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Equities: Priced for a Calamity, But Not for a Near-Term Recovery

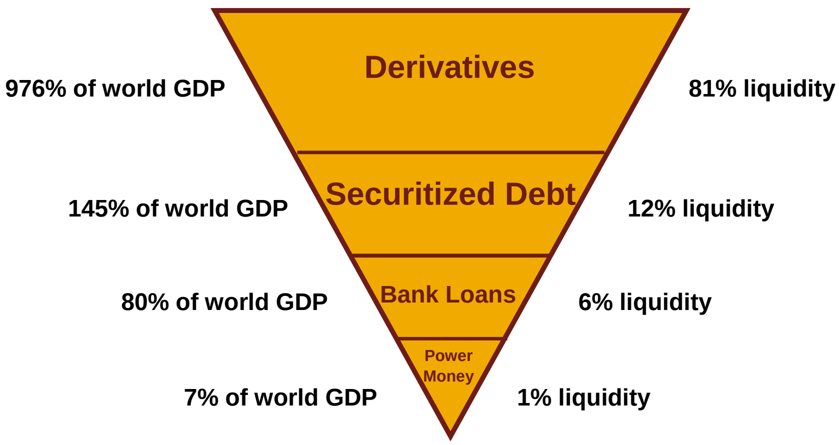
Today's investor is witness to a truly unique time in economic history. In the 21 months spanning October 2007 to March 2009, irrational exuberance has been transformed into irrational despair, with global equity values falling from over $60 trillion to nearly $25 trillion. Simultaneously, we've seen a worldwide collapse in housing values (particularly in the U.S.A., Great Britain, Australia, and Spain) and large declines in fixed income securities incorporating credit risks. All told, the international economy has ended the first quarter of this year with a $50 trillion hole in its balance sheet. This amount is staggering, not just because of its size, but because of the speed at which it has accumulated.

To create these conditions, many powerful forces came together within a short period of time:

1. The actions of the Central Bank – In reaction to the stock market decline of 1999-2001 and driven by a fear of repeating Japan's mistakes, the US Central Bank established extremely easy monetary conditions, which played a major hand in fostering the housing boom.
2. The proliferation of exotic securities – The repeal of Glass-Steagall resulted in the birth and rapid growth of new financial products with strange acronyms, poor transparency of structure, and an absence of regulation, all of which became characteristics of the new shadow banking system.
3. The absence of proper institutional due diligence – As a result of the rapid rise of "mark-to-model" pricing and the hand-in-hand relationship between the rating agencies and the investment banks, these risky new financial products were falsely deemed "safe."
4. The rise of hedge funds – The existence of very large pools of hedge fund capital managed under the pressure of large and built-in incentives resulted in a speculative binge, mostly financed with other people's money.
5. The leverage boom – The ability and the incentive to deploy the unchecked use of leverage across a global financial system resulted in financial security values nearly ten times the value of global GDP.
6. The mixed blessing of globalization – Because of the interconnectivity of economies around the world, the spread of this contagion could not be prevented.

At the heart of this dramatic confluence of forces and events was the rise of a shadow banking system that was unregulated, opaque in structure, and contained few disclosures that might have helped investors navigate its dangerous complexities. Via a rapid expansion in securitization and derivative products, the shadow banking system generated a massive explosion of liquidity, as seen in Figure 1. Within this four-tiered liquidity model, the top two tiers are the most important, as they once comprised 93% of all liquidity in the marketplace. Today, these two tiers are in the process of collapsing. The insolvency issues associated with this collapse are the reason for the current deflationary pressure in the financial economy.

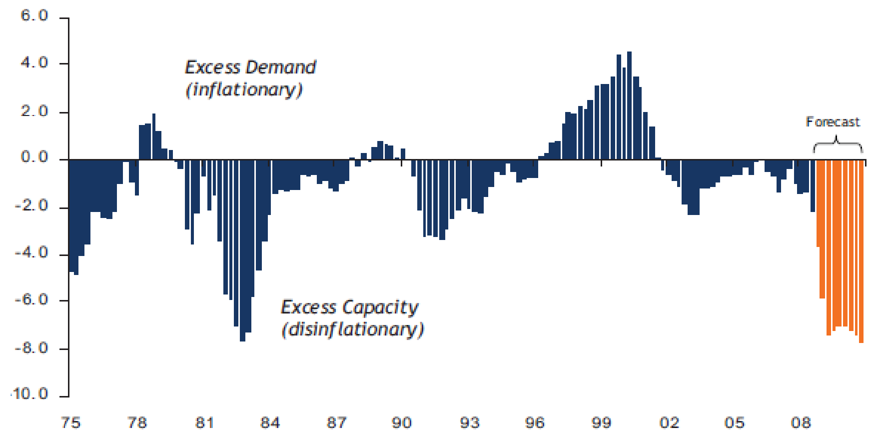
Figure 1
The Liquidity Pyramid:
Global Liquidity by Source of Claim



Source: Independent Strategy, CLSA

At first, the conditions outlined above were confined to the global financial markets. But, as we all know, the system is linked: nothing can happen in the financial economy that won't eventually affect the real economy. In this case, the real economy began to show some signs of weakness in the fourth quarter of 2007, but it was very visible by the third quarter of 2008. Today, the contraction in the real economy is the largest since the Great Depression. The global output gap (Figure 2) is also the largest since the Great Depression and carries a similar set of deflationary concerns.

<u>Figure 2</u>
Output Gap to Widen to Record Levels
Output Gap (Actual GDP as a % of Potential GDP)

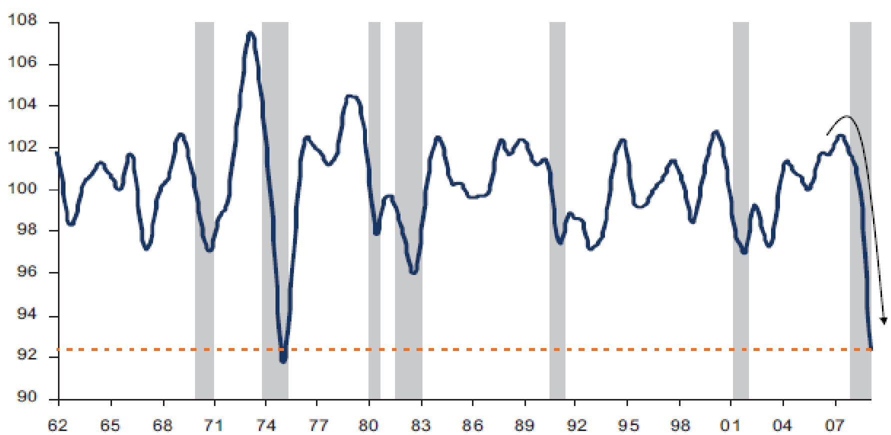


Source: Federal Reserve Board, Banc of America Securities – Merrill Lynch

In addition to encouraging deflation, this weakness in the real economy also encourages protectionism: a knee-jerk set of policy measures designed to protect local economies. In reality, however, protectionism will end up weakening economic conditions both globally and within the local markets such policies were intended to protect[1].

All things considered, we are in the deepest recession in over 30 years (Figure 3), and no one really knows when it will end.

<u>Figure 3</u>
Deepest Global Recession in over 30 Years
OECD Leading Indicator (Index Level)



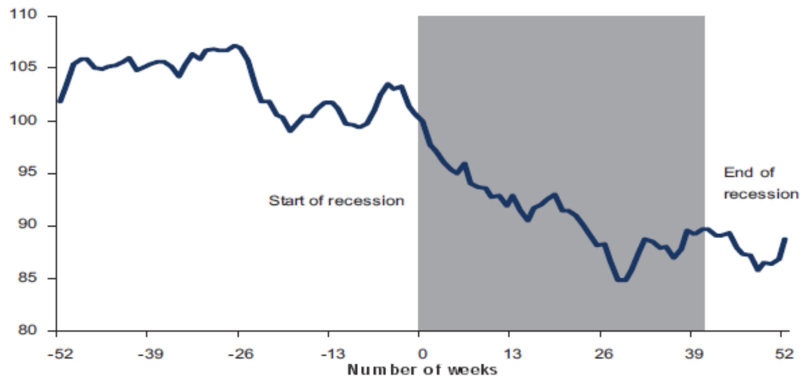
Shaded region represents period of U.S. Recession
Source: OECD, Banc of America Securities – Merrill Lynch

[1] See paper on our website: "A Really Bad Idea," www.eipny.com.

Historically, declines in stock prices have tracked closely with plunging labor markets and corporate profits. This decline, like all others, will certainly end; but the performance of the equity markets – up until the last three weeks of March, at least – has given few signs that the end is near.

Is there a basis for optimism? Yes and no. While we are not forecasting that a bottom has been reached, there are reasons to suggest that a bottoming process is underway. History suggests that markets bottom at 60%-70% of the way through a recession (Figure 4).

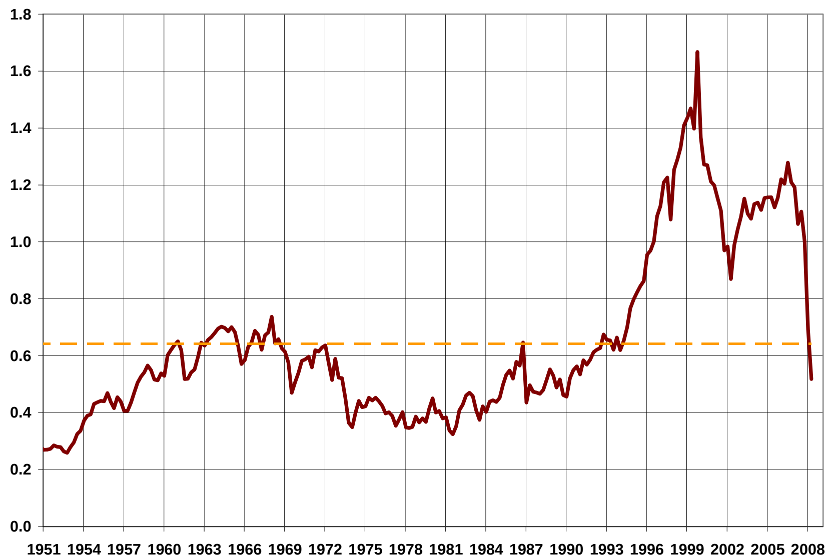
Figure 4
Stock Market Bottoms 60-70% of the Way Through a Recession
S&P 500 indexed to 100 at start of recession*



*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

We can gain additional perspective on the potential timing of the turnaround by remembering that the financial economy and the real economy are two sides of the same coin. In this regard, it's helpful to compare the value of equities to the value of GDP. In Figure 5, we see that in early March, equity values for the S&P 500 represented less than 60% of the value of GDP. According to the chart, this is not necessarily a bottom. However, it would suggest that "reasonable value" is now appearing. For perspective, the reader should also recall that the 1970s had much higher interest rate levels than today. This fact largely explains the difference between the 40% equities-to-GDP ratio in the 1970s and the 60% ratio today.

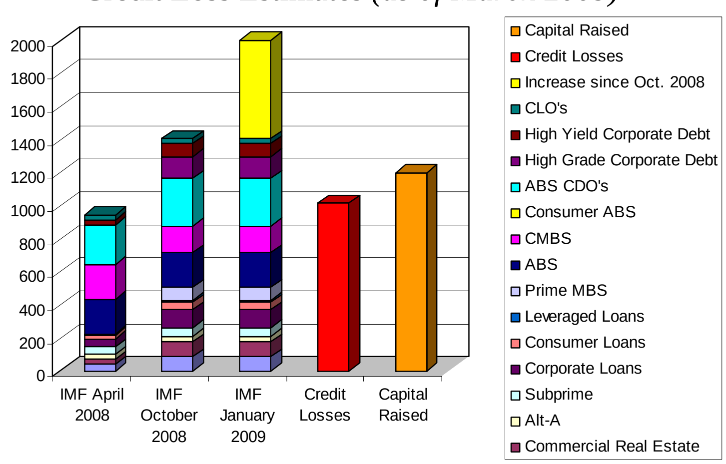
Figure 5
Total Stock Market Value / Nominal GDP
(1951-2009)



Source: Factset, Federal Reserve, http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

Another potential source of guidance is the data presented in Figure 6. Much of today's economic uncertainty centers around insolvency risk. Here, we track the evolution of the IMF's estimate of global financial losses by product, showing an increase from $900 billion in April of 2008, to $1.4 trillion in October of 2008, to $2 trillion in January. If one balances these losses with the amount of new equity raised and credit losses recognized, it can be said that we are already two-thirds of the way there. Again, the market will discount that missing third.

Figure 6
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*

Our concern, however, is that the IMF's $2 trillion estimate is too low. This point of view is supported by other economists, including Nouriel Roubini, who suggest that the number will be much higher. If they are right, we may well return to the equity market lows of early March, but with the encouraging caveat that values will have continued to appear in many parts of the world.

Turning our attention to the political sphere, questions still remain as to the size and content of the current stimulus program. Is it too small, too back-end loaded, too focused on entitlements rather than stimulus? Regardless of the debate, the measures already put in place will start to have an effect in the second quarter of 2009. By year-end 2009, it is quite possible that the stimulus packages instituted around the world could well total 2% of global GDP. This is a large number and it will have a material effect. We may not return to growth rates of prior years, but 2010 should certainly be better than 2009: an event that will be discounted by the market, as well. What's more, the G20, to its credit, is saying the right things about protectionism, even if not all countries are acting in unison on the subject.

As the eventual recovery begins to take shape, many forecasters worry about inflation. In our view, inflation is a distant concern that should not occupy us at the moment. The expanding output gap combined with the collapse of securitization and related derivative products are, at present, more powerful forces than the expansionist monetary and fiscal policies that could exacerbate inflationary tendencies. This, among other things, supports our continued focus on investment strategies that emphasize the identification of recurring free cash flow and a history of intelligent free cash flow allocation.

Yield has always mattered, but never more so than now. In a recent study by CSFB and Elroy Dimson of the London Business School, it has been shown that, over the past 100 years, equity returns averaged six percent per year, with over 70% of those returns coming from dividends.

In the future, it will be dividends combined with the successful reinvestment of incremental cash flows that will determine equity returns. The days of expanding P/E ratios (the 1980s and 1990s) are long gone, as interest rates (certainly Treasury rates) are more likely to rise than fall over the coming period, thus placing pressure on P/E ratios[2].

Going forward, here is our advice:

1. Focus on companies with low financial leverage and high liquid asset ratios. In other words, balance sheets matter.
2. Emphasize dividend yield and dividend growth.
3. Avoid firms with high operating rate levels, low barriers to entry, and poor elasticity of demand indicators.
4. Beware of financials as long as a deflationary environment exists. In this sector, liabilities and asset write-offs will expand faster than stockholder's equity.

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[2] Interest rate and P/E ratios vary inversely with one another. Over time, the relationship possesses a correlation coefficient of -0.8.

In conclusion, it is important to reiterate that while we are not calling a bottom, we are suggesting that current dividend yields plus a long-term real growth rate for the global economy of 3% implies 6-7% growth before inflation. While this rate of return may look poor compared to the 1980s and 1990s, it is certainly better than the past 21 months, especially when we keep in mind the fundamental characteristics of equities. Over time, equities capture the effects of productivity gains, and even inflation: two things that cannot be said for bonds.