Virginia Global Asset Management, LLC
409 Yarmouth Street, Norfolk, VA 23510
P 757.962.7976 www.virginiaglobal.com

HOOF BEATS OF THE FOUR HORSEMEN?
INVESTMENT STRATEGY
OCTOBER 7TH, 2011

SUMMARY

Judging from the stock market's performance in September and the first two business days of October, many were hearing the hoof beats of the "Four Horsemen of the Apocalypse" referenced in our last strategy statement. Fears abounded as the S&P 500 set a new 2011 intraday low of 1074 on October 4th.

The fears were driven primarily by concerns that Europe was rapidly heading for a financial crisis similar to that in the US with the sovereign debt of the PIIGS the equivalent of our subprime mortgage debt. A Greek default would lead to declines in other sovereign debt, e.g. that of Spain and Italy so substantial as to bankrupt many of the major European banks. Investors feared a European financial crisis, combined with (fears of) an economic contraction in China, would lead to global recession. At 1074, the S&P 500 represented a greater than 20% decline, not far from the average market decline from peak to trough during past recessions.

There is no way the Europeans are going to let Greece or anyone else default until they can afford it, i.e., until their banks have sufficient capital or another solution has been engineered to avoid bankruptcy or a substantial loss of capital. Rather, the Europeans are working on a facility to add capital to their banks; they are also working on leveraging the European Financial Stability Fund to provide $2 trillion with which to support the various bond markets that to a large degree have already shut down making it difficult to fund government operations/deficits while economies recover.

As a result we expect a non-bankruptcy/default workout, probably based on a voluntary exchange program for the bonds of Greece, and perhaps the same for the others in difficulty. In the meantime, Greece will get its payment due in October, now postponed until November.

The slowdown in China is just that, engineered to reduce inflationary pressures, and unlike many, we do not expect a hard landing (recession = 4%-6% growth). However, policy there increasingly will be focused on stimulating domestic demand rather than exports while its two largest export markets (Europe & the US) recover.

We are more sanguine than most about the possibility for some stimulus and tax cut measures in the US as the incumbents of both sides want re-election. Tax and Medicare reform probably get left for post election treatment. Furthermore, while we do not expect much on the housing front, the deleveraging of the consumer has largely been forced, and thus, we expect good Christmas sales and consumer spending in line with income growth of 2.5%-3%. In short we remain positive for the US and the global economy, and find stocks very modestly valued. The yield on the S&P 500 is greater than the 10 year bond – a true indicator of the fear and the value in stocks that exists today. Thus, we continue to hold our cyclical portfolio and are buying stocks where we have cash.

David R.Kenerson., Jr
Niklas K. Oskarsson

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Our view has been (see the last and prior strategy pieces), and remains, that there is no way the Europeans are going to let Greece or anyone else default **until they can afford it**, that is, until their banks have sufficient capital or another solution has been engineered to remove the impact of the losses on PIIGS debt on bank capital. The invitation to Secretary Geithner in mid September to meet with the European finance ministers suggested that he was indeed being called upon to share his experience with the US Government's TARP program in support of its banks.

Since that time several things have become clearer: the Europeans are working on a facility to add capital to their banks; they are also working on leveraging the European Financial Stability Fund to provide $2 trillion with which to support the various bond markets that to a large degree have already shut down making it difficult to fund government operations/deficits while economies recover.

Part of our confidence in the European banks has to do with the nature of the European countries themselves. In contrast to the US, in many cases European banks have historically been instruments of government policy. The ruling classes and the major banking families and/or banking policy makers are all members of the same private club. They don't/won't let one or more of their members fail. Thus, we look to each country's government to support its own banks, and it will be the task of the EU, perhaps the European Central Bank (ECB), to coordinate it all – even though that requires the cooperation of some 17 different countries. We think that it is partly for this reason, that Secretary Geithner said several times during an interview after his meeting with the finance ministers, that "there will be no Lehman" in Europe.

As for Greece itself, the "troika" of the IMF (International Monetary Fund), the ECB (European Central Bank) and the European Union Commission, appear to be working towards a non-default work out. In a nutshell Greece has about $500 billion in debt, about $400 billion in assets (e.g. utility companies, land, etc.), an income of $87 billion and payments of about $101 billion excluding about $20-$25 billion in interest. By insisting that the Greeks go cold turkey, and continue to cut expenses to balance their budgets, the Germans and the IMF are forcing Greece into a deep, long lasting recession that makes it harder for Greece to meet its balanced budget goals. While the wisdom of this is debatable, the flip side is that the Germans and the Europeans generally recognize the need to reduce Greece's debt load by default or otherwise.

The methodology, which ultimately may be used by all the PIIGS, will be to have a voluntary surrender of current debt for new debt of very long maturity (say 30 years) that has a very low interest rate, much lower than market rates today. In today's environment, the market value of these new bonds will be substantially less than their face value resulting in an immediate "haircut" of 20% to perhaps as much as 50% in value.

These bonds may be marked to market, and if so, losses will be realized by the holders, i.e. by the banks who can be expected to receive additional capital from their governments (?) to cover the losses. As Greece's economic condition improves, the bond prices should increase as well, allowing the banks to write back in profits offsetting the losses initially realized. However, while the banks may put these bonds into accounts that hold the bonds until maturity (so that no tax loss is realized), the accounts still run the risk of a default.

Other options are available as well, e.g. "Brady" bonds in which the Greek sovereign bonds are exchanged for assets owned by the government that can be privatized, e.g. a utility company. The benefit is a reduction in interest payments by the government, perhaps better management and profitability of the Utility, a reduction in Greek outstanding debt from the proceeds of sale as well as the exchange of bonds for shares in the company.

The point of all this is – there are solutions to the problems; one can see that the ministers are taking the problems seriously, and are finally doing something about it. The fact that the Europeans are recapitalizing their banks actually removes one of the levers Greece has had with the Eurozone – that allowing Greece to default would be as costly to Europe as it would be to Greece itself. Having said that, we suspect that the EU is nonetheless loathe to see a breakup of the European Monetary Union for geo-political reasons. The bottom line is **an eventual, probably voluntary (on the part of Greece and its creditors) restructuring of Greek debt all handled within the EU.** These solutions may then be applied if necessary to one or more of the other PIIGS.

Since it will take time to put this all together, we expect Greece, regardless of the findings of the "troika's" examination of its finances, to receive the payment due it by mid-October, but payment of which has been postponed until November.

Fear of a second financial crisis (starting with Greece) has been the primary depressant on investor psychology; fear of a second dip recession in the US, occurring on its own accord without help from Europe accounts for a large portion of remaining fears, although considerations such as recession in Europe, a hard landing in China, etc. exacerbate the first two concerns.

Were Europe to go through massive defaults by the PIIGS today, it would no doubt cause recession in Europe and hurt US growth as well because of the impact on trade and losses by US businesses on their European subsidiaries, etc. We do not expect a European wide recession although several of the PIIGS may experience a two quarter contraction as a result of the draconian attempts to bring their budgets into balance so quickly. Portugal, and Greece of course, are already there.

Part of our perceptions about European growth result from our view on China. China's growth is slowing as a result of deliberate measures by the government to reduce inflationary pressures. We believe inflation has now peaked as a result of the decline of oil, food, and housing prices. Because of the relatively slow growth in Europe and the United States, which are China's two largest export markets, we expect to see measures introduced to stimulate domestic spending and investment. In the meantime the market appears to have priced in a "hard landing" recession for China, i.e. 4%-6% growth for six months or more, which in turn would lower exports by Germany and Europe to China – slowing growth in the key European economies. While this argument is too simplistic in of itself, our overall view remains that Germany is not and will not be in recession this year or next nor will Europe as a whole although Europe's growth may come close to nil.

Thus, we come back to our original argument about the US - that despite Congress's ability to shoot itself in the knee – the US is nestled in a world of growth, slower growth than we anticipated, but relatively good growth nonetheless. Instead of 3%-4% growth for the second half of this year, we have modified our expectations to 2.5%-3.5% with some allowance for a softer number depending on our net imports.

In July and August, Congress scared the wits out of some about the availability of their paychecks and social security checks. The grandstanding behavior of both parties created the impression that we are at an ideological impasse, and that our government is just no good, incapable of coming up with intelligent solutions to our problems, incapable of compromise. The popular wisdom is that no compromise will be reached in November/December, draconian cuts will be instituted, and we will be headed for recession again if we are not already.

We are a bit more sanguine about the possibility of some action on the stimulus and deficit reduction front. While ideologically opposed, both parties are interested in re-election. Given the spending cuts already proffered by the

Democrats, the Republicans/Tea Party risk being blamed for inaction, and losing all the gains they made at the mid-term elections, and thereby losing more from a policy standpoint than they will by compromising. Thus, we expect some favorable action on employer payroll taxes, perhaps some stimulative measures, offset by some tax increases on the very wealthy. Major policy initiatives such as tax and Medicare reform will probably be left until after the elections, although simply aligning the availability of medicare benefits with normal retirement age would go a long way to reducing both Medicare and the future debt levels.

Whether this has a numbing effect on stock market performance remains to be seen.

As we have pointed out before in these strategy pieces, as long as the world perceives that we will deal with our debt in due course – and clearly the psychology of the population is behind doing so (as long as it is at the other guy's expense?) – the US will continue to be the reserve currency and a place of major investment interest.

US growth will gain substantially when housing and unemployment improves substantially. The US workforce lost 8 million jobs during the Great Recession. So far it has rehired about 2 million. Of the remaining 6 million jobs about *half are attributable to the construction industry.* New housing construction only represents 2% of the economy – in 2006 it was 6%. As it is so small, any change in it is relatively insignificant in terms of GDP growth.

However, the collateral benefits of a much improved housing market are considerable. While it may be another two, possibly three years before the glut of foreclosed homes for sale is erased, when it does happen, there should be a substantial increase in construction employment, and therefore, consumer income and spending; the rise in house prices should permit greater labor flexibility as owners can sell homes (no longer underwater) and move to better jobs. The implication is that **growth in the US must come from the consumer, investment, and/or exports**. As prices rise more homeowners will be able to refinance, thus improving their cash flow and spending.

This is an improvement to be expected later in the economic cycle. For now we are looking only for an improvement of the economy over its slightly better than recession level foundation with only 140 million (instead of 146 million) people with jobs.

Much discussion has been had about the continued deleveraging of the consumer. We have examined this issue and come to the conclusion that the bulk of deleveraging has been forced, i.e. by foreclosure and the closure or reduction of lines of credit by banks afraid of defaulting consumers. Also, the drop in automobile sales has contributed to the appearance of declining non revolving credit – **which at last has been rising for 14 of the last 15 months**. These two facts – that deleveraging has largely been forced and the expansion of auto credit cause us to conclude that the consumer is alive and well, and that consumer spending will continue in line with his income growth, i.e. 2.5%-3% - not a dynamic 4%-7%, but still quite satisfactory relative to current expectations. We expect Christmas sales to be 2%-3% above last year**, contrary to earlier expectations of others that sales might be below those of last year.**

We are most interested to see what will happen to the US trade balance. Improving economies elsewhere should facilitate exports. With corporations competing on a global scale, and with plenty of cash as well, we would expect continued growth in business investment. Finally, we note that the ISM reports for both manufacturing and services remain in positive territory, and leave us with the conclusion that we have been seeing a fear of recession which the statistics don't support. All in all we still look for US growth in the 3% range.

In conclusion our outlook remains positive for stocks globally. Investors have faced the abyss of another financial crisis, and the boil has been lanced by the recognition that the Europeans are facing up to their problems. As confidence increases that we are not going into a second recession, the stock market should rise further, perhaps to finally break out on the upside of its trading range between 1074 and 1225 on the S&P 500, and perhaps to go on to the heights we envisioned earlier this year, i.e. 1400+ on the S&P 500.

Given what we have been through, it may take a bit longer than year end to reach our target – but even so, it represents very substantial gains from here – 1160 on the S&P.

What To Do?

We are impressed with valuations in the US stock market – selling at an estimated 11.8 times 2011 estimated earnings and 10.4 times 2012 expected earnings, the US market is selling at almost recessionary levels – which per the above, we think is inappropriate. Furthermore, the S&P 500 has a dividend yield greater than that of the 10 year US Treasury bond. I have never seen this before in my investment life time (since 1970) although it happened regularly prior to World War II. We think the US market is a screaming buy.

While we will continue to invest in our cyclical portfolio in anticipation of a more confident stock market, we will also be looking to invest more abroad in the event that the stock market here is limited by its own political considerations. We expect to open positions in India, Indonesia, increase positions in China, and when we feel the timing is right, in Germany and Spain – both of which will benefit from an improving European outlook and Germany in particular with its exports to a strengthening China.

We encourage your questions, and look forward to discussing this strategy piece with you as we review your quarterly results.

David R.Kenerson., Jr
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