VIRGINIA GLOBAL
Asset Management, LLC

409 Yarmouth Street, Norfolk, VA
P 757.962.7976 www.virginiaglob

THE BIG PICTURE
INVESTMENT STRATEGY
MARCH 31ST, 2012

SUMMARY

During the last two years we have witnessed very skeptical and fearful markets, and many of those fears continue today as is demonstrated by the low or negative level of real interest rates, i.e. after adjusting for inflation. With the exception of rolling recessions in Europe, none of the fears have come to pass as expected: Greece received its bailout; no major European bank failed that would have set off another global banking crisis, and the European Central Bank found its “big bazooka” – three year loans at 1% in unlimited quantities to any European bank.

Almost three years after the Great Recession, many major and some minor countries have debts almost equal to or greater than their annual GDP. The global cyclical recovery is slower than normal – partly as a result of the damage done to both credit and confidence by the financial crisis. While Italy, Spain and Greece go about restructuring their labor laws, regulations, and conditions for doing business in their respective countries, the US continues to experience political paralysis, and an inability to deal with its own debt and regulatory environment.

The changes that have been taking place in Europe bode well for the ultimate improvement in the relative uniformity of economic policy as well as improvement of the relative competitiveness of its weaker (economically) countries. It will take time for these changes to take effect. In this sense, the can has been kicked down the road, and the problem of the PIIGS’ debt will remain with us until it again creates problems at the time of the next recession. But postponing the day of reckoning was the right thing to do – as the patient will be stronger when it undergoes its next operation/recession!

The US can continue to get away with things that no other country can because it is the strongest, safest, and most dynamic of the mature economies/markets. Its failure to address its long term deficits will come home to roost eventually, unless action is taken beforehand. We recall that it took a while to develop the political will to get Graham-Rudman passed. The same may be true of the Simpson-Bowles proposal.

The global recovery has been slower than normal for multiple reasons and is likely to continue in this fashion for another year. But given the improvements in Europe, the development of India, China and South America, and perhaps even the restructuring of American spending and taxation, we suspect that the long term outlook for a US with less debt as a percent of GDP, lower military spending, energy self-sufficiency, and a fully employed workforce is excellent.

For this reason we continue to invest as we have in our core industries: banking, commodities, technology, housing, and industrial companies. We have limited consumer exposure, but may increase it through automotive companies, and are likely to increase our international exposure to mainland China, India, Indonesia, and Brazil.

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The Last Two Years:

During the last two years we have faced skeptical and very fearful financial markets. And if we said that the S&P 500 would reach 1400 by year end 2011, we were wrong, but we'll take being only two and a half months late as a victory. Investors feared a second dip into recession in the US, recession in China, another global banking breakdown, a disorderly default by Greece, then Italy, & Spain, and finally a breakup of the Euro-zone.

Of course none of the above occurred at least not in the way that was feared. The Europeans organized an "orderly" default by Greece and provided it with another 130 billion Euro to be paid in tranches over time and subject to fulfillment of various reforms. Italy and Spain are implementing their own reforms to avoid the fate of Greece. And as many feared, European countries are now experiencing rolling recessions. In any event there was no breakup of the Euro-zone, and the slow growth in the US during the first half of last year, as we noted at the time, did not portend a recession here. Finally, the European Central Bank found its " big bazooka", i.e., three year loans at 1% in unlimited amounts to any bank in the Euro-zone.

Where Are We Today:

Almost three years after the end of the Great Recession we find the world in the following predicament:

1. Many major and some minor countries with debts almost equal to, and in a number of cases, more than 100% of their respective GDP's;
2. A global cyclical recovery that is slower than normal, and likely to remain so for another year;
3. Political Paralysis in the US until elections (not necessarily this November's) change the balance of power;
4. Changes in Southern European and Greek labor laws that bode well for the long term health of Europe;
5. A fairly valued market in the US given the level of investor fear, but many attractively valued foreign markets.

Debts:

The level of debt principally in the US and the PIIGS is such that interest costs are acting as drags on economic growth. To the extent debt is held by foreigners, the interest costs represent a loss of buying power. Within a country, however, interest payments become simply a transfer within the country that may change who gets to spend the money paid out as interest, but it does not affect the buying power of the country as a whole. Thus, Japan, which has issued debt that amounts to about twice its GDP, has little problem with it, since virtually all of it is owned internally. In contrast, the US Treasury debt, while less than its GDP currently, is half owned by foreigners.

In the US we do not expect a resolution of the debt problem until after elections and even then only if one party is dominant. But then, the matter is not as urgent as the US remains the safest, most resilient of the mature markets and remains the reserve currency of the world. It can, for a while longer, get away with what no other country can.

The debt problems of the PIIGS, however, have not gone away. But several major milestones have been passed that makes disaster not so imminent as may have appeared before now. First, Greece, Spain and Italy are all working on their labor laws to make themselves more competitive. The issue of relative competitiveness is at the heart of the problem. In both Greece and Italy one sees technocratic governments, and if the changes are indeed implemented, one should see productivity and income rise from current levels in these countries.

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Secondly, the Europeans have moved to create a second crisis fund (the European Stability Mechanism or ESM) which with its additional $500 billion Euros to bring total crisis funding to just short of Eu 1 trillion. Although some think the fund should be Eu 2 trillion, one trillion could well be sufficient depending on the circumstances.

Finally, the European Central Bank has produced its “big bazooka” in the LTRO (Long Term Refinancing Operation) – a long term lending facility – to supply adequate liquidity to the banking system to meet all possible payments. Some banks are using these funds to buy back their own debt at a discount or buying their country’s sovereign bonds which yield 4%-5% more than their LTRO interest cost of 1%. These actions have all produced calmer financial markets and lower yields and higher bond prices for the most, if not all, the sovereign debt of the PIIGS.

Many have noted that nothing more has happened than the “can has been kicked down the road”, i.e. the problem has simply been postponed and no solution has been found. We think this is partially but not totally accurate. First, if significant labor reforms are implemented, productivity and income should improve and the relative competitive position of these countries should improve as well. In this sense we are seeing long term solutions being put in place, not postponement of the problem. Secondly, time is necessary for economic recovery to take place, to lower the deficits and to begin reducing the debt as a percentage of GDP. If the world can produce a long extended economic cycle of moderate growth, a number of the PIIGS should be in much better economic condition by the time the next recession arrives.

Nonetheless, it may take the threat of additional crises to obtain the necessary political action on reforms. Although investors are perhaps somewhat inured to them now, such crises should produce more market volatility. Finally, our concern is less about the debt during this economic cycle, but what happens during the next recession when two problems may arise: first, the restrictions on budget deficits now in place across the Euro-zone may cause governments to act in a way that exacerbates the recession as they attempt to reduce their budget deficits by cutting spending. Secondly, because even with some improvement during this cycle, we suspect that governments will not have the capacity to borrow further to stimulate their economies. ***Coming out of the next recession may be a very slow process for such countries.***

In short, the debt of the PIIGS is going to be a chronic problem for some time. In the near term, it may have less effect on financial markets than during the past two years. The proverbial can has been kicked down the road in the sense that the debt of the PIIGS will probably not have been reduced sufficiently by the time of the next recession to prevent more problems then. But time has been provided in order to help countries improve their financial condition, and for the Europeans to get their defenses together. It was the proper thing to do.

Cyclical Recovery World Wide Continues, albeit slower than usual:

As we noted in our first strategy piece this year, “The Virtuous Circle Returns,” rising employment in the US begets increased demand which increases the demand for labor, etc.” Employment in the US has risen sharply in the last three months, partly because employers have delayed hiring until they were sure of demand, and partly we suspect, because of unusually warm weather. In any event we expect these employment gains to continue although statistics in the second quarter may appear weaker because of the seasonal adjustment factors.

Because of the warm weather, economic activity has been greater than it would otherwise have been with a normal winter- particularly in the housing area. Because of this higher level of activity, the economic statistics for the second quarter may look softer causing some concern in the stock market. Although economists are well aware of these factors, the investing public may not be, and take the “softer” statistics as a sign that the economy is slowing down and possibly going into recession. Expect volatility.

$4 gasoline and $100-$120/barrel oil will finally put a pinch on consumer pockets in the US during the second quarter. This too will contribute to the softer second quarter statistics, and it will have the same effect in many other countries although in some cases governments shelter consumers from what they believe are temporary rises. Having said that, longer term we are optimistic about the relative stability of the oil price as Libya and Iraq increase production, and the world begins to receive the benefits of past exploration off the coasts of Brazil,

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Norway, and in the Gulf of Mexico. Natural gas is incredibly cheap in the US and there is lots of it. Over the next ten years we may see all our trucking convert to natural gas, some autos, and certainly some will be shipped overseas where prices are much, much higher than the US.

Part of the oil price increase since last year has been the threat of an Israeli attack on Iranian nuclear facilities, and Iran's counter threat to sink ships in the Strait of Hormuz, preventing oil from Iran, Iraq and other Arab states from being shipped. Our best guess is that such an attack doesn't come for another year. We perceive that both Israel and Ahmadinejad (in a perverted way) have an interest in an Israeli attack. Israel of course wants to eliminate Iran's nuclear capability and is ready to attack now. Ahmadinejad cannot stand for re-election, but he would like his surrogate to win (as opposed to the Ayatollah's preference) in June of 2013. What better way to gain and solidify voter support than by an Israeli attack, one that he thinks Iran can survive with its nuclear capability (largely?) intact? By blocking the Strait of Hormuz in May of 2013, just as the peak driving season hits the US and Europe, Ahmadinejad might believe that he can also wreck the weak US (and European) economies by a very high oil price. Finally, he gets a better price for his own oil which is being sold on the black market. Of course there is no guarantee that the Israelis will wait that long.

We thought Netanyahu's visit with President Obama was a well choreographed example of "good cop-bad cop". It is necessary to try diplomacy first, particularly for the US, which is trying to extricate itself from Mideast wars, not create or inflame them. The US will insist that Iran give up its nuclear ambitions and submit to inspections. Iran will talk about it, but won't agree except at least temporarily, any more than Iraq did. In the end we expect the Iranians to walk away from the negotiating table, Israel to strike, the oil price to spike, and then the question will be did the Iranians successfully block the Strait of Hormuz?

We would not be surprised if Seal teams were already on site – prepared to board any Iranian ship that moved. Might they do a pre-emptive strike as Israeli bombers took off? We don't know. But we are sure that the West will be prepared for such an eventuality complete with salvage crews. We go through this scenario to demonstrate that the oil price spike might in fact be very short lived, and therefore, not have much impact on global economies.

In China, we do not expect a "hard landing", i.e. recession as some still do, but rather non-inflationary growth of 7.5% to 8.5%, considerably less than the 11% reported two years ago. China's inflation, reserve requirements, and interest rates are all declining. We understand that a fiscal stimulus package is being held in reserve in case it is necessary. For the Chinese, 6% growth is recessionary. Because of the expected difficulty with its exports (Europe is its largest export market), we expect the Chinese government to begin emphasizing domestic consumption but do not expect it to let its currency strengthen.

Financial Market Valuations:

If the US has the best economic outlook of all the major mature markets, it is also fairly valued, given all the fears at about 13 times estimated S&P 500 operating earnings of $106.00. At the end of 2010 the S&P was about 14 times forward expected earnings at the time. This rise in valuation from even lower levels (10-11 times earnings) in early October, 2011, is largely the result of declining fears of recession caused by any number of factors including a global banking system breakdown, starting in Europe. But investor fears are clearly visible in the still very low level (ca. 2.3%) of the ten year US Treasury bond interest rate. Given the remaining fears of investors we expect the S&P 500 to be in a trading range of 1400 plus or minus 100 points until later this year.

However, looking longer term, the valuation of stocks at 13.2 times earnings implies an earnings yield, i.e. the amount one could earn on their investment if they bought all the companies in the S&P 500 Index, of 7.5%. Normally the equity risk premium (higher required return for owning a riskier asset) is about 3%, which suggests that stocks are cheap and US Treasury bonds are expensive.

In contrast Chinese stocks are selling at about 10.5 times forward earnings, and the Shanghai Index is relatively close to its low of the last several years at 2,263. With the central government encouraging investors to invest in stocks, and passing tax legislation to encourage the same, it is about time to increase our position in China.

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There are other markets equally attractive when we think about how investors will perceive them in nine months to a year from now. The US is certainly not overvalued, but a number of foreign markets are now more or at least equally attractive.

What To Do:

It is a difficult call, whether to raise cash at this time for tactical as opposed to strategic reasons. A tactical sell anticipates a repurchase relatively soon whereas a strategic sell does not anticipate reinvestment for nine months to a year. Our expected slowdown in economic growth statistics has been anticipated by at least most economists, and to some degree the investing public – particularly by professionals. The same is true for the impact of the oil price. Having said that, the number of hedge funds who will be delighted to short stocks at the least impetus may create a fearful atmosphere that becomes a self-fulfilling prophesy.

In any event there are certain foreign markets that are very attractive as their inflation declines and growth accelerates. Examples are China, Brazil and Indonesia – and we may be adding positions in these countries. Otherwise we remain invested in the industries we have been: financials, commodities, technology, housing and industrials. We have stayed away from the consumer side, but have renewed our interest in automotive stocks as the average age of vehicles on the road is now over ten years, and consumer credit is expanding. Unless something “blows up” in the world, we could see 1600 by year end on the S&P 500 as the market anticipates better growth worldwide next year. This would not be a significant change in valuation, i.e. the p/e would still be about 14, but it would reflect the increased earnings expectations.

However, if the political tension in the US is not resolved by the elections in November, fears of further political failure to address the US debt, and fears of the mandatory sequester may keep the market from reflecting the probable economy and earnings of 2013. We do not anticipate a mandatory sequester, but at worst a postponement of it under the circumstances.

Longer term, however, we remain reasonably optimistic. We remember in the early ‘80’s the fears of $200 billion dollar deficits as far as the eye could see. By the end of the decade we had Graham-Rudman which contributed to a budget surplus 10 years after that. We now have $1 trillion deficits as far as the eye can see. Will Simpson-Bowles be the new mantra?

The declining military expenses and the prospect of energy self sufficiency in time, even the aging of the population (if more immigrants are allowed) should all contribute to a stronger US economy. Developments in Asia, South America, and Europe should all contribute to a stronger global economy. We can foresee another decade like the ‘90’s starting in a year or two if it hasn’t started already.

David R.Kenerson., Jr
Niklas K. Oskarsson

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