PLEASED, BUT NERVOUS ...

RECAP OF PREVIOUS FRETTING

Three months ago, I groused about the near-term economic negatives associated with fiscal uncertainty and the partial economic vacuum that was likely to result from the full reinstatement of social security payroll taxes and the imposition of higher income tax rates on high earners. I noted that the Conference Board's Leading Economic Index® had tapered off, that the U.S. economy remained fragile, and that other important countries such as China, India, and Brazil were slowing economically as was most of the rest of the world. I lamented that the guidance for corporate revenues and earnings had turned overwhelmingly negative and I worried that the eventual lopping off of any significant portion of the federal budget deficit would be the economic equivalent of a gardener having to decide which part of her garden to *not* water.

Arguing in favor of stocks, I presented data that suggested domestic stock prices were very much in line with historical norms — both as a whole and for each of the ten sectors that comprise the U.S. stock market. I also noted that the Federal Reserve had committed to further stimulating the U.S. economy as warranted and that, in general, it was unwise to "fight the Fed" (which meant that, historically, there is little reason to *not* own stocks during times when the Federal Reserve is stimulating the economy as is now the case).

Although I could not really make a case for it, I mentioned that many forecasters believed that after a breather in the first half of 2013, economic growth would reaccelerate. Many forecasters still believe this as does the Federal Reserve. Either way, I told you that although I felt that caution was in order, I remained strongly convinced that common stock dividends offer investors the best prospects of a rising income. I still think all these things.

MATERIAL REVISIONS TO ANALYSTS' EARNINGS ESTIMATES — 6 HIGHER; 11 LOWER

Since the level of corporate earnings is of vital interest to investors, CNBC publishes a number of metrics related to corporate earnings and analyst sentiment. As such, it publishes a continually updated list of analysts who have recently revised corporate earnings estimates by at least 20%. While this list is obviously of use to stakeholders in the companies appearing on this list, it also provides a snapshot of the current earning's wind. As of March 30th, those winds were negative.

REVISIONS TO ANALYSTS' BUY/SELL OPINIONS — 175 UPGRADES; 245 DOWNGRADES

CNBC also publishes a daily summary of the number of analysts who have revised their previous buy/sell recommendations. Of the 420 opinion changes that analysts have issued over the past five weeks, 58% of them represented opinion downgrades. Since analysts have historically been an overly optimistic bunch, this reading might be somewhat worse than it already appears.

25 Monday	26 Tuesday	27 Wednesday	28 Thursday	1 Friday
Announcements 46	Announcements 71	Announcements 83	Announcements 118	Announcements 41
Consensus Revisions 227	Consensus Revisions 178	Consensus Revisions 193	Consensus Revisions 256	Consensus Revisions 235
Downgrades 14	Downgrades 12	Downgrades 10	Downgrades 9	Downgrades 15
Upgrades 12	Upgrades 3	Upgrades 10	Upgrades 8	Upgrades 8

4 Monday	5 Tuesday	6 Wednesday	7 Thursday	8 Friday
Announcements 19	Announcements 41	Announcements 72	Announcements 82	Announcements 20
Consensus Revisions 267	Consensus Revisions 189	Consensus Revisions 216	Consensus Revisions 243	Consensus Revisions 225
Downgrades 15	Downgrades 7	Downgrades 12	Downgrades 20	Downgrades 15
Upgrades 13	Upgrades 5	Upgrades 10	Upgrades 11	Upgrades 7

11 Monday	12 Tuesday	13 Wednesday	14 Thursday	15 Friday
Announcements 31	Announcements 46	Announcements 39	Announcements 54	Announcements 28
Consensus Revisions 195	Consensus Revisions 194	Consensus Revisions 197	Consensus Revisions 164	Consensus Revisions 213
Downgrades 12	Downgrades 11	Downgrades 7	Downgrades 8	Downgrades 8
Upgrades 6	Upgrades 8	Upgrades 15	Upgrades 7	Upgrades 9

18 Monday	19 Tuesday	20 Wednesday	21 Thursday	22 Friday
Announcements 41	Announcements 20	Announcements 37	Announcements 38	Announcements 13
Consensus Revisions 140	Consensus Revisions 164	Consensus Revisions 130	Consensus Revisions 184	Consensus Revisions 152
Downgrades 9	Downgrades 13	Downgrades 7	Downgrades 7	Downgrades 9
Upgrades 10	Upgrades 2	Upgrades 2	Upgrades 3	Upgrades 7

25 Monday	26 Tuesday	27 Wednesday	28 Thursday	29 Friday
Announcements 14	Announcements 20	Announcements 34	Announcements 39	Announcements 1
Consensus Revisions 171	Consensus Revisions 158	Consensus Revisions 119	Consensus Revisions 148	Consensus Revisions 53
Downgrades 10	Downgrades 5	Downgrades 4	Downgrades 6	
Upgrades 6	Upgrades 4	Upgrades 6	Upgrades 3	

CONSENSUS EARNINGS REVISIONS — 275 HIGHER; 345 LOWER

Analysts constantly tweak their earnings estimates because the reward for analytical prescience is a large paycheck. Data aggregators take note of the earnings estimates released by individual analysts and assemble them into consensus earnings estimates. From March 25th through March 29th (look at the bottom of the previous page), consensus earnings estimates were revised 650 times — a number plenty large from which an inference about the relative direction of corporate earnings as a whole can be confidently drawn. As was the case with revisions to analysts' opinions, 58% of these revisions were negative.

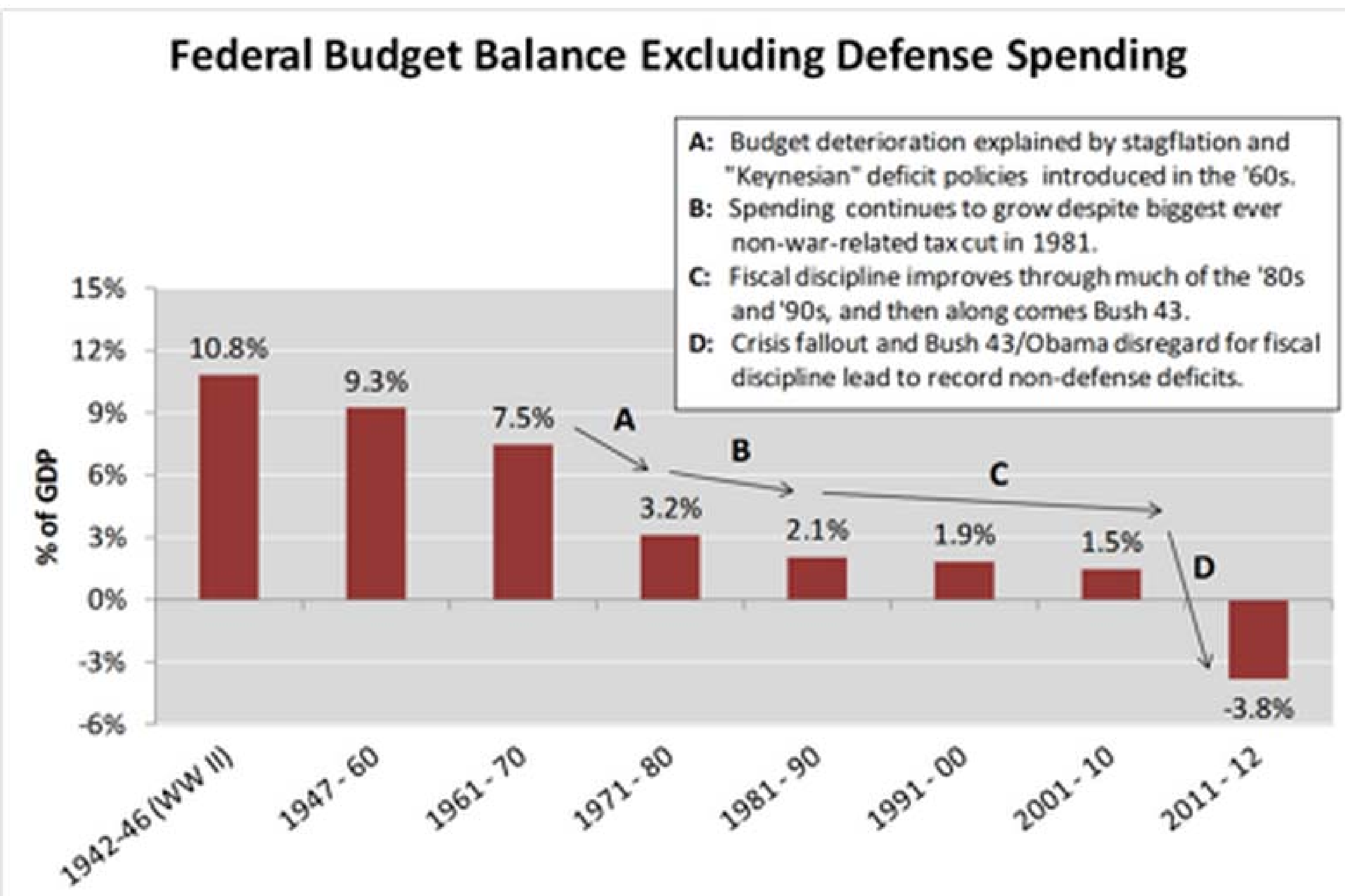
So, despite the fact that the Federal Reserve and many other forecasters continue to expect economic growth to rebound in the second half of this year, most of the revisions to analysts' earnings estimates and investment opinions continue to move in the wrong direction. I won't argue that forecasters are delirious, but since changes in the level of corporate earnings is a primary determinant of stock prices, I do think it's worthwhile to heed data that suggests that corporate earnings growth continues to moderate.

Although this reality does not at all induce me to abandon stocks, I am inclined to favor companies that are operationally stable and financially sturdy that also have a history of not only paying dividends, but increasing them regularly. Because I prefer our equity investments to have a margin of safety, I favor the shares of companies that sell for prices that are relatively low in relation to their earnings, and I especially favor companies who routinely use some of their excess cash flow to reduce the number of outstanding shares (by repurchasing shares in the open market). I favor these share repurchases because it essentially results in the remaining shareholders (you) owning a relatively larger chunk of each company. All else being equal, owning 100 shares of a company that has reduced its share count from, say, 300 million shares to 200 million shares may be about as beneficial as if that same company were instead to have increased its dividend by 50%. A number of companies we hold have a history of repurchasing shares *and* raising their dividends.

U.S. DEBT — FIRST, SOME FALSE COMFORT

Although the U.S. is certainly struggling with budget deficits and a huge accumulation of debt, some have argued that, in relative terms, the U.S.' debt burden is still significantly less onerous than it was at the end of World War II. Technically, this statement is true (refer to the next graph).

Publicly-Held Federal Debt as a % of GDP (1790 — 2012)



Source: CYNICONOMICS calculations using Office of Management and Budget (OMB) data

If you compare the circled areas in the graph on the top of page 4, you can see that although the U.S. debt burden is currently elevated, the relative level of debt is still much lower than it was at the end of World War II. Like any good fib that contains elements of undeniable truth, the comfort provided by this graph fades as the underlying details are examined.

BALANCING THE U.S. DEFICIT — A DOSE OF REALITY

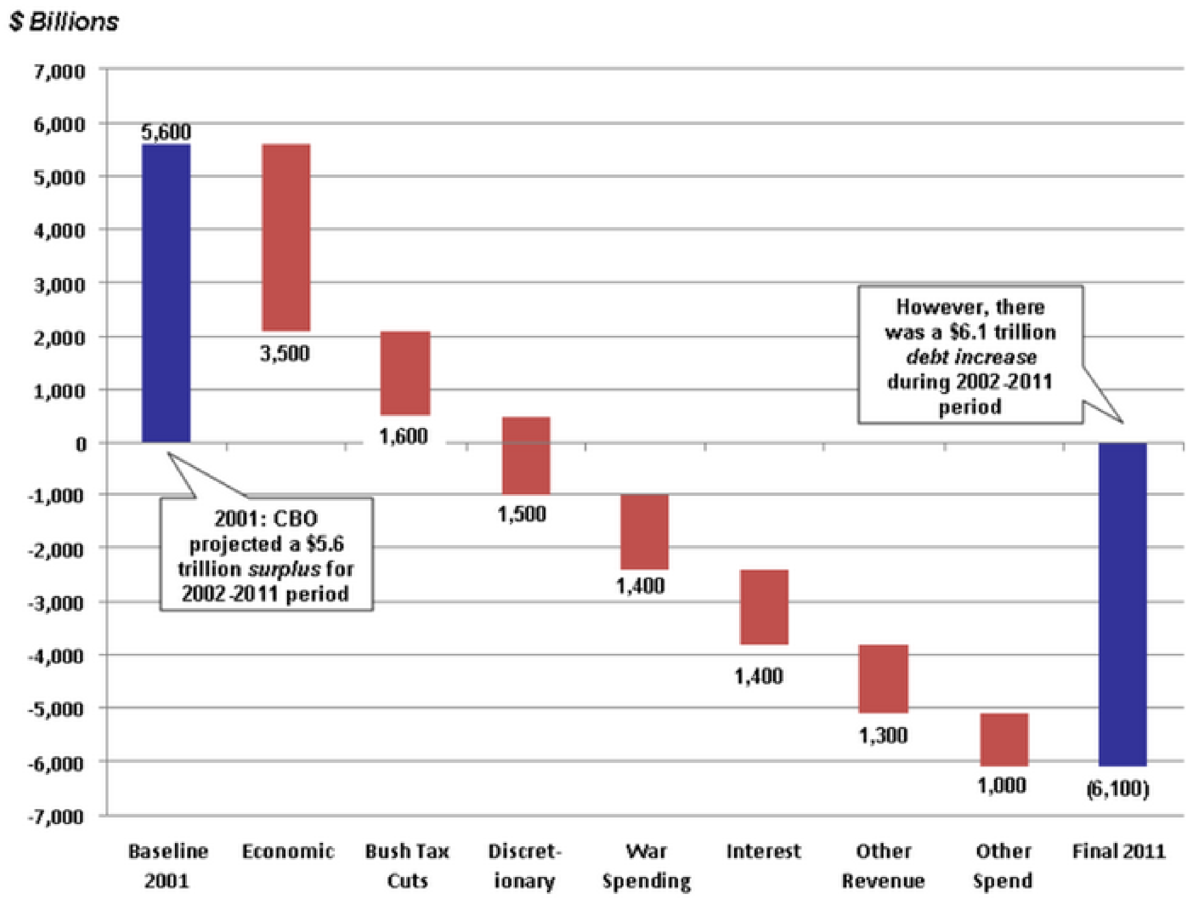
Even though the relative level of U.S. debt was substantially higher at the end of World War II than it is now, correcting the budget deficit was much more easily fixed back then than it is now. The graph on the bottom of page 4 illustrates what the various U.S. budget surpluses and deficits would have been during various periods of time *if defense spending were ignored*. During World War II, the U.S. would have been running a budget *surplus* of some 10.8% if defense spending had been ignored. As military spending fell materially after World War II, the budget deficit was eliminated. The combination of post-war budget surpluses and a growing economy resulted in a markedly improving debt-to-GDP ratio from the end of the war until about 1970.

Now, take a look at the 2011-12 period on that same graph. You'll see that if the U.S. were somehow able to eliminate its defense spending today, it would *still* face a substantial budget deficit that would continue to add to its already large debt burden. So, while the current level of debt is relatively less onerous than it was in 1945, the fix will be far more complicated and politically difficult as is already evident by a polarized Congress. In oncological terms, the budget problem the U.S. faced in the 1940s is analogous to having a tumor on an elbow whereas the budget problems the U.S. faces today are more akin to having an internal tumor that has already metastasized. The agent for that metastasis is the growth in the number and size of the various entitlement programs that are now inextricably intertwined in the U.S. economy. Shrinking them will require tremendous amounts of political courage because the process will undoubtedly be painful.

BUT WAIT, IT GETS WORSE

The Congressional Budget Office (CBO) is the impartial analyzer of budgetary and economic issues that are relevant to the Congressional budget process. If you look at the graph that appears on the top of page 4, you'll see that the CBO has projected future levels of federal debt based on two different scenarios. For now, I respectfully request that you root for the "extended baseline" scenario. While rooting for that, look at the chart on the next page. It illustrates how well a CBO projection made in 2001 worked out after it had estimated that the U.S. would run a cumulative budget surplus of some $5.6 trillion over the ensuing decade.

Cause of Change in U.S. Debt Position (2001 Projected vs. 2011 Actual)



Source: CBO Data

By the end of 2011, the expected surplus of $5.6 trillion had somehow turned into a $6.1 trillion deficit. As Maxwell Smart of *Get Smart* fame might have said (as he brought his fingers together), the CBO was only off by "this much," i.e., $11.7 trillion. Incidentally, if you have as much trouble conceptualizing 11.7 trillion of something as I do, try thinking of it as $11,700 billion or even $11,700,000,000 thousand.

I hope I'm wrong but I fully expect future debt levels within the U.S. to be significantly worse than whatever the CBO is currently forecasting simply because people and politicians are naturally more inclined to withdraw energy and money from a shared system than to contribute to it.

INTEREST RATES

The Federal Reserve has reiterated its willingness to continue pumping funds into the economy at least until the unemployment rate declines another 1% or so, or until the annual rate of inflation approaches 2.5%. The Fed has room on both fronts, so I do not expect it to unleash any contractionary policy moves this year that would cause interest rates to rise. Of course, rising interest rates are anathema to bond values — especially longer-term bonds. But, since I do not expect the Fed to raise rates this year, one could make the case that investing in longer-term bonds might make sense for at least a while longer since longer-term bonds typically provide higher levels of income than shorter-term bonds.

This is true, but the wrinkle in this logic is that the Fed is not in complete control of the level of interest rates. Market forces play a large role, too. To the extent decent economic news continues to be the norm and investors begin to expect the Federal Reserve to begin to cease its stimulation efforts, the level of interest rates could rise well ahead of the time the Fed actually takes any action. Consequently, I continue to prefer floating-rate and shorter-term fixed income instruments in an effort to control interest-rate risk because this allows us to capture most of the yield that is available on longer-term instruments while having to bear only a minor portion of the interest-rate risk.

FINAL THOUGHTS

I've already addressed how burgeoning debt levels tend to sap the growth of an economy in previous rants, so I'll not revisit that topic here. I'm still concerned about debt and budget issues, but I also recognize that much of the current economic news is decent. Consequently, our investment stance has not really changed much over the past few months. We still favor higher-quality dividend-paying equities, we're still keeping most of our portfolios moderately underweighted in equities, we still favor floating-rate and shorter-term fixed income securities in an effort to mitigate interest-rate risk, and we're still hoping that economic growth both here and abroad does, in fact, reaccelerate in the second half of this year. The good news is that we expect most of the portfolios we oversee to hang pretty tough if that rebound in growth does not occur.

— Glenn Wessel

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