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HOOKED ON THE COCAINE OF EASY MONEY?
INVESTMENT STRATEGY
JUNE 30TH, 2013

SUMMARY

The Central Banks of Europe, the United States, Japan and China have been supplying their economies with huge quantities of money and credit. The Fed has been supplying the US with more than $1 trillion, or about 7% of its economy, as it has purchased 90%-95% of the new debt issued by the US Treasury. Japan has plans to supply twice as much relative to its economy. The European Central Bank (ECB) has promised to buy European sovereign debt without limit if necessary. Credit in China has grown by 23%, more than three times its GDP growth rate. As a result global interest rates are lower than they would be otherwise. The world is hooked on this cocaine of easy money!

Thus, when the Federal Reserve expressed its tentative time table – which didn't sound so tentative – for eliminating its Quantitative Easing program, the market place took it as change in policy and the beginning of rising interest rates. In June the Chinese Central bank refused briefly to supply cheap money to its banking system with the result that overnight rates shot up. Financial markets swooned! Earlier, Japan's stock market had declined by 22% when its Central Bank hinted at a somewhat less aggressive monetary easing than it had previously announced.

China has some enormous problems that its new leadership believes should be tackled first, before pushing the economy for growth. The clear implication is a growth rate of 6%-7% for an extended period going forward, not 10%. With Europe still in recession, and the sequester in the US impacting US growth adversely in the 2nd and third quarter's, and with other countries such as Brazil still mired in recession, we expect continued modest growth in the US at best, and are therefore less concerned than the market place about rising interest rates.

However, we are concerned about the complacency of politicians. In the US we still have no decision about how to reduce our long term deficits. Our debt will become a problem when interest rates finally do rise. In the meantime, Euro-zone politicians have yet to empower the European Stability Fund to recapitalize banks directly as planned, and the original plans for bank supervision have been watered down and postponed. Italy has not addressed its labor problems, with the result that nothing has been done to solve its underlying competitive problem that is now expressed in its financial markets. Spain's banks remain under threat from a real estate bubble that is worse than that of the US. In other words, we can **expect change to arise only out of further crises!**

Thus we expect the S&P 500 to trade in a range between perhaps 1500 and 1700, and subject to chronic bouts of turmoil driven by geo-political and economic events. S&P earnings expectations are still too high, but fears of higher rates are still overdone as well. We keep significant cash available to buy on significant declines. There will come a time to head for the hills. It is not now. It is now time for a more tactical approach to investing and a search for stocks and markets that have already experienced substantial declines but which represent excellent long term value.

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Recent Events:

The critical event this quarter was the Federal Reserve's announcement of a timetable for eliminating its formerly indefinite program of quantitative easing, i.e. supplying money to the market place to the tune of $85 billion monthly or more than $1 trillion annually. That's about 7% of our gross national product – a huge amount. The Fed anticipates starting its "tapering" later this year, and finishing by next June! Financial markets swooned!

As we have noted before, the Federal Reserve Bank of the United States has been buying 90% to 95% of the new debt being issued by the US Treasury. As a result interest rates are significantly lower than they would be otherwise. The central bank gets the money to buy these Treasury bonds, largely by printing money, although there are some other modest sources. In other words, it is not private investors and pension funds that are funding the government deficit, but the government itself. It is monetizing its own debt. Historically, such monetization is associated with the build up of powerful inflationary forces.

However, as noted in the past, we are not concerned with the potential for inflation as long as there is such a large gap, not just in the United States, but world-wide, between what is being produced and what can be produced. Under such circumstances the prices of goods and labor do not get out of hand. Thus, barring a geo-political or natural event that damages food and/or energy supplies, we don't anticipate inflation as a problem near term.

Nonetheless, financial markets demonstrated how fearful investors are of any tightening of monetary policy. Mistakenly, but not illogically, the Fed's announcement of its time table was treated as a change in policy and a tightening of interest rates. The weaning of the nation from such easy money has always been part of the plan. The Fed has always said it would reduce its supply of funds to the market *when the economy could stand on its own* without the Fed's monetary support, and it said several times that it would look to sustained data that demonstrated the economy's capacity, not just one or a few data points. We also note that the end of quantitative easing is not the same as raising the Fed funds rate. Historically, when the Fed has tightened interest rates, there are almost always multiple increases, which ultimately produce recessions. This is what frightens investors.

Many investors have attributed the recent stock market recovery to a Fed driven flow of funds into financial assets. Modest economic and profit growth backed by a generous dose of money have resulted in a 14% gain for stocks this year in the US. Similar results may not be found in Europe where most of the countries remain in or close to recession. However, the Japanese market also rose by about 11% when its new administration announced a quantitative easing that was twice the size(relative to its GDP) of that of the US!

Of course it is not just in the US and Japan that easy money has floated financial markets. It was not until the European Central Bank (ECB) agreed to do whatever was necessary, including the purchase of government bonds, to keep the Euro-Zone together that European markets, in spite of their recessions began to rally. Interest rates in both Italy and Spain are well below their levels before Governor Draghi's statement.

In short, to a large extent the world is hooked on the cocaine of easy money, and any threat to withdraw it causes severe withdrawal pangs in financial markets. When the Japanese central bank appeared to back track on its commitment to supply funds to its economy, stocks declined 22%. Here in the US, the discussion of "tapering" by the Fed, produced a drop of about 7% from May 22nd, to its low point of 1560 on the S&P 500. Long term US Treasury bonds declined on the order of 5%-7%. Only after reassuring noises were made by various Federal Reserve Governors, did the decline shrink in stocks and to a lesser extent in bonds.

Not helping the situation at month end was the decision by the Chinese Central Bank to limit its supply of funds to its banking system causing interest rates to rise very sharply. It is our understanding that the central governing committee wants 1) the rate of economic growth to slow (in order to avoid inflation) and, 2) the dominance of investment demand in its economy to shift toward personal consumption. China has many imbalances in its economy and its leadership, appropriately, has decided to tackle the structural problems first before pushing for growth. Furthermore, having been accustomed to growth rates in excess of 10%, it would appear that the leadership believes a 7% growth rate can now be expected given the substantial increase in the size of China's

GDP. As their economy gets bigger, it is harder to grow at 10% annually. The leadership wants to manage growth expectations downward.

The kinds of structural changes that China would appear to be undertaking are the kind that take several years to implement. This of course is a subject unto itself, but the bottom line is that we may well see several more years of moderate GDP growth, i.e. ca 7%-8% rather than higher, as China implements its reforms. Some changes, like the coming investment in housing will contribute significantly to GDP growth. The plan is to build some 10 million homes over the next five years, a rate that is twice US investment in housing today? But getting its population to break their savings habits in order to consume, will be a major task for the Chinese government. In contrast to the US where consumer spending represents about 70% of GDP, in China, personal consumption is only about 40%. Increases in capital spending have been the primary driver of GDP during the last ten years, but that capital spending has not always been efficient.

Looking Forward:

With China going through structural change, and Europe only showing the faintest glimmerings of a nascent recovery from recession (starting in Germany), we anticipate continued relatively slow growth in the global economy for the next year, and possibly two years. This includes the US which is recovering at the slowest rate ever witnessed in our lifetime**. The good news in our recovery is that it's likely to last for a long time**, as the slow growth rate is unlikely to exacerbate inflationary fears and tightening by the Fed. Nonetheless, the steady growth in housing is providing job growth (remember building one new home creates 3 new jobs for a year) and rising total consumer income, and therefore consumer spending. States, too, will be spending more on infrastructure – roads and bridges - which in turn also provides jobs, etc.

We can foresee an improved environment in Europe a year from now, but how much improved is a major question as we have continued concerns about both Italy and Spain (see below under the implications of political inaction). Such an improved environment would be critical to the outlook for China as well as Europe (Europe is China's largest export market). But if both the outlook for Europe and China have improved by next June, then it is understandable why the Fed would like to have discontinued its quantitative easing program already! Improvements in both these markets will result in improvements in the US economy as well.

The Failure of Politicians: Implications – A Time Bomb is Ticking!

Thus, our basic thesis remains continued slow growth worldwide, keeping us relatively sanguine about global interest rates at least for the coming year. But economics do not tell the whole story: there are politicians. With the exception of China, we are deeply concerned about the failures of politicians in Europe and the US to come to grips with their problems.

In the US, we have yet to come to grip with a political agreement about how we are to reduce our deficits over the next ten years. The sequester, which should be felt this quarter, is crude, brutal and stupid in its failure to make important value judgments about how the nation should spend its resources. Now that our economy is improving and there is a $400 billion improvement in our annual deficit, Congress has become complacent? Unfortunately, however, the improvement is largely either a one off event, and/or a cyclical, but not structural, improvement. It will take a crisis of some sort to galvanize Congress into a compromise.

We see similar failures in Europe. Italy has made little progress in restructuring its labor laws – and therefore, will remain uncompetitive with its northern European brethren. This lack of competitiveness is at the heart of its financial problems. The problems in Spain stem as much as anything from the breaking real estate bubble. The

Spanish banks have yet to deal with their mortgage problems, and the Europeans have dramatically slowed the time table within which they will be able (through the ESM – the European Stability Mechanism) to directly capitalize Euro-zone banks. Once again it will take a crisis to galvanize the politicians into action.

Thus, we hear the ticking of a time bomb! The explosion may come from two probable sources. First, as the US economy strengthens, US Treasury bill and bond interest rates will rise **in anticipation** of the Federal Reserve's

tightening. Other interest rates around the world will have to follow suit since the US Treasury and Agency bonds represent more than half the world's sovereign debt market. Bond rates will rise in Spain and Italy, possibly enough to force one or both of them into a "soft" default or restructuring.

Secondly, a Spanish bank may suddenly find itself short of capital before the ESM is ready to offer them new capital. While the ECB's actions will support the Spanish government's additional borrowing requirements to add capital to its banks, the event may well trigger a crisis putting financial markets in turmoil yet again!

These events, i.e., rising US interest rates, threats of European bank defaults, and threats of government defaults on their bonds are all the stuff of which 10%-20% market declines are made. Thus, we expect continued chronic financial market difficulties. The Federal Reserve has clearly fired its warning shot across the bow vis-à-vis its Quantitative Easing program. The second shoe to drop will be when it announces its intent to raise interest rates gradually to bring about a normalization of interest rate levels.

However gradual the Fed may intend to be, we would **expect the market place to anticipate the end result, and therefore interest rates will rise virtually immediately to that estimated level.** It will be ugly in both stock and bond markets, at least for a brief period. Then, the stock markets gradual rise, driven by further earnings growth, may continue. One only sees a price-earnings ratio expansion, if and when confidence returns to the market place that solid growth will continue for an uninterrupted period of time. Perhaps a declining unemployment rate will do the trick? Or stronger economic growth in Europe and/or China?

What To Do?

The valuation of the S&P 500 is 15.25 to 15.75 times our estimated $103-$106 earnings for the Index. This is right in line with the historical average of about 15.5 times and represents a p/e expansion from the 11-13 times forward earnings for the past several years. There are some sectors, such as steel and aluminum, for example which are selling at valuations last seen in the Great Recession of 2008-9. Their prices reflect the gloom created by a slow growth world, particularly in China which has been the largest source of incremental demand for these commodities.

Our outlook for continued modest growth worldwide suggests that the S&P 500 remains in a trading range of 1500 to 1700, as earning expectations continue to be adjusted downward but slow growth suggests continued monetary support from the Fed. It suggests that we should continue to hold our fixed income securities and our stocks as long as we have a significant portion of the portfolio in cash (money market funds). We remain convinced that Europe will not break up the Euro-zone, and that precisely because the economic recovery from the Great Recession has been so slow, that it will be much longer than usual, as well.

Therefore, our strategy must be to buy markets, such as Japan, that have already experienced a serious correction, or stocks that have yet to reflect the economic recovery. Housing stocks can be bought on any correction as we think the outlook for housing demand, interest rates not with- standing, is excellent. But most importantly, it will be our tactical strategy to use geo-political and economic events to buy "on the dip".

There will come a time to head for the hills, but it isn't now.

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