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MANAGEMENT BY CRISIS
INVESTMENT STRATEGY
SEPTEMBER 30TH, 2012

SUMMARY

We have grown more cautious lest the already slow US economy tip into recession after an exogenous event. We see both in Europe and in the United States a profound conflict between economic necessity and political expediency. Budgetary reforms are necessary in both places, but they seem to occur only in the face of the threat of financial crises. The minute the threat eases, the pace of progress towards the necessary reforms slows dramatically. In the US, a financial crisis could tip the US into recession and thereby worsen that in Europe.

As a result of the balance sheet recessions in Europe and the US, as well as actions taken to fight the temporary inflation produced by the "Arab Spring," we find the world running at a very slow rate of growth – which makes it vulnerable to an exogenous event. The combination of the necessity to repair sharply expanded debt levels in the US and Europe and the impact of the recent balance sheet recession promise continued slow growth for the next several years. Thus, we find many countries (much of Europe, Brazil) already in recession, and others with growth rates only 1%-1.5% above what constitutes normal recessionary growth levels in second and third world countries.

As usual, we find politicians reluctant to make the necessary painful economic adjustments both here and abroad, and thus are concerned that we will continue to move from financial crisis to financial crisis before politicians will do what is necessary to cure the long term ills of their respective countries. Such financial crises are almost always reflected in declining stock markets.

In addition, we continue to expect an attack by Israel on Iranian nuclear installations sometime between March and June of next year. Our thesis is simply that Ahmadinejad calculates that such an attack will facilitate the election of his proxy (Ahmadinejad cannot run again) as President in June. He will negotiate up until that time, and then harden his stance, provoking either a back down by the West, or an attack by Israel. Either way, he "wins."

Nonetheless, everything is not lost. Housing is recovering and each new house brings three new jobs. The Federal Reserve's "QE-3" is lowering the cost of mortgages facilitating purchases by a rate of family formation that will be greater in this decade than last. We also expect China's new government to increase economic stimulus after its installation in mid-November, and mini-crises notwithstanding, we expect the Euro-Zone to keep the Euro intact. All of these are good for stock markets world wide.

What to Do?

First, we will look for opportunities to raise cash; next we will be looking for companies that can grow much faster than the economy, including both small and mid-cap companies as well as in large cap companies in faster growing sectors. Income oriented assets are appropriate for lower risk accounts.

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We have grown somewhat more cautious because we are concerned lest an exogenous event tip an already slow economy into recession. We see both in Europe and in the United States a profound conflict between economic necessity and political expediency. Budgetary reforms are necessary in both places, but they seem to occur only in the face of the threat of financial crises. The minute the threat eases, the pace of progress towards the necessary reforms slows dramatically. In the US, a financial crisis could tip the US into recession and thereby worsen that in Europe.

A World of Slow Growth:

Europe is already in recession and would appear likely to remain so for possibly another year? US GDP growth is trundling along at 1.5%, about half the normal rate. China, the second largest economy in the world is growing at a rate of 7.5%, also about 1.5% above what is considered recessionary levels (6% or less) of growth in this still third world economy.

A study by Rogoff and Reinhart(1) demonstrates that countries who have had a "balance sheet" recession (as opposed to an income statement recession) experience subpar growth for a period of 4-5 years after the onset of recession. (An income loss driven recession occurs when the central bank raises interest rates to fight inflation, economic activity slows down, and consumers lose their jobs, and businesses lose sales. As soon as the central bank lowers interest rates, the process almost immediately begins to reverse itself. However, a balance sheet recession is one that occurs because the valuation of the consumer's assets, particularly real estate and/or securities declines significantly for an extended period of time. The balance sheet recession ultimately also becomes an income loss driven recession but its rebound characteristics are very different in that the recovery is much slower.) This study would suggest that slow growth will continue through 2013, and because of the debt load, possibly continue for much longer (see discussion of debt below).

Chairman Bernanke has suggested that interest rates, and by implication growth, in the United States will be low/slow until 2015, i.e. for another two years or more. This projection takes into account not only what is happening in the US but also the extended recession in Europe and the slowdowns or the near recessionary levels of growth in China, Brazil, India and much of the rest of the world. The fact that the Federal Reserve Board has thrown not only the kitchen sink, but also the refrigerator and stove too (known as Quantitative Easing #3 or QE3) is both good news (see below) and bad news. The bad news is that Dr. Bernanke and the FRB must perceive that the US has very serious problems if he and the FRB are willing to supply money indefinitely and increase it if necessary!

In 2011, we were not concerned about the possibility of recession in the US since it was nestled in a world of relatively strong growth. It is true that exogenous events such as the tsunami in Japan and the "Arab Spring" have contributed to a slower global growth than would otherwise have been as countries responded to the rise in oil prices with interest rate rises that slowed their economies. We saw these as temporary factors. However, while the impact of these temporary factors has subsided, growth levels remain subdued, and therefore we perceive the economic risks as having risen.

The Impact of Debt on GDP Growth:

It is a proper concern to be worried about the level of debt in the US. The average interest rate on the US government's current $16.2 trillion of outstanding debt is about 2.6%. Foreigners hold about one third of this, and about one half of the publicly traded Treasury debt. (Some debt is held by governments and is not publicly

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traded.) At 2.6%, the US is paying **foreigners** some $138 billion annually in interest, or about 1% of our gross national product. This is money that could otherwise be spent in the United States, contributing to its growth.

If, like Japan, virtually all the US debt were owned domestically, the $138 billion would simply be a transfer payment between the government and its citizens, and presumably would be spent or invested here without any damage to our growth rate. **It is the fact that we owe so much to outsiders that is problematical.**

More importantly, the reduction of US debt can only be done by paying down the debt with budget surpluses, or through an inflation rate that is greater than the interest rate promised on the debt. The former is taking money that could otherwise be spent to stimulate the economy, thereby lowering growth from what it might be have been. The latter is a very subtle tax on savers, and increases the cost of doing businesses, thereby lowering growth again. **Thus, the impact of a balance sheet recession combined with an excessive debt load (the US now has a 102% debt to GDP ratio) can produce an extended period of slow growth.**

Economic Uncertainty: The Conflict between Economic Necessity & Political Expediency:

While difficult to quantify overall, we can see the impact of fear of another banking crisis and a fall off the fiscal cliff in 2013 on consumer spending in the second quarter of this year. Those fears remain, and perhaps have had a greater impact on consumer behavior and the economy than we have recognized heretofore.

Furthermore, in both the US and in Europe we see politicians unwilling to take the required steps until a financial crisis is upon them as reflected in their financial markets.

In the US, we face the draconian spending cuts (from the sequestration agreement- $109 billion), the removal of the payroll social security tax cut ($112 billion), and the expiration of the "Bush tax cuts" (could be as much as $255 billion) in January. Everyone knows all of these cuts at once will dump the US into recession. Thus, everyone believes that the Democrats and Republicans will make a deal after the election. Since we expect no substantial change in the political landscape from today, we are **concerned that, at a minimum, the political grandstanding may last long enough to damage the economy** with a concomitant effect on financial markets.

Similarly in Europe, banking supervision by the ECB, expected to be completed by January 2013, in order to permit the recapitalization of European (translate Spanish, Irish and Italian) banks directly by the ESM (European Stability Mechanism), now may take another year for the politicians to complete their work. This suggests that it may take another financial "mini" crisis in Europe to get the necessary political action accomplished.

Spain is in focus, now. Its government is delaying asking for help ("a bailout") and signing a memorandum of understanding (MOU) with the ECB which everyone agrees Spain will need soon. The MOU requires Spain to execute a government budget drawn up by ECB, something that the government, for political reasons, is very reluctant to do. When it does finally do so (and the market place will consider

it good news when it does), the ECB via the ESM, can then commence buying bonds so that Spain can fund its budget deficit. But it may take a market driven run on Spanish bonds (massive sales), i.e. a mini crisis, to force the government into action. In turn, such a run will probably be reflected adversely in the US stock market.

Italy is not in focus now, but could be as recession there increases its budget deficit. Elections will be held in April, 2013, and it will probably not be until after the election that Italy too signs an MOU. It is not clear whether Monti will stand for re-election after having been appointed to his first term. His labor reforms were watered down significantly when passed, and thus Italy will continue to be non-competitive because of its high cost, inefficient labor market. This will continue to be reflected in its exports. Again economic necessity has given way to political expediency.

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Iran vs. Israel and the US

In an earlier strategy piece, we expressed the idea that Iran would try to position itself as sincere about negotiating a nuclear agreement with the West until shortly before election time – at which point it would harden its stance inviting the West (and Israel) to back down, or attack. Either event would be helpful to reinstating

Ahmadinejad via his proxy (since he can't run again). Thus, we continue to expect Israel's attack between March and June of 2013.

Israel has clearly backed off for now, and one can expect no attack before the US elections. It will be interesting to see how expectations change after the elections. If they do, we can expect oil prices to rise again with some adverse pressure on the stock market and a flight into US Treasuries.

The Good News!

But let us recognize that all is not lost. Housing is recovering steadily and should do so for a long time as household formation is growing and will grow at a higher rate than it did in the last ten years. This is the primary source for housing demand. Furthermore, the central bank is buying mortgage backed bonds to lower mortgage rates to facilitate the housing recovery. Housing is important, not because it is such a large portion of GDP, but because each new home built creates 3 new jobs, and by our estimate about 2.25 million unemployed are ex construction workers.

Furthermore, the US Federal Reserve is supplying about $85 billion/month to the market place via "operation twist" and the purchase of mortgage backed securities. Since economic growth is slow, the money is not needed for commercial transactions, it is rather finding its way into financial assets, i.e. stocks and bonds. And this may be the predominant theme for the next several months, and may force those who have been bearish back into the stock market further exacerbating the upward rise of the stock market. There is an old saying: "Don't fight the Fed."

On November 15th, the Chinese leadership changes hands, and subsequently we may find implementation of additional stimulus programs which should be good for Chinese and global growth as well as financial markets.

Finally, backsliding by politicians notwithstanding, we do believe that the Europeans realize that for many reasons, it is essential to hold the Eurozone together, and that, although it may take many mini-crises along the way, they will manage to keep the EZ intact.

What to Do:

At this point the S&P 500 has risen about 16% year to date, and our inclination is to hold our positions until it is clear that investors' mood is beginning to shift adversely. We would look for signs (without being exhaustive) such as the following: that

1. The US and global economy is deteriorating rather than improving;
2. Earnings expectations are being lowered for the 4th quarter and next year;
3. Worries similar to our own are being expressed more often by others;
4. Europe continues to deteriorate without action on the political front to do the necessary;

But even if we have a resolution of the uncertainties in the political environment in the US during the next 6 months – and this would be very positive for stocks – the underlying slow growth suggests that we should be looking for smaller capitalization, but faster growing companies and countries, and that the large cap companies

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we hold should be in specific faster growing sectors of the economy. After clarification of the tax treatment of dividends some focus on income producing securities is probably relevant for those who are volatility sensitive.

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