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LETTER FROM THE PORTFOLIO MANAGERS

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Has The Flight To Quality Landed?


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Despite plenty of negative economic and earnings reports in recent weeks, coupled with extremely bearish investor sentiment from a month ago, April ended up being the best month for the S&P 500 stock market index since December 2003. And for some of the troubled, lower credit-quality fixed-income market segments it was the best month since April 2003. As our Manager of Fixed Income, and bond guy extraordinaire, Chris Keith mentioned in his monthly fixed-income report (see website), "The flight to quality theme of the past few months seems to have found an airport and landed, at least for now."


Rusty Vanneman

Has the flight to quality really landed? Ignoring price action for the moment and just looking at some basic fundamental statistics, that may seem hard to believe. Estimates for 2008 reported earnings growth dropped again in April (declining 5%) and they have now fallen nearly 25% since the start of the year! While stock prices have declined, too, earnings estimates have fallen more, so the forward P/E (price/earnings) ratio based on expected 2008 reported earnings has increased from 17x to 22x this year, with nearly half of that increase coming in April. Neither a drop in expected earnings growth, nor an increase in valuations, is the stuff that most people think big positive moves in the stock market would come from.

The markets, however, do quite a few remarkable things. For instance, when it comes to earnings growth, some of the best market moves begin with below-average growth rates (unless the growth rates are really negative). Conversely, some of the worst market periods occur when earnings growth is very strong. The reason for this seeming contradiction is that the market is always anticipating *future* growth and the likely direction of change from current conditions. As we have mentioned before in this space, the last decade has clearly been above-average for corporate earnings growth, but that hasn't translated into strong stock market returns which, instead, have been decidedly sub-par.

We reported last month that **investor** sentiment was very negative. In addition, **consumer** sentiment was also quite negative. It seems that if everybody hates the prospects for both the economy and the market, that it would be a good time to sell. Again, it's just the opposite. Historically, such strong negative sentiment has tended to mark a good time to buy. At the risk of sounding like a broken record (or should I say an MP3 that constantly loops), in fact (as regular readers of these "Letters" will not doubt remember), the *only* sentiment environment from which above-average stock market returns follow is when sentiment is very negative. All other environments, including periods with no sentiment extremes, produce below-average returns.

Where do we go from here? Well, we don't think the flight to quality has landed yet. Or should we say the flight to quality is not a non-stop flight. There is still more work to be done. One indicator that may suggest when the flight to quality has ended is something called the TED Spread.

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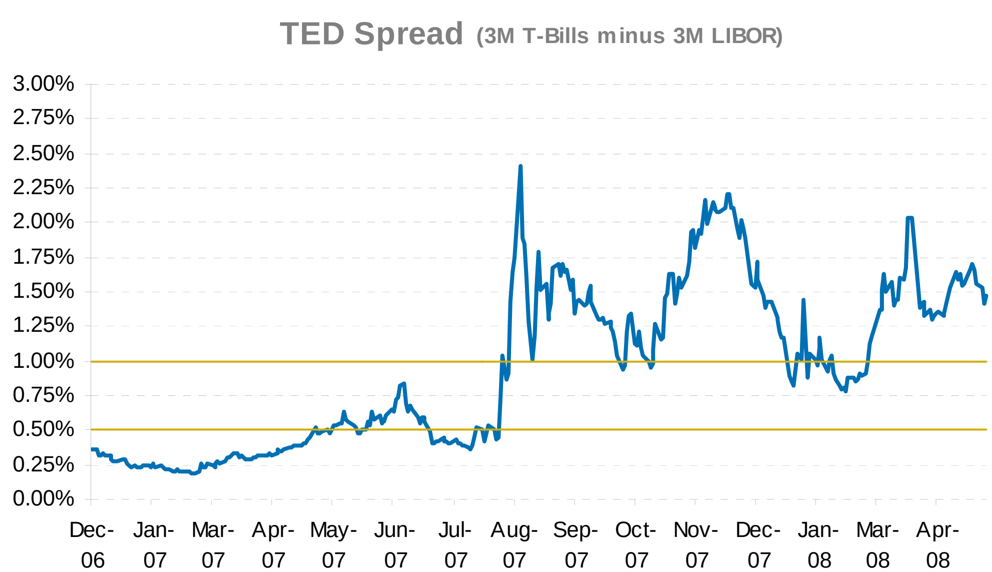
TED Spread

Technically, the TED spread is the price difference between three-month U.S. Treasuries (the "T") and the three-month futures contracts for Eurodollars (the "ED") of the same expiration months. Eurodollars meanwhile, are U.S. dollar-denominated bank deposits at international branches of American banks or at foreign banks themselves. As the physical location of these deposits are outside of the U.S., Eurodollars avoid Federal Reserve Board regulation. Therefore, they offer a slightly higher interest rate due to a slight uptick in perceived credit risk (note: Eurodollars can be bank deposits anywhere in the world outside the U.S.; they don't have to be in Europe).

On the expiration of a Eurodollar futures contract, the contract is valued using the current 3-month "Libor" (London Interbank Overnight Rate). Libor meanwhile, is arguably the most widely used short-term interest rate benchmark in the world. It is calculated by taking the average of the short-term interest rates the world's most credit-worthy banks charge each other to borrow money in the London Interbank market. Given the connection between Libor and Eurodollars, many TED Spread charts often just compare U.S. Treasuries to Libor (like we do at Kobren).

When economic and liquidity conditions are stable, watching the TED spread is typically as uneventful as watching paint dry (I should know – I used to be responsible for analyzing and trading it). Then again, when conditions are not stable, the value of watching the TED Spread comes into play, as it can be used as an indicator of over-all credit and liquidity risks within the global financial markets. If the spread is rising, it is often an indication that market participants are very concerned about credit risks and that market liquidity is typically drying up as a result. Bottom line, when the TED Spread is widening, it is generally not a very good environment for risky assets, including the stock market.

See the chart below. The TED Spread was pretty well behaved up until last summer. It was trending ever so slightly higher early last year, which was a signal in itself, finally crossing 0.5% last May. It was about that time problems really started to show up in the financial markets. While these problems originated in the fixed-Income markets, they obviously spilled over into the stock market and broader economy — as could be expected. It should be noted that the S&P's price level was 1531 at the end of May. (It is currently around 1400.)



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The TED Spread is one of several indicators we look at when it comes to assessing the Liquidity conditions in the marketplace. As long as the TED Spread stays elevated, we will remain concerned about liquidity conditions in the marketplace. We would like to see a sustained drop back below 1%, and preferably to see the spread back beneath 0.5%.

Sell in May, Go Away?

There is an old saw that when it comes to the stock market: "Sell in May, go away." This refers to a seasonal period of weakness where stock market prices have a tendency to sag or stagnate this time of year. Some of it is blamed on summer vacations, while some of it is blamed on the strong seasonals that precede it, particularly with April typically being one of the stronger months (last month was no exception).

Though battle plans tend to change once the battle begins, it does seem to be setting up that the next few months could be sub-par. Earnings growth is still trending lower, valuations (at least price/earning ratios) are fairly high, the Federal Reserve is suggesting a pause in the easing cycle, the bickering and posturing of the political season continues, and there are the aforementioned liquidity conditions.

One thing the near-term outlook does seem to offer is continued volatility. Volatility tends to move in cycles and it appears we have moved back into a higher volatility period. Higher volatility environments often accompany inflection points in the economy when economic forecasts tend to be widely dispersed. This appears to be the case now. So, for the short-term trader (which we are not), the next few months could be rewarding if volatility does indeed persist and the volatility shakes thing up enough to create opportunities.

More importantly, however, for the long-term investor, if we indeed get a period of weakness, the coming few months should provide excellent entry points for increased market exposure. Look at it as buying stocks on sale.

Later this year, as we head into autumn, a more promising outlook seems to be shaping up. Seasonals will improve, the election will be over, earnings comparisons will be easier to beat and perhaps even valuations and liquidity conditions will improve. Again, battle plans can change a lot between now and then!

At present, we are satisfied with our portfolios. Though valuations on some of the riskier market segments are more attractive to us than they have been in some time, we continue to emphasize higher quality stocks and bonds. If the market follows the template we have just sketched out though, we would expect to start nibbling on more aggressive fare as the year unfolds.

Inflation

Lately, we have been getting lots of questions about inflation. We have also spent considerable amount of time in internal Research meetings debating the topic. Like most subjects, we can get some pretty good "discussions" going.

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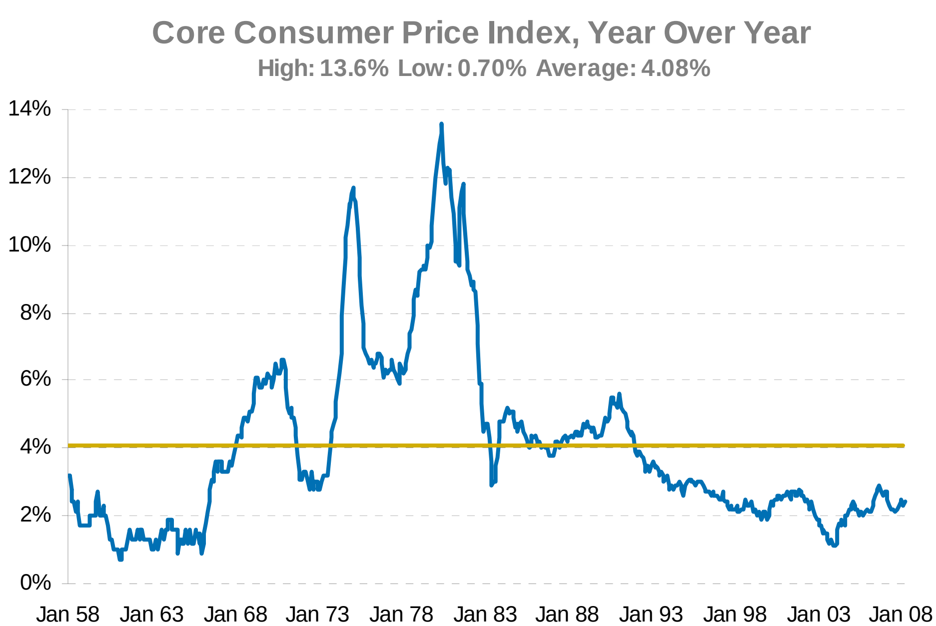
Filling up the car with gas and buying groceries has hurt lately. I realize that for some Americans, and for many people in other countries, the economic pain caused by higher food and energy costs is real. It is particularly painful for lower-income consumers as food and energy consume a larger share of their disposable income. In other countries, food and energy also make up a larger portion of their day-to-day expenditures. We are not debating that these are real, painful costs.

That said, in the aggregate, we don't think inflation is a serious problem – at least not yet. Whether we look at actual inflation numbers in the U.S., or more importantly inflation expectations, neither is particularly out of control. It could be that inflation is front of mind for so many people because: (1) prices are higher for our high-frequency (though relatively low dollar) purchases (such as milk); (2) it is the political high season and politicians need something to generate interest (angst!) and votes; and; (3), the media needs a steady stream of provocative news. That said, I did just pay more for a tank of gas than I ever have before. How can I not be at least a little worried?

Before we talk about why inflation is not a problem right now, let's first talk about why the topic is so important. First, after nominal economic growth, inflation takes the stage as the most important economic statistic. Growth, of course, is the most important because without economic growth there isn't increased wealth, employment, and opportunity. Once growth is in place though, a stable price environment is critical. The key word is **stable**. A stable pricing environment is more conducive for encouraging economic decision-making and risk-taking, which in turn generally spurs economic growth. Unstable pricing conditions, however, whether it is high inflation or even deflation, discourages this behavior, which in turn suppresses economic growth. Inflation is also destructive to financial market valuations - as interest rates rise, stock market valuations tend to get depressed. In short, worrying about inflation is exactly what investors should do.

Why do we think that aggregate inflation is not out of control? Let's first review the latest Consumer Price Index (CPI) numbers. Headline CPI (which includes food and energy costs) is 4.0% year over year, though the last three months of data annualized is 3.1%. Core CPI (which strips out food and energy) is 2.4%, with the last three months annualized at 2.0%. While there is much academic debate about this topic, and while I recognize we eat food and drive cars, the core CPI is generally considered the best measure of actual inflation **over time**. See the chart of core CPI (right). In short, inflation doesn't really seem to be a problem at present:



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More important than looking at historical economic data though, is looking at the "inflation expectations" embedded in the markets. Remember that the markets are attempting to discount the future, not to reward the past. Currently, one can look at "inflation expectations" in a variety of ways.

First, one can examine the yield spread between Treasury bonds and Treasury Inflation Protected Securities (TIPS) of the same maturity. The difference is the "break-even yield spread." If actual inflation comes in above this spread, then TIPS are a superior investment, and vice versa. Technically, this is an oversimplification of the relative valuation between TIPS and nominal Treasuries, but it is an approximate estimation of how billions of dollars are invested in anticipation of what will happen regarding future inflation. In other words, this isn't a sound bite, but a bet with cold hard cash. Looking at the chart below, the break-even spread over the next 10 years is approximately 2.3%. This number has been relatively stable for some time.

Another way to examine this is to look at "inflation swaps." These swaps are over-the-counter and exchange-traded derivatives that are used to transfer inflation risk from one counterparty to another. Looking at these swaps for the next 10 years, the current range of implied inflation forecasts are between 2.2% and 2.6%, with the near-term expectations being a bit higher than those 10 years out. Again, these markets have been fairly well behaved.

Break-Even Inflation Spread:
10-yr Nominal vs. 10-yr TIPS

Besides, let's just get to the best economist forecast of all – the Treasury market. Treasury prices, given their assumed lack of credit risk, are primarily driven by inflation expectations. While shorter maturity bonds are heavily influenced by Fed policy, the longer maturities are mostly determined by inflation expectations. (Given that part of the Fed's mandate is to promote price stability, it could be argued that inflation expectations also drive the short-end. But in our view Fed policy has a tendency to be more

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reactive than proactive and tends to lag the signals sent by longer-term bonds.) Currently, 10-year Treasuries are yielding less than 4%. With core CPI at 2% that means the real rate offered on Treasuries (their nominal rate less the inflation rate) is approximately 2% – which is below the long-term real rate average of 2.5-3%. The drivers of real rates, again the topic of many papers, include many things besides expectations about inflation. But with real rates below long-term averages, it doesn't appear that this tremendously huge and liquid global market is currently extremely concerned about inflation.

Besides, just thinking about the current economic situation, what should the expectations be for inflation? Do lower residential real estate prices, lower consumer net worth, low consumer confidence, and the de-leveraging of consumer balance sheets encourage spending? And, if the economy is getting weaker, will companies have increased pricing power? Will workers be able to demand wage increases? It doesn't seem that many companies are able to pass on rising costs due to inflation.

But what about the signal from surging prices in the commodity markets? Good question, but we think that much of the recent move in commodities is more about the weakness in the dollar, financial market stress, and heightened interest from investors (ranging from short-term momentum players to more "sophisticated" long-term investors diversifying into alternative asset classes), than it is about inflation.

If we are not that concerned about inflation, then what is the value of holding securities that have inflation-hedge aspects, such as TIPS? We are big believers in TIPS, and hold them in many client portfolios (depending on their risk profiles). TIPS are attractive as they are increasingly being seen as one of the **ultimate anti-risk assets.** While many financial advisors and planners emphasize their inflation-linked return as central to their safety, this emphasis is misplaced. First and foremost, TIPS are *high quality* Treasury bonds with no credit risk. The fact that they also have an inflation protection feature – basically some embedded insurance – makes them even more attractive than nominal Treasuries (particularly if TIPS are priced right). Besides, the inflation protection is nice to have – in case we're wrong about inflation!

Sincerely,

Eric

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