

Investment Update



May 2009

Green Shoots — Tulips or Garlic Bulbs?

Ah spring! As a transplanted West Coaster, a true joy of living in New England is witnessing new life that spring brings. Watching new shoots rise from the ground, opening as crocus, daffodils, hyacinth or tulips, is an amazing thing. Occasionally, rather than the early spring Emperor Tulips, new growths stem from wild garlic bulbs, marring an otherwise pristine garden. While my wife accuses me of having the motto "When in doubt, rip it out," if left unchecked, these little suckers can take over a garden!

So are the green shoots, (recently mentioned by Fed Chairman Bernanke) which are now appearing in the economic garden, the real thing? We think so. In last month's *Update*, our headline was "Less Bad — The New Good?" We continue to believe this to be an apt description of recent improvements. Sufficient signs of relative improvement have relieved fears that the economy might slide into depression. The most recent Federal Reserve Beige Book, which periodically gathers anecdotal data on current economic conditions in the various Fed districts, paints a picture of continued economic challenges though one in which negative forces appear to be moderating. While retail sales remained "sluggish," the report indicates that some districts reported slight improvement. Most notable were indications that factory activity may have stabilized and that orders and sales of high-tech equipment have firmed somewhat. We have seen modest decreases in initial unemployment claims, a possible stabilization in housing

inventories and improvement in other leading indicators. These, coupled with signs that the financial sector also may be beginning to stabilize, has resulted in the "less bad" data improving investor sentiment and has given rise to a significant stock rally. Investors mostly have moved away from fears of a depression or widespread bank nationalization.

Investors frequently are caught off guard by rallies such as the one we are now experiencing. They extrapolate bleak current conditions (such as those in early March), and fail to consider possible catalysts for future improvement. In the case of the current rally, these catalysts first came from improved clarity and tone in the banking bailout and traction from prior policy initiatives. On the heels of these signs, fuel for improvement came from a number of events, including lower mortgage rates, the surge in refinancing, lower gas prices, tax refunds and improvement in credit conditions.

The recent market move is a reminder of a point we have mentioned in the past. Those who wait until it is clear to everyone that the economy has recovered risk missing a large portion of an equity rally. Points of maximum uncertainty and fear typically offer good entry points. However, to take advantage of these "opportunities," investors must understand their risk tolerance, their long-term goals and how much and when they might commit additional funds. While it is very difficult to add to equities when all appears bleak, when viewed in hindsight, opportunity is usually greatest during these times.

Only after the fact are market bottoms clear. They are a process rather than an event. Even now, we are not ready to sound the all clear. There has been recovery from the extreme negative sentiment that pushed the market to very low levels. Even with the recent advance, we believe that valuations remain attractive, especially relative to other investment alternatives. We have been encouraged by investors' willingness to take on some degree of incremental risk levels in their investment decisions. The challenge is that markets have rallied on these early signs of economic stabilization and improvement in credit markets. A slower rate of economic decline will not remain enough to improve the earnings outlook in 2010. In order to fuel further advances, we think that indications of sustained improvement will need to be demonstrated.

No Stop Signs

New England traffic planners have a distinct fondness for traffic circles. Compared to stop signs or stop lights, I'm sure they keep the flow of traffic moving better. However, to describe these interchanges as confusing to newcomers would be a gross understatement. The concept of "merge" simply does not exist for Bostonians.

If you hesitate even momentarily, you shut out of any opportunity to enter the roundabout. Meanwhile, increasing numbers of horns sound behind you. When I see someone in this predicament, I reminisce about when I too held up traffic. But don't get me wrong; I still start honking after 1/10th of a second, just like everybody else.

Unfortunately, another area that appears not to have stop signs is our growing Federal Budget deficit. In the face of a consumer deleveraging process, which is likely to last for an extended period, and due to economic impact from the financial crisis, it is appropriate for government spending to offset the spending shortfall created by the massive decline in consumers' balance sheets (which can be attributed to the concerted decline in stocks and home prices). Without government spending, a turnaround in economic activity would otherwise be much further in the future. The monetary and fiscal policy response has been unprecedented. While we are confident that the Fed will be able to reign in money supply growth to forestall future inflation current monetary policy might engender, once economic growth and credit demand revives, we are less sanguine about the impact of fiscal policy. Even prior to the current severe recession, the U.S. was running a sizable deficit. As the stimulus bill is enacted, government expenditures are set to rise to a 30-year high.

To be clear, we do not expect inflation in the near-term. Given the very large amount of slack in the real economy from unemployment, excess capacity and downward price pressures from imports, deflation will remain the greater risk well into 2010.

However, looking further out, we are concerned about the impact of structural budget deficits. Even with aggressive tax increases and future spending cuts (the likeliness of this we find quite dubious), the level of the deficit is likely to remain high compared to historical levels. A large increase in the issuance of Treasury securities will likely be necessary to fund these expenditures. Optimistically, future economic growth will allow tax receipts to rise and facilitate lowering the deficit and repayment of the debt. We are skeptical that growth alone will allow us to reduce the budget deficit; our view is that economic growth, while likely to gradually recover, will remain muted.

As such, interest rates, pressure on the U.S. dollar and future inflation all have the potential to be higher than investors currently expect. Because of deflation concerns and the very weak economy, valuation for asset classes that may perform better in a possible future reflationary environment such as commodities, emerging markets and TIPS (Treasury Inflation Protected Securities), appear attractive to us. Our view is that investors may benefit by considering such investments in the form of potential diversification and inflation protection. At the very least, we would recommend structuring a portfolio heavily tilted toward a deflationary outcome.

While early signs of improvement and progress encourage us, we believe that investors will need to remain disciplined and prepare for ongoing volatility. The current environment has no playbook and policy response by necessity is ad hoc. We have never been here before. As we have commented previously, the changes on the investment and economic landscape are likely to be long lasting. If you water your garden with a fire hose, you are sure to give it a good soaking, but you are likely to alter the terrain in so doing.



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