SOLID MARKET FUNDAMENTALS ... CRUCIAL INFLECTION POINTS

INVESTOR ANGST HIGH AS SECOND QUARTER ENDS

Despite the fact that second quarter growth estimates were being slashed as the end of the quarter drew near, the Federal Reserve steadfastly maintained that it would end its $600 billion bond buying program (popularized in the media as Quantitative Easing #2 or QE2) at the end of June as had long been scheduled and that it would not be followed by a third round of economic stimulus. Investors were begging for additional economic sugar as they wondered if they were witnessing the onset of a new downturn, but the Federal Reserve didn't deliver. Instead, the Fed suggested that it expected growth to reaccelerate during the second half of this year. The Fed's expectations were very much at odds with investors' expectations and the debt and deficit issues that plague Greece (and the U.S.) further poisoned investor sentiment. As such, angst rose and the S&P 500 fell about 7% from its April highs before recovering sharply upon the news that Greece accepted further austerity measures.

THE CASE FOR REACCELERATING GROWTH

The Fed believes that the second quarter slowdown was due primarily to transitory forces such as high gas prices and supply disruptions stemming from Japan's earthquake and from flooding in the Midwest. Zacks Research agrees with the Fed's outlook as it too expects growth to reaccelerate during the second half of 2011. As such, Zacks expects domestic equity prices to be supported by three key forces: solid corporate earnings, their cash-rich balance sheets, and a supportive interest rate environment. Let's take a look at each of these forces.

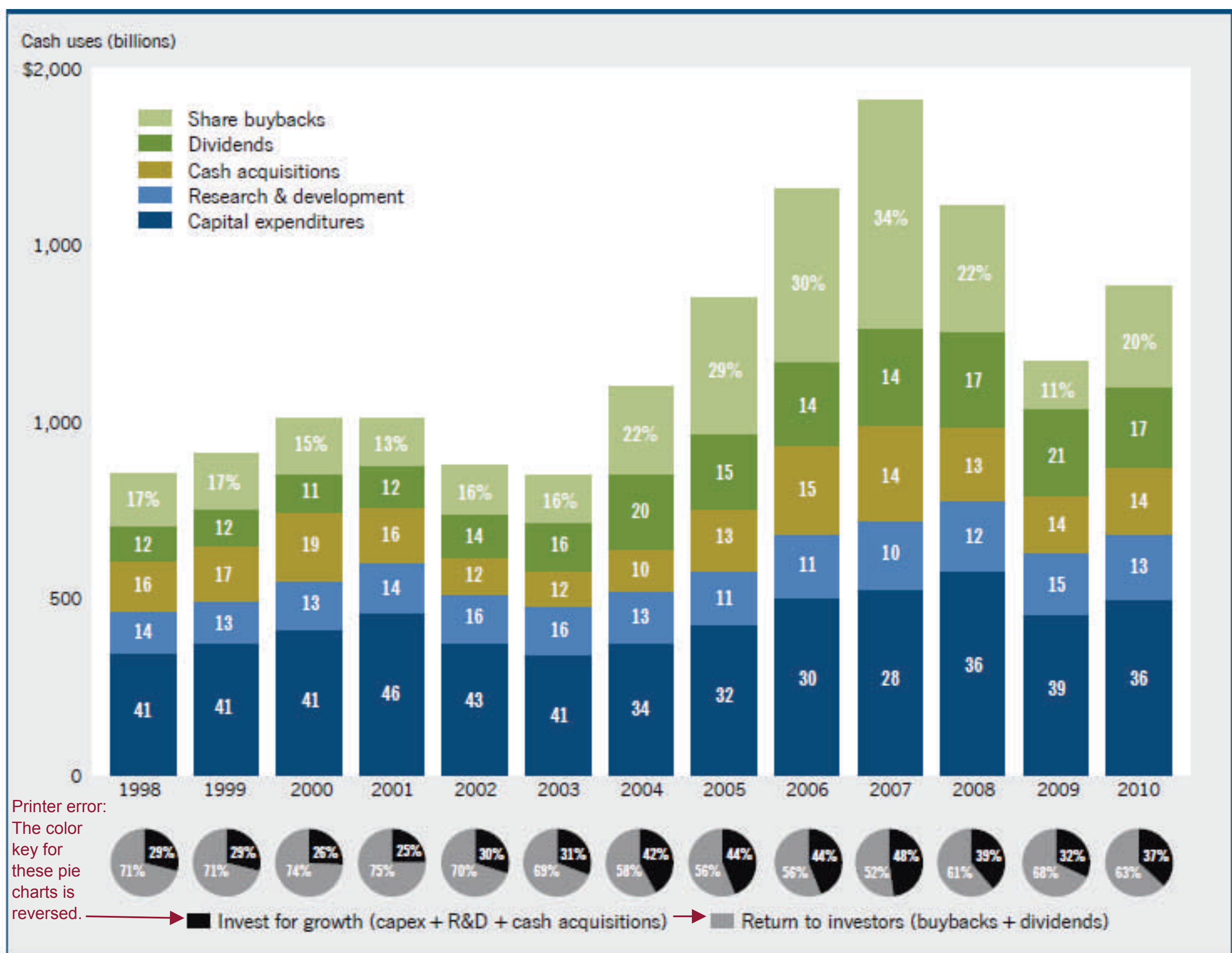
SOLID CORPORATE EARNINGS

Although the growth of the U.S. economy has so far been decelerating throughout 2011, first quarter earnings were stronger than expected as revenues advanced in most industries. Despite the recent slowdown, Zacks expects second quarter earnings to make for good reading since over a third of the earnings of companies within the S&P 500 come from foreign operations that often sport attractive growth rates.

CASH-RICH BALANCE SHEETS

Companies within the S&P 500 are sitting on record levels of cash and that cash is increasingly being used for shareholder-friendly purposes such as dividend increases (which put more cash in investors' pockets) and share buybacks (which tend to boost share values).

The vertical bars in the graph below depict how non-financial companies in the S&P 500 have used their cash each year since 1998. Note that the total amount of cash available to these companies has tended to rise over time. This is an important point since the value of a given company's shares is heavily influenced by the amount of cash it generates. All else being equal, higher levels of cash flow tend to result in higher share valuations.



Sources: Computstat and Goldman Sachs Global ECS Research. Data represent S&P 500 non-financial firms.

Dividend payouts for companies in the S&P 500 increased about 13% during the fourth quarter of 2010 and almost 8% during the first quarter of this year. Through May 3, 2011, companies within the S&P 500 announced 144 dividend increases and 12 dividend initiations. In contrast, only two dividend reductions have been announced. The net result is that the dividend increases announced so far through May 3, 2011 already amount to 8% more than the increases that were announced during *all* of 2010.

Corporate management teams are generally loathe to reduce or eliminate dividends once they have been established since dividend reductions are often regarded as a sign of corporate stress. Therefore, dividend hikes may be regarded as a sign that corporate management teams believe that their higher cash inflows are sustainable.

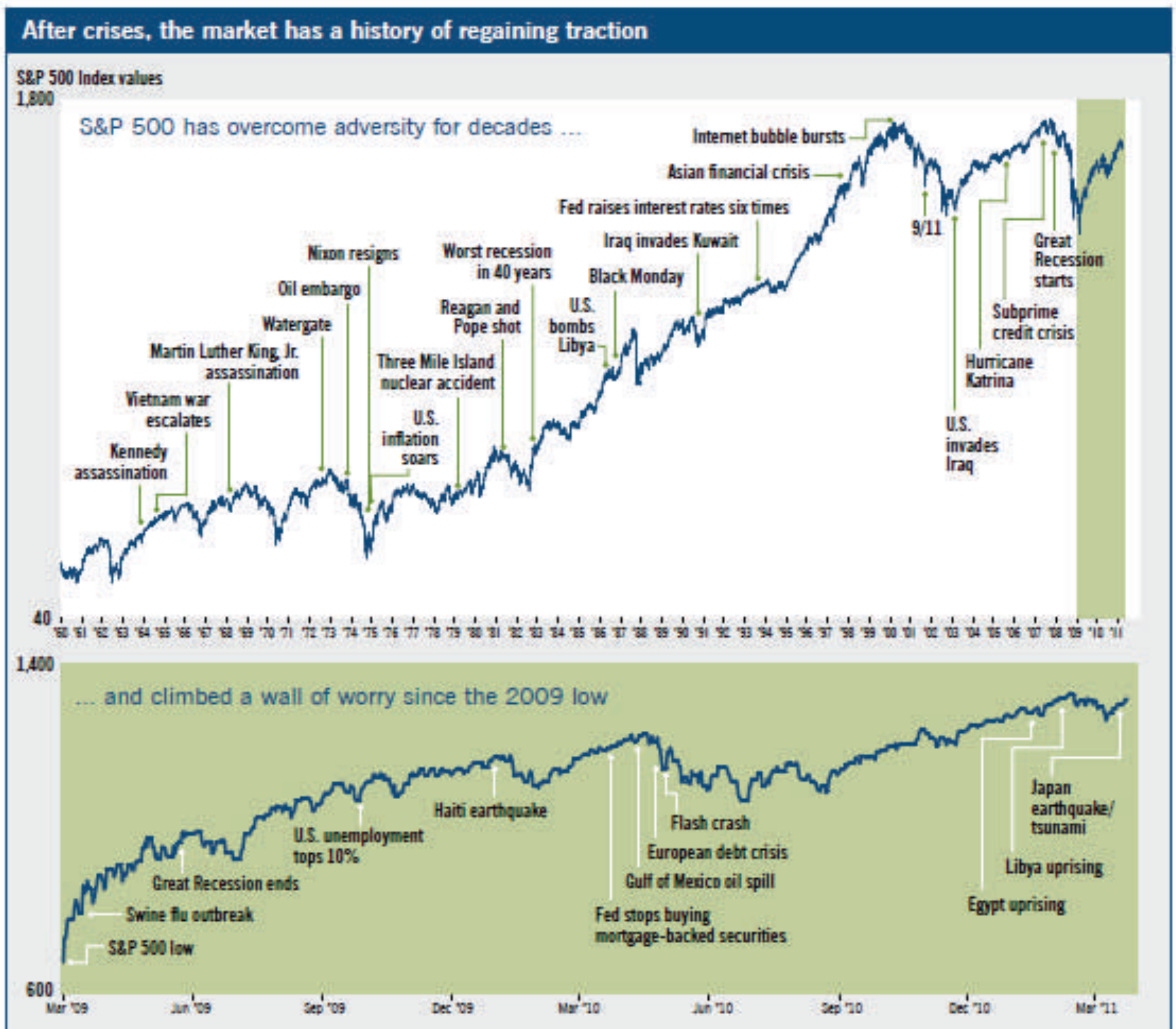
SUPPORTIVE INTEREST RATE ENVIRONMENT

The end of the Federal Reserve's $600 billion bond repurchase program means that the Fed will no longer be introducing incremental funds to the U.S. economy via its most recent quantitative easing effort (Quantitative Easing 2). However, opting to not add additional funds to further stimulate the economy is very different from removing funds in an effort to slow it. In essence, the Fed has chosen to lift its foot from the accelerator while simultaneously indicating that it does not plan to apply any form of economic braking for the foreseeable future. (In Fed-speak terms, the "foreseeable future" might equate to two calendar quarters, or so.)

In general, low interest rates encourage borrowing, reduce the rate of return necessary to make economic undertakings profitable, and result in cash flows generated by productive activities to be more highly valued. So, even though the Fed is no longer adding fuel to the economic fire, its low-rate stance still favors economic activity and the capital markets in a number of ways.

A FINAL FEEL GOOD MOMENT

Before I switch gears and begin explaining why I have chosen to tilt the portfolios I manage to a somewhat more defensive posture, take note of some of major events that have taken place over the past 40 years, or so, in the following graph.



The specific periods depicted are as follows: 1/1/60–3/31/11 (top chart) and 3/9/09–3/31/11 (bottom chart). The S&P 500 Index is unmanaged.

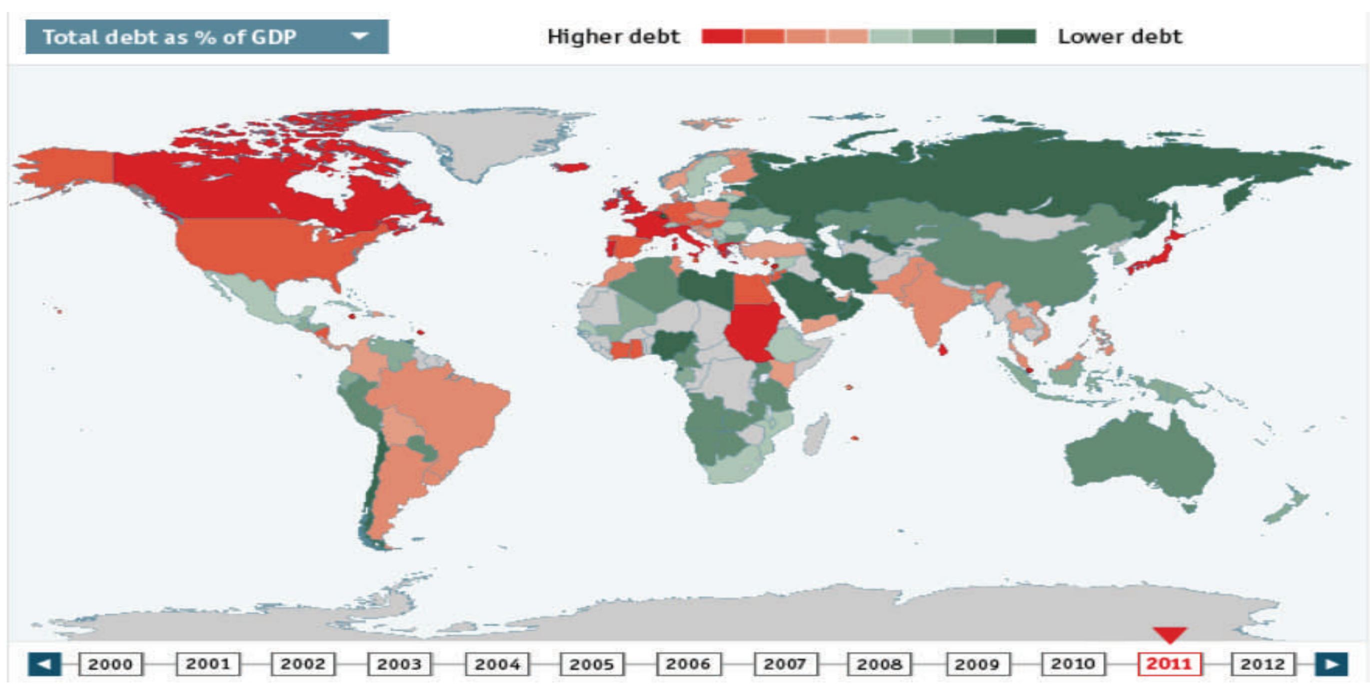
The vertical axis is scaled logarithmically so the actual volatility of the S&P 500 Index has been greater than it appears. Nonetheless, the lesson here is that the U.S. equities market has been amazingly resilient to many types of economic and political shock. The underlying supposition that I'll not try to support here is that people and the capital markets have been amazingly resilient in the past and that there is no reason for this dynamic to change.

GETTING NEGATIVE: RISING GLOBAL DEBT ... DOES IT MATTER?

Globally, government debt currently totals approximately $42.6 trillion and that total is rising. Since we essentially owe the money to ourselves, one might wonder if the size of government debt should matter. It does — for several reasons:

- Since debt is really just a mechanism to *temporarily* redistribute wealth between parties, ignoring unpaid debts would allow debtors to capture a windfall wealth increase at the expense of creditors. Fairness suggests that debts ought to be collected.
- When government debt rises faster than economic output, those same governments tend to become more meddlesome as they impose higher taxes to service that debt. Opinions differ as to the merits of a meddlesome government, but there's no doubt that higher taxes are an economic drag.
- Since debt must be refinanced periodically, it creates a recurring popularity test for whichever government happens to be in control at the time. If it fails the popularity test (as the Greek government did in early 2010), crisis tends to ensue.

So, even though debt creates no net winners or losers in an aggregate sense, the higher the global government debt, the greater the risk of fiscal crisis, and the bigger the economic impact such crises are likely to have. Unfortunately, as the developed world has gained access to credit, it has seemingly become addicted to it. Take a look at this debt map created by *The Economist*.



The world's most debt-laden countries are listed, below. The text colors are keyed to match the map on the previous page. Figures in bold are noteworthy inasmuch as they belong to countries that are either particularly debt-laden, particularly large, or both.

Debt as a % of GDP	2000	2011	Change	Public Debt *($ Trillions)*
Most Debt-Laden Countries				
Japan	131.3	**199.5**	68.2	**10.90**
Greece	108.2	**133.9**	25.7	0.37
Iceland	42.2	**129.2**	87.0	0.01
Jamaica	121.8	**122.3**	0.5	0.02
Italy	111.2	**119.6**	8.4	**2.23**
Sudan	196.0	96.2	-99.8	0.05
Portugal	50.9	87.3	36.4	0.87
France	58.0	86.2	28.2	2.05
Ireland	43.4	84.2	40.8	0.16
Canada	86.6	82.1	-4.5	1.30
United Kingdom	42.3	79.3	37.0	1.79
Debt-Laden Countries - Next Highest Tier				
Germany	60.3	76.7	16.4	2.28
Nicarauga	157.8	68.3	-89.5	< 0.01
Spain	60.8	68.2	7.4	0.87
United States	32.4	67.2	34.8	**10.13**
Cote d'Ivoire	117.9	59.9	-58.0	0.01
Ghana	144.8	58.4	-86.4	0.01
Singapore	84.9	97.5	12.6	0.22
Mauritius	33.0	60.6	27.6	< 0.01

All figures from www.economist.com.

GREECE — SOFT DEFAULT IS STILL DEFAULT

European leaders are trapped between domestic political demands for banks to share the cost of a Greek bailout and the consequences of a default which could include the collapse of Greece's banks and economy followed by an eventual exit from the eurozone.

European officials and bankers recently expressed optimism that if Greek bondholders would agree to take *voluntary* haircuts with respect to the amounts owed to them, Greece might then be able to avoid defaulting on its debt. Of course, asking lenders to voluntarily forgive a portion of the money they are rightfully owed is a little like committing suicide to avoid being murdered.

Responding to a French proposal that would have allowed Greece more time to repay loans as they come due, Standard & Poors made it clear that any such haircuts or repayment extensions would be regarded as what they are — a default.

GREEK DEFAULT — AN APPARENT EVENTUALITY

Just prior to Greece agreeing to a fresh round of austerity measures, the cost of obtaining credit insurance on Greek debt (accomplished by purchasing a derivative instrument known as a credit default swap) rose to a record that equated to an approximate 84% probability that Greece will default on its debt obligations within the next five years. That 84% probability carries some weight since it is derived by analyzing the transactions of investors and institutions that have money on the line. Even though Greece has since agreed to further austerity measures, the cost of insuring Greek debt has actually risen further. So, the consensus of those who are presumably most informed about the intricacies of the Greek debt crisis is that Greece is still very likely to default on its obligations in some manner at some point.

SMALL ECONOMY ... BIG SHOCKWAVES

According to the International Monetary Fund, Greece's total economic output during 2010 amounted to $305 billion. That's a lot of economic activity, but when viewed in a larger context, Greece's output represents less than 3% of the eurozone's (17 member states) economic output and less than .5% of the world's output. Since Greece's economy is relatively inconsequential in global and in eurozone terms, one might wonder why a Greek debt default should matter as much as it apparently does.

If Greece were to default on its debt, doubts about the solvency of other countries within the eurozone would undoubtedly intensify even if the default could be absorbed adequately (and many believe it could). Capital would flee Greece and that capital that did remain available to Greece would be available only on punitively high terms. After all, if the European Union and the International Monetary Fund couldn't resolve the debt problems facing a relatively inconsequential eurozone economy that has only a small portion of the eurozone's debt, how might it be expected to resolve subsequent debt and deficit problems that threaten the viability of larger eurozone members such as Italy, France, or Portugal?

BANKING SYSTEM COULD EXACERBATE A SHOCK

If Greece were to default on its relatively small $.370 trillion of debt, the structure of the banking system could magnify that shock as it transmitted that shock to various economies. And, since most economies are part of the global economy, the shock would have quite a reach.

Most of Greece's debt is held by European banks, but many feel that Europe's banking system is capitalized well enough to withstand a blow from Greece. Nonetheless, bank capital is a fairly precious commodity so even a default by a country as small as Greece could materially dent the banking system's capital reserves. The important point here is that when banks sustain material losses, they typically halt their lending efforts and may even sell assets in an effort to further reduce the size of their balance sheets. This strategy effectively allows banks' remaining capital cushion to grow in relative proportion to their remaining assets.

Since bank lending is the primary means by which money is created (despite the media's routine insistence to the contrary, only trivial amounts of money are actually "printed") and because money is the fuel by which economies operate, a banking system that is induced to halt its lending starves the underlying economy the same way a candle-snuffer starves a flame.

You might recall that after banks suffered huge losses in 2008 and 2009, they halted their lending efforts even though regulators and lawmakers encouraged them to do otherwise. The lack of credit exacerbated an already severe problem. Central banks compensated by undertaking massive stimulation efforts, but it took a while for economic activity to rebound and there was a lot of pain in the process. In this context, it not surprising that the European Central Bank has suggested that if Greece were to default on its debt, the magnitude of the resulting financial shock could rival the one caused by the collapse of Lehman Brothers.

JAPAN

Of course, to the extent larger and/or more debt-laden countries were to default on their debt, the shock could be far worse. If you accept the notion that a fair way to measure a given country's debt burden is to relate that burden to its economic output, Japan, with a debt-to-GDP ratio of

almost 200%, easily tops the watch list. Nonetheless, countries with widely ranging debt-to-GDP ratios have defaulted on their debt at various times. For instance, Albania defaulted on its debt in 1990 when its debt-to-GDP ratio was only 17%. Other defaults occurring at relatively low debt ratios include Germany at 24% (1932), Argentina at 63% (2001), and Uruguay at 83% (2003).

Japan's fiscal woes are not yet rattling the global financial system because Japan's public debt is largely funded by Japan's own citizens (who have a strong savings mentality). To the extent Japan finds itself needing funds from external sources (i.e., the global capital markets), Japan can expect the same objective scrutiny that Greece has so far endured. If creditors sense excess repayment risk if/when Japan holds its hand out, they will certainly demand to be compensated for accepting that risk. I am not predicting that Japan will default, but the situation is worrisome.

U.S. DEBT CEILING

The U.S. bumped up against the official debt ceiling on May 16th when total public debt reached $14.294 trillion. The Treasury has indicated that it has enough legal accounting tricks to keep the bills paid until August 2nd, but after that the Treasury will be forced to decide who gets paid and who doesn't. None of this is new, however, as the debt ceiling has been raised over 100 times since it was first established in 1917. 10 of those increases have occurred since 2001 so Congress has quite a bit of practice with this drill.

In truth, the debt ceiling is mostly a charade. Inasmuch as debt ceiling decisions are addressed *after* Congress commits to spending more money or accepting less tax revenue, they are typically pretty well divorced from the budget decisions that cause the limit to be reached in the first place. Although there is always a chance that Congress will play hardball with itself and not raise the debt ceiling, the probability of Congress allowing the Treasury to default on its obligations are probably pretty slim since it would create a strong political backlash.

House Republicans have proposed a plan that proposes major reductions in Medicare spending and other entitlements, but the most likely outcome is that Congress will increase the limit enough to get us to the 2012 elections. That increase will probably be coupled with at least some budget cuts to save political face. Expect a lot of political posturing during the remainder of July.

FINAL WORD

Although I believe there's merit in the Fed's argument that the recent economic slowdown was caused by transitory forces, and although I still believe in the resiliency of the capital markets and the long-term benefits of investing in equities, my enthusiasm is somewhat tempered by these concerns:

- A number of central banks in other parts of the world have already taken steps to slow the expansion of their economies. Historically, this has put a wind in investors' faces.
- Our own central bank has stopped stimulating the U.S. economy. While this is not yet a negative factor, the absence of further economic stimulation is clearly the removal of a former positive.
- The debt issues in Greece are likely to resurface. And, even if Greece does not default on its debt, I expect major disagreements to develop within the eurozone as more countries become dismayed at not being in control of their own monetary decisions. This wrangling is likely to upset the financial markets no matter what the outcome is.
- Although policymakers might wish for the U.S. economy to be able to "grow" its way out of its debt and deficit problems, a safer approach to achieving fiscal sustainability is probably to strike a balance between consistent GDP growth and a modest increase in taxes. I would expect those tax hikes to come sooner rather than later and I would also expect investors to continue to be unhappy about it.

Since many people have been psychologically scarred by the last downturn and because most of my clients are in the later stages of life with limited capacity to recover from another major financial setback, my preference is to manage portfolios somewhat more conservatively for the time being.

As always, I appreciate having you as a client. If you have any questions or concerns, or if you wish to alter your investment posture, please do not hesitate to contact me.

— Glenn Wessel