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Quarterly Newsletter

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Fourth Quarter 2011

US & World Economy - The US economic growth stalled over the summer as consumer confidence dropped to a 30 year low amidst the disappointment of watching a nearly nonfunctioning Congress and the first time ever downgrading of our government debt. This has led economic forecasters to increase the likelihood of a recession to 50/50, produced sharply lower worldwide stock prices and reduced earnings estimates. Inflation fears have also receded and interest rates were driven to multi-year lows. All of which has left US consumers a bit shell shocked as they continue to deleverage to shore up home finances and trim spending, while the stock, corporate bond and commodity markets had their worst quarter in almost three years.

Whether we reenter a recession or not, the aftermath of our 2008/09 recession will feel like a continuation of the same sluggish, uncertain times until after the end of 2012. Recoveries from financial crises and large leveraged asset declines simply take years. However, with recent high levels of cash for both households and corporations ($10 trillion), future housing/mortgage stabilization and advances towards balanced government spending – the base will be built for a solid decade of American growth.

US Stock Market - Given this US economic backdrop paired with European worries and a worldwide slowdown in growth – stocks are cheap. Unfortunately, they will probably remain cheap for 6+ more months. One bright spot is the emerging markets where rapid growth had lead to inflation and tighter monetary policies (higher interest rates) in response. With the easing of inflation/currency pressure, interest rates can come down to spur growth (something the US, Japan and Europe cannot do from our already too low rates). We expect these Asian/Latin American markets to resume their growth early next year and their stock markets to anticipate that in the fourth quarter. Multi-national firms will likewise benefit from this pocket of renewed growth while waiting for financial healing in the developed countries. Specifically, we expect the S&P500 Index to stay in a mostly sideways trading zone of 1050-1300 for the remainder of 2011.

Fixed Income - Credit spreads, the difference in interest rates of Treasurys vs. average corporate bonds (junk/high yield) widened as the economy weakened. As a result, Treasury and high grade municipal bond prices climbed and lower grade bonds and foreign bond prices sank, just the opposite of the first half of 2011. These current price levels reflect the 50/50 chance of a recession, with further widening likely if one is announced. The result is that "safe" investments pay virtually nothing and "moderate risk" investments are yielding 4-6%, but with high volatility.

Real Estate - Commercial real estate continues to slowly improve overall with high credit trophy properties leading the way. However, lower rent and high "move-in concessions" are keeping cash flow at reduced levels while the slow recovery continues. Texas and the North East, with lower unemployment and high job growth, are the strongest markets. Florida and the West remain weak. Like the residential mortgage market, commercial debt has 18-24 more months of recapitalization/stabilization to go until most problem properties are appropriately leveraged. Opportunities for discounted purchases in this environment will be well rewarded in the years ahead as there are now more properties being demolished than built. Even with slow growth, this will lead to limited supply and higher rents in the future.

Recession - Despite the dire headlines, an imminent second recession is unlikely. The most widely followed early warning indicator of a pending recession is the "Conference Board's Leading Economic Index." This index has turned down for 2-3 months before every recession since 1958. As of the latest data reported on October 19, the index is still climbing. Further, recessions by their nature are "excesses in need of a correction." So far, consumers have not bid up the prices of houses or durable goods. The household debt service burden is back to 1985 levels and savings rates are at a 20 year high (Wells Fargo). Banks are not over lending. Companies are not over hiring. Inventories are not too high. Households are not over exposed to stocks. Liquidity is at historic levels. It is hard to see why today's economy is in excess of anything and needing to be recessed. Continued sluggish growth is more likely.

Strategies - Investing during extreme lows in sentiment are rare and have almost always resulted in oversized returns in 2-10 years when economies stabilize. This is the fourth time that consumer confidence has dropped over 20% since 1978 (the last time it was this low was the Bay of Pigs in 1961). The following 12 month return for the S&P500 averaged 21.47% in the first three instances and it's likely to have a similar return this time as well. It usually feels just like this, with uncertainty, fear and hopelessness at every turn. Be patient, have courage and buy the dips. We believe downside risks are limited to 1050-1100 on the S&P500 and the 2-5 year outlook is 2-3 times the risk. Likewise, selective commercial real estate should also be acquired (individual risk levels vary).

Political and fiscal (government spending and taxing) challenges remain high, but America is waking up and I believe incremental positive changes will return our country to a favorable place to build business. In the meantime we will be patient in a low return environment.

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