
Research Perspectives

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Yes, But What About...



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In our February Portfolio Manager Commentary, we surveyed the list of risk factors that we considered important for the stock market. In this report, we will also address some of the various concerns that many investors have (some of which don't disturb us, at least not yet). Please note, however, we do recognize that virtually each concern addressed below is worthy of an entire report, not just the paragraph or so (for the sake of time and space) that we have dedicated to it for now.

Outside of the five factors that we monitor (The Equity Five Factor Model can be found at www.kobreninsightmanagement.com), there are clearly numerous additional factors which have put many investors ill at ease with the stock market's potential this coming year. We think there is legitimacy to some of these factors, although we also think some of the concerns are overemphasized.

A common concern among many sidelined investors is that there are simply too many different opinions on the market, and just **not enough clarity** of future conditions. Then again, this is always the case; there will always be uncertainty and concerns. However, one certainty regarding the markets is that investors often pay a high price in waiting for perceived comfort and a "cheery consensus."

The biggest concern for many investors is the level of **federal debt**. *We agree this is a problem.* Increased debt, and the expected deleveraging that should come afterwards, will most likely translate into lower economic growth down the road. Given the stimulus that is still expected to come into the market this year it may not be a near term problem, but eventually it will become an issue. With President Obama's February 1st announcement regarding the \$3.8 trillion budget for fiscal year 2011, the federal budget deficit is likely to reach a record \$1.6 trillion in 2010. In addition, the problem seems to be getting worse, as federal spending will now represent a new post-World War II record of over 25% of GDP, rather than being closer to the 40-year average of 21%, a number seen as recently as 2008. Using the assumption of higher economic growth, it is also notable that even a few years down the road, federal spending will still be 23% of GDP; the federal government is getting bigger.

That being said, there are some mildly offsetting factors that should take a bit of the edge off. First, with the economy expected to improve, it's likely the deficit will contract; a rising economy raises tax revenues while lowering countercyclical discretionary spending. While a rising GDP won't be enough, it should make the overall picture a little less ugly. A second item to take into account when evaluating debt levels are the ratio of debt to assets in addition to the ratio of debt to income, much like a bank would look at when evaluating a borrower. According to the latest (which is a bit stale) White House's Office of Management and Budget (OMB) report, "Analytical Perspectives of the Budget of the United States for 2010," it noted that the trend for federal debt/assets has actually been in decline over the past fifty years, from 10.3% in 1960 to 6.5% in the latest report.

Third, and perhaps most significantly, it should be noted that the recent Senate election in

Massachusetts, where Republican Scott Brown pulled off one of the state's biggest upsets in its political history, really could be as significant as the breathless pundits made it out to be. While it would still take an overwhelming landslide in November for the Republicans to gain a majority in the House, thereby controlling the legislative agenda, the Democratic Party losing a 60th senator does appear to reduce momentum for an expanding federal government, as both the popular and political momentum is shifting back toward less government, not more. This also appears to lower the odds of major **health care** reform and **cap and trade** legislation being passed, at least in the near-term. While ideologues, especially those in power, may disagree, gridlock in Washington is often considered a good thing for the economy. An example that some cite is the gridlock that occurred during the Clinton administration between a Democratic White House and a Republican Congress (elected in 1994). Some feel that each party was kept in check during this time, which in turn contributed to a budgetary turnaround.

Still, there is a concept that the U.S. economy will move into "**The New Normal**," which refers to the idea that we will experience lower overall economic growth in the years ahead due to higher taxes, more regulation, and less globalization. It is hard to refute this. Higher taxes generally translate into lower growth. More regulation, while often good politics, is generally not good economics. In addition, trade wars, which may benefit specific groups at times, are rarely good for the global economy. While these are factors that concern us and bear monitoring, a "New Normal" does not necessarily mean poor returns from the stock market in the years ahead. Various studies have shown that starting valuations are often more significant drivers of intermediate-term market returns than economic growth.

When it comes to government policy, one cause for concern is the **bank tax** the administration is considering placing on major U.S. banks, which have been viewed as the primary beneficiaries of the recent bail-outs. While politically popular, this is a slight negative in our book because it's another tax, but only slightly so because it's not necessarily a large tax. In the end, even though there might be some satisfaction knowing the banks were used as scapegoats and that they paid a price, in reality, they will likely pass this tax onto consumers.

Also, the debt problem in the U.S. isn't just about the government, it is also about **consumer debt**. In some respects, this could be a bigger problem than the federal debt. However, the situation is clearly improving as consumers are saving more, spending less and reducing their debt levels. The personal saving rate is just under 5%, versus a low of less than 1% in early 2008. The over-all financial obligations of households (which is debt service plus car leases and rents), relative to after-tax income, is back to its lowest levels since mid-2000. More work is definitely required to continue repairing consumer balance sheets, and while this will likely represent more of a challenge than an opportunity to the over-all economy, the situation is improving.

Commercial real estate remains a favorite concern of many, noting a parallel to the problems that began with residential real estate a few years ago. This concern is legitimate, but also overstated in our opinion. Commercial real estate tends to lag the rest of the economy, and additionally, the overall debt in commercial real estate is only a fraction of what it was for the residential market.

Poor **lending conditions**, when banks are not lending, is a leading worry. The January U.S. Senior Loan Officer Survey, however, revealed that no large banks reported tightening

conditions between October and January. While only a small fraction actually reported easing, it was still the best report for lending conditions since May 2007; the tide may be turning.

Many investors cite that **European debt** is the key problem for global markets. While there are multiple sovereign credit risks coming out of Europe, the one gathering the most attention is Greece. Though officials state that: “There is no bailout problem, Greece will not default. In the euro area, default does not exist,” many investors are not so sure. Many investors wonder if this debt problem can really be contained or if it will eventually blow up and take other markets along with it. While this indeed may be a problem in our opinion, we also recognize that we have seen multiple crises in recent decades and yet somehow the global economy and markets march on. One interesting note on Greece is that according to a recent weekly John Mauldin article (which actually is a bearish take on the situation), Greek debt has been in default in one way or another for 105 out of the past 200 years. A debt problem in Greece isn’t something new.

Another potential concern is **China**. While many investors think that the China story is actually a positive one for the global markets, we have our doubts. The Chinese stock market peaked last summer, their real estate market is arguably overheated, and interest rates are starting to rise. The over-all growth story appears intact as GDP continues to impress, with China on track to become the world’s second largest economy by the end of the year (passing Japan) if the current growth rates continue. That said, valuations may already capture these growth expectations. In other words, the good news is already baked in; the question is what happens when economic data starts to disappoint, which is likely given that 10% GDP growth rates are rarely sustainable. In addition, this valuation problem isn’t specific to China, as many emerging markets are no longer attractively priced.

Some say that their primary concerns are **geopolitical**, citing Middle East tension, terrorism, trade wars, or U.S. relations with emerging economies as possibly having a negative impact on the stock market. Recent press regarding the U.S. providing ballistic missile defense (BMD) to four countries on the Arabian Peninsula makes this a worthy question. Nonetheless, geopolitical stress is hard to quantify, especially when it’s in a wait and see mode. Besides, it’s not as if the U.S. has recently embarked on a radically different policy regarding the Middle East. As Stratfor Global Intelligence states, “In the end, Obama has followed the Bush strategy on Iran — make vague threats, try to build a coalition, hold Israel off with vague promises, protect the Arabian Peninsula, and wait — to the letter.” Still, an external geopolitical shock would concern us.

What about **unemployment**? A common view is that if people don’t have jobs, how can the economy and the markets recuperate? While we all have experienced, either directly or indirectly, the pain of the current unemployment situation, the reality is that the unemployment rate is a lagging indicator for the economy. Given that the stock market is a leading indicator for the economy, there can often be extremely significant lags between turning points in the stock market and the unemployment rate. As citizens and neighbors we are concerned about unemployment, but not as investors.

Some investors worry about **inflation**. Some worry about **deflation**. They are both right, as either scenario would be problematic. What the market really likes is price stability; when inflation is low and steady, the market is able to support higher stock market valuations. However, when there is markedly higher inflation, valuations tend to deflate, and when there is deflation, valuations deflate even more. Price stability threats should always be monitored by

investors, but with ten-year break-even spreads between ten-year Treasury Inflation Protected Securities (TIPS) and ten-year nominal Treasuries at 2.3% at the end of January, inflation expectations are currently well behaved and arguably in the sweet spot.

What about a weaker **U.S. Dollar**? While many are nervous about a fall in the dollar's value due to our current economic and political environment, we do not share this same level of concern. There are several reasons for this, which were articulated in our letter last month. Bottom line, even if the dollar does weaken, that doesn't mean the stock market has to weaken. In fact, there has been an inverse correlation over most of the past few years between the dollar and the stock market.

We still hear that the market has come "**too far, too fast**" and needs a breather. This may be the case, but despite that, many data series are back at levels seen before Lehman Brothers went bankrupt in September 2008, the stock market is still over 10% below those levels. It's also hard to say that the bull market is mature, given that the duration and magnitude of the current bull market is still far shy of the average. While the early stages of bull markets typically have the biggest gains in the shortest amount of time, this doesn't mean that the gains can't continue, even if the market becomes choppy.

Some people are concerned about the market's performance in **January** and its effect on performance during the remainder of the year. Some investors maintain that the market's performance in the month of January is an indicator for how it will perform during the rest of the year. Given the market lost ground in January, the thinking goes that the market will therefore trade lower throughout the rest of 2010. While we'll admit we like to review seasonal tendencies, we don't put as much stock in this particular effect; it's like saying a team that scores first in a game is most likely to win. While that is probably statistically correct, I would prefer additional information to forecast an eventual winner.

Lastly, we often now hear that "stocks are a poor long-term investment" and as proof many cite the **negative 10-year stock market returns** for the S&P 500. While stocks have indeed lost ground over the past ten years, this does not prove that stocks are a poor long-term investment moving forward – it simply shows how massively overvalued the stock market was a decade ago. Those high valuations from ten years ago clearly suggested below-average returns (though not necessarily negative returns), and low returns should have been expected. Now, however, the market is priced to roughly deliver average returns in the decade ahead. Additionally, this is occurring during a time when cash and government bonds are currently priced to deliver below-average returns in the coming years. Based off current valuations, the long-term investor should not run away from the stock market due to its recent historical returns.

Sincerely,



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