VIRGINIA GLOBAL
Asset Management, LLC

409 Yarmouth Street, Norfolk, VA 23510
P 757.962.7976 www.virginiaglobal.com

# THE VIRTUOUS CIRCLE RETURNS
# INVESTMENT STRATEGY
# JANUARY 12TH, 2012

We remain optimistic about the prospects for the stock market in 2012. The fears that caused Wall Street such consternation last year should steadily wane, and with that should come increasing confidence in the US economy and its stock market. The fears that remain are already priced into the S&P 500 that sells at about 12 times expected earnings plus or minus. Here are the fears and our developing views on them:

## Europe:

Conclusion: The European Currency Union will not come apart; Italy will not default, and probably will not even require a restructuring of its bonds as Greece does.

We expect Greece to restructure its bonds, but they do have some difficulties facing them as many of the hedge funds holding their bonds also hold credit default swaps (cds's) (a kind of bond insurance) that are not payable if the restructuring is voluntary. If there is a default, however, the underwriters (translate banks?) become liable to pay on their CDS's. We suspect, that Greece will obtain the necessary super majority (75% of bond holders) and will force the remaining holders (translate hedge funds) to go along. Greece may get sued, but it will be years before there has to be any further payout, if a court grants such relief at all.

Spain, already a worry, may become the next primary focus of concern. Even though it is further along the austerity curve, it is only beginning to tackle its massive housing bubble which leaves it with a vulnerable banking system and economy. To a large extent this is already priced into financial market valuations. Nonetheless, the Europeans, are working towards, and in our judgment will, in the end, deal with and solve most of their problems. This period will become known as the "third major step" towards European unity, and Angela Merkel will become known as the "Second Iron Chancellor."

The Europeans have already arranged for more than adequate capital to meet the funding needs of the PIIGS (Portugal, Italy, Ireland, Greece and Spain) for 2012 and 2013. They have accelerated the implementation of the European Stability Mechanism (ESM) from July, 2013, to July, 2012. It, combined with the current European Financial Stability Fund, will have Eu 500 billion to deal with the sovereign debt funding needs. They also have provided the IMF with an additional Eu 200 billion facility which, with the IMF's current Eu 300 billion set aside for European assistance, will provide a total of Eu 500 bilion for the IMF, and a total of Eu 1 trillion to help any European country get through its funding crisis.

By our calculations the PIIGS have about Eu 625 billion in bonds and short term paper coming due during 2012. If no local buyers participate, this uses up a substantial portion of the available funds. However, local purchasers of sovereign debt, short and long term represent at least 50% of the demand for these funds, and thus the funding requirement is a much lower drain of Eu 300 billion.

Furthermore, the "big bazooka," i.e. the Long Term Refinancing Operation, has in fact been provided by the European Central Bank (ECB) with its three year lending facility in unlimited amounts to the banks of Europe. Eu 489 billion was utilized by the banks in December, and initially was put on deposit with the ECB. Because they can use sovereign debt as collateral for these loans, some of the selling pressure on this debt has been alleviated. This loan facility guarantees that the banks will be able to meet any withdrawal demands from their customers, and will be able, if they wish to make additional investments and/or loans to business and consumers.

For the moment the banks have secured their cash needs – at a minimal cost of 1% - but there is evidence that banks are beginning to draw down these funds and are investing in their own bonds which are selling at substantial discounts. In so doing the banks are improving their equity capital positions. In addition the repurchase of their own bonds lowers their interest costs, improves their earnings, and again reinforces the positive shift in their capital position. Also, there is some evidence that the banks are buying the sovereign bonds at much higher yields, thereby earning the difference in the loan cost and interest earned. Finally, there is also some evidence that institutions are beginning to return to the sovereign markets as investors. As a result the Italian bond auction today went very well.

## Italy:

We note that Italy, with the 3rd largest bond market in the world has been of particular concern to the financial market place. We have been somewhat less concerned because a bit over half of the bonds are owned by Italians which suggests that of the approximately Eu 400 billion coming due, i.e. to be rolled over this year, only Eu 200 billion might need to be funded by the EFSF etc.? But more importantly, the technocratic administration of Sr. Monti is putting legislation into place that should create a more competitive, more profitable, and more fiscally sound Italy.

## Spain:

Spain's outstanding government debt is much smaller than Italy's and is less as a percentage of its GDP. It is also further along the curve of making intelligent changes to its laws to make itself more competitive and more fiscally sound. Nonetheless, like the US and the UK, it has had a significant housing bubble which it is only beginning to sort through. At some point, Spain and its banking system may become the primary worry of financial markets, but it is difficult to say how much additional concern it actually will generate.

In general, however, the austerity measures are resulting in recessionary conditions in Europe which will detract from US growth. The decline of European markets by 15% to 20%+ last year reflects the expectations of recession there. The critical question is how long the European recession lasts? With so many countries cutting spending, with so many banks cutting lending (to improve their balance sheets), **the recession may last longer than most anticipate because of an adverse (vicious as opposed to virtuous) cycle.** Cutting spending causes contractions in economies which causes government deficits to increase as a per cent of GDP which then requires further cuts in spending and the cycle repeats itself until other factors produce an improvement in the economy. We are pleased to see the first signs of European concern with creating growth and flexibility!!!

The treaty changes and austerity measures taking place help Europe in several ways: they lower government cost structures, improve the flexibility of labor, and tend to reduce the differences among countries in their relative competitiveness. In turn this allows for a more uniform "European" as opposed to individual country oriented policies.

## Greece:

Greece is going through its bond restructuring process right now, and while its negotiations may cause some further consternation in the sovereign bond as well as stock markets, we expect it to be brief.

It is offering 15 cents on the dollar in cash and 35 cents on the dollar in the form of new 30 year bonds to arrive at the agreed upon 50% haircut. The key question will be what interest rate is required to make the deal as promised? It would appear that Greece is trying to orchestrate a 60%-70% haircut instead of the 50% agreed upon last fall.

## Other European Countries:

With the onset of recession, other countries may find themselves in difficulty, but their funding needs are much smaller.

Standard & Poors, Inc has indicated that it may lower the bond ratings of France and other key countries, which may affect adversely the yield required on ESM and EFSF bonds. The downgrade is largely priced into financial markets already.

## China:

With the slowdown in economic growth, inflation is subsiding. Further slowdowns are anticipated as the exports to Europe decline in the wake of their recession. As inflation subsides (it is now about 4% year over year versus 6% several months ago, one can expect the Chinese government to lower interest rates, and further, a domestic stimulus package is already in the works to strengthen and continue the restructuring of the economy.

## The US:

No recession here! as we have noted consistently despite other investor fears to the contrary. That is clear for now, but the fears will arise again as slower growth in China and recession in Europe hurts our exports and corporate profits. The slowdown in Europe is likely to cost about 1% in US GDP growth this year. Further, we are not sure yet whether the improvement in the new housing activity for the last three months is due to warmer than usual weather or if it represents a genuine recovery in housing. If it is a genuine recovery, then our employment should continue improving and the self-reinforcing cycle of more employment, greater demand, more employment etc. of our virtuous circle will continue.

## Financial Market Valuations:

The S&P 500 was flat in numerical terms last year, i.e. it started and ended the year at 1257! In fact however this represents a significant decline in valuation because the earnings rose from $83.80 in 2010 to about $97 in 2011, a 15.5% gain in earnings which means the trailing 12 month price earnings ratio declined from 15 to 13, a 13% decline in valuation using 12 month trailing earnings. Valuations were not flat at all!

Looking at p/e's on a forward basis (assuming market prescience), valuations have declined from a 13 p/e to an estimated p/e of 12 or an 8% decline as the S&P's earnings are expected to rise to $105.00 and perhaps more this year.

Partly as a result of the continued bearish mood in the United States – institutional and individual expectations for a financial market crash are almost equal to the expectations in March of '09. To us, this is a contrarian indicator, and we anticipate some further rise in the US stock market as investors continue to view the US as the safest and best performing market on a relative basis. This should produce a stronger dollar as well without necessarily hurting commodity prices.

Given only a 5%-6% improvement in S&P 500 operating earnings this year, we can still foresee an improvement in the S&P 500 to 1450 to 1500 – if investors become confident enough to raise the p/e on stocks to only 14 (from the current 12). The historical average is 15!

Our thought is that the continued difficulties in Europe for the next 6 months might prevent our market from rising significantly, but as those difficulties subside, we could have a very nice run.

## What To Do:

Investors already recognize the recession in Europe and the slowdown in China. No doubt we will have moments of angst during the first several months of the year, but from here the change is likely to be better rather than worse. But for the moments of refreshed fears, we expect most investors will be focusing on the recovery in global growth during the second half of the year. As expectations for global growth rise, our infrastructure and cyclical oriented portfolios should do well as should the housing stocks. We remain fully invested and are looking for the moments of angst to add to portfolios where we have cash.

David R.Kenerson., Jr
Niklas K. Oskarsson