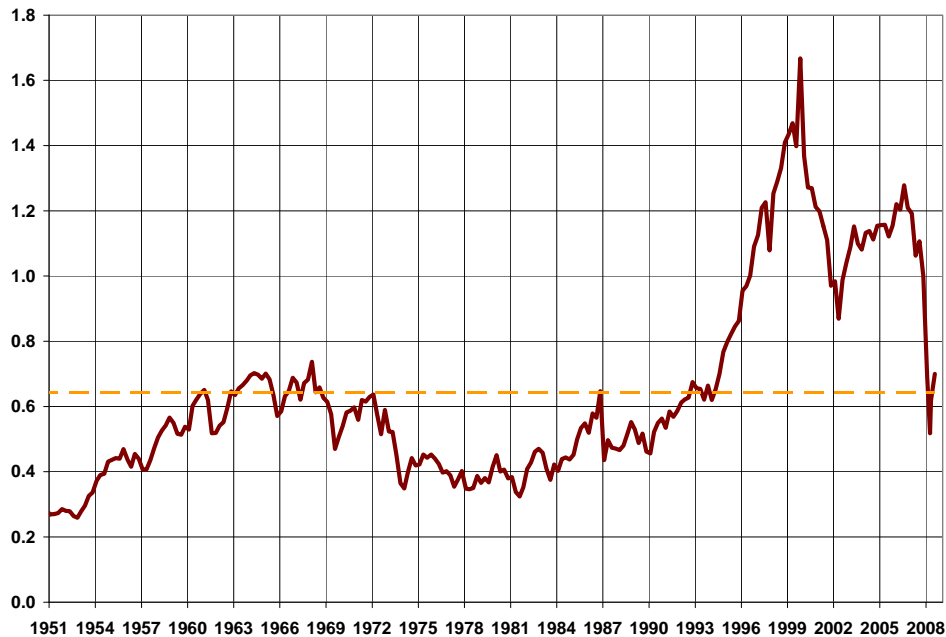


Source: Bloomberg

All told, the stock market has been reflecting the positive effects of global monetary and fiscal policy actions. After bottoming in March, most equity indices have risen well over 30%. The rise in value has, however, ushered in an absence of cheapness. Figure 7 shows the relationship of equity values to U.S. GDP. The post war average is around 62% with lows in the 40% range (generally in periods of significant inflation) and highs over 160% (in periods such as the dot-com bubble in 2000). The recent low occurred at 52% and today we are over 70%. Unless one believes we are about to see a return to three or four percent real growth rates, the equity markets are more likely to be choppy and trendless awaiting further signals on profit growth over the next two years.

Figure 7

Total Stock Market Value / Nominal GDP
(1951-2009)



Source: FactSet, Federal Reserve

So the question remains: in buying time – and an improved stock market – over the past few months, have government actions sown a minefield for future travelers? Have we taken the easy way out? Huge monetary and fiscal policy actions may have saved us from a Depression and perhaps even launched a mild recovery, but how good a “solution” is it? In our view, the “solution” we have adopted for this crisis in the real economy is actually the “problem” when viewed over a multi-year period². An analysis of U.S. government debt issuance in 2008 suggests that the government raised approximately \$700 billion of new debt to pay for a deficit of \$450 billion and supplemental appropriations of \$250 billion for the wars we are fighting. In 2009, the government needs to sell nearly three times that amount given the projected deficit of nearly \$2 trillion. Where does the money come from?

Eric Sprott and David Franklin raise this question in an excellent essay³. They suggest that, after looking at who owns our debt and who could buy more of our debt, it is simply impossible for current holders to fill the gap. The only solution is for the Fed to buy what

² The IMF suggests that the public debt of the ten wealthiest countries will rise from 78% of GDP in 2007 to 114% by 2014. On a per capita basis, these governments will owe \$50,000 for every citizen. This debt surge, unlike that of wartime, will not be temporary. By 2050, one-third of the world’s population will be over 60 years of age. The demographic bill will be much much larger as a result. The real question, then, is the following: how much damage will greater indebtedness do to economic growth and a government’s creditworthiness?

³ “The Solution...is the Problem,” Eric Sprott and David Franklin, Special Issue, May/June 2009

the others cannot. Hence, “quantitative easing” is not just the solution of choice; it is, for the moment, the only solution.

As a result, confidence in the U.S.’s ability to manage its financial affairs will decline, which will manifest itself in higher rates on our long term debt and a lower dollar over time. This is the reason for the unease expressed by China and the Gulf States regarding the notion of maintaining the dollar as the world’s principal reserve currency. These nations are fearful that the U.S. will deal with its unsustainable fiscal path via inflation and a debasement of the value of the U.S. dollar via depreciation. As a result, many international investors are moving away from dollar-denominated investments. There is a global movement afoot, particularly in China, to diversify into hard commodities, including gold, through the purchase of real assets, such as mines, oil, and significant investments in countries like Africa, Brazil, and even Canada. In due time, both of these powerful economic forces – rising real interest rates and a weakening dollar – will act as depressants on real growth in the U.S. economy.

Consider the following: From an arithmetic standpoint, a government’s debt burden is sustainable only if it can pay the interest without borrowing more. If that is not the case, the government will eventually fall into a debt trap, borrowing even more just to service earlier debt. Extra public debt crowds out private investment and drags long term growth downwards.

While this potential problem is clearly a potential issue for the U.S., debt growth for the U.S. need not be seen as a calamity at the moment but more as a warning. There is, after all, another way to look at the problem: one that makes the distinction between gross debt and net debt and, in so doing, paints a slightly more positive picture of our country’s financial state. To quote *The Economist*: “Gross debt is a good measure of the public sector’s demands from financial markets, since it includes all outstanding government paper. It is the measure used in the recent IMF study. But it does not give a full picture. Some countries include internal government IOUs in their figures: America, for instance, counts the bonds held in its government pension plan. Because other countries do not, that overstates America’s relative gross debt burden. Washington policymakers prefer to look at ‘debt held by the public,’ which excludes those internal IOUs. At 37% of GDP in 2007, it puts America in a better light...Although gross debt is the best guide to governments’ financial obligations, net debt, which subtracts the value of their assets, is a better indicator of their creditworthiness⁴...”

While, in purely technical terms, our recession may be coming to an end, the positive momentum of the past several months does not signal durable expansion. The last recession officially ended in November 2001. In the following 12 months, the S&P 500 dropped roughly 18%, the unemployment rate rose from 5.5% to 5.9%, and consumer confidence was unchanged. In the 1990-91 recession, which ended March 1991, the unemployment rate jumped from 6.8% to 7.4% and consumer confidence dropped sharply in the ensuing year. Today, the pattern is similar but the real economy numbers are worse. While the recession may have ended, a durable economic expansion remains

⁴ “The Big Sweat,” *The Economist*, June 13, 2009.

elusive. Importantly, the economy may start growing but not fast enough to keep the unemployment rate from rising, no doubt well in excess of 10%. This is the scenario that will characterize the economy in 2010.

The resulting strategy implications follow. First of all, Armageddon is off the table. A modest recovery is about to begin, but significant increases in the fiscal deficits of developed countries threaten to ultimately cause a rise in real interest rates and lower real economic growth rates. It will be a very weak recovery in the developed countries. Long term bonds over time look like losers in this environment, leaving short term debt instruments of high quality and equities as the asset classes of choice over the long term.

Bear in mind that equities protect the investor in two ways. They are an eventual hedge against inflation, and they capture the benefits of productivity gains reflected in corporate earnings gains. A global investment perspective is also required by the investor, with the caveat of limiting one's investments to markets that are subject to a "rule of law."

An important point on cultivating an international portfolio: owning American equities need not mean one is U.S. centric. Firms that compete globally must be domiciled somewhere, and a domicile in the U.S. is a plus for the investor because of the aforementioned rule of law. In order for it to be a wise investment, however, the U.S. company under consideration must also think globally. Politicians may be "border controlled," but capital is not; hence, company management must think globally as well.

An old saying suggests that money goes where money is made. Over the next several years the developing countries will grow faster than the developed ones. The former will continue to build a middle class while the latter will continue to deal with extraordinarily large fiscal deficits. Debt levels in the emerging markets are a fraction of those in large countries. The emerging members of the G20, for example, had a public debt to GDP ratio of 37% in 2007. By 2014, the IMF states the number could be as little as 35%. To the extent these countries buy the debt of developed countries, such actions can be viewed as a form of vendor financing. Gradually, these nations will build a middle class with consumption trends of their own. They will be able to decouple from the problems of the West to a greater extent than ever before.

More specifically, consumer spending in the developing world will increasingly offset the depressants affecting consumer spending in the developed countries. Information Technology will likely be an outperforming sector as a result. IT is no longer solely driven by business capital spending. Consumer spending on IT gadgets has become increasingly important to the IT sector on a global basis. When people migrate from subsistence to affluence, the first thing they buy is a cell phone, then an iPod, then a flat screen TV and a laptop. Such trends are a good indication that the IT sector may well be in for a long run of outperformance.

On the other hand, the financial sector, particularly the banks, is in for a tough slog. Between 1973 and 1985, the financial sector accounted for 16% of U.S. domestic profits. In the '90s, the range was 21%-30%. In this decade, it peaked at 41%. Going forward,

this number will plummet, reflecting the deleveraging of the sector and write downs from the “financially engineered earnings” that have recently corrupted the industry.

In sourcing equity returns, dividends will matter more than ever. Dividends and their reinvestment contributed 43% of equity returns in the U.S. in the 1925-2008 period; that percentage could exceed 50% in the years ahead. Why? With regard to the other determinants of equity returns, P/E ratios are unlikely to expand in a world where interest rates are more likely to rise than fall. Earnings growth mirrors growth in nominal GDP, and GDP is likely to be muted over the next few years in the developed countries. Therefore, dividends will become an even more important source of equity returns.

On a more theoretical level, it is clear that a major shift in investment methodologies is underway. Accounting metrics that rely on price-to-book, price-to-earnings, and a reversion to the mean methodology will give way to free cash flow analytics. The latter is at the heart of the corporate capital budgeting process and private equity capital allocations. At Epoch, we believe that winning stocks can be found in almost every industry by understanding the role of the cost of capital in allocating free cash flow among growth options and dividend choices (cash dividends, share buybacks, and debt pay downs) and by seeking out management teams that have a history of doing so successfully. That is the challenge for money managers, especially in environments as simultaneously encouraging and daunting as the one we currently face. There really is no easy way out for today’s investor.