Economic & Capital Market Summary

First Quarter, 2010

The Rules of Investing Have Changed

Many of the people that we have worked with over the years have been "fixers;" they are wired to fix things. And, for the past two years during the financial crisis we have been reading, analyzing and thinking through how this mess of a financial crisis can be fixed. However, we have come to believe that it will not be fixed and that the rules of investing have forever changed. You won't receive a memo from the government describing the changes that have been made, but we believe that the world we learned about in our graduate level Money & Banking and Financial Markets classes is vastly different. As a result, we operate and invest in capital markets that have structural barriers and a sustained, heightened level of risk. With the excessive levels of fiscal debt, weak capital levels in the financial system, ineffective regulatory oversight, lack of rules surrounding complex derivative trading and large amounts of troubled assets still in the capital markets, we believe the expected returns for financial assets will be challenged for the next decade.

While the seeds were planted back in the Clinton administration with the repeal of the Glass-Steagall Act, the financial crisis did not accelerate until mid-2007 when the first signs of tightening in credit became evident. Today, our economy and capital markets still operate in the dark shadow of the Financial Crisis. There are structural issues in our capital markets which will impede the price appreciation of financial assets. Until those structural issues are addressed, we believe stocks will be range bound and individual investors are fodder to Wall Street firms. For the US economy to truly experience sustained economic growth, and investors to recognize more reasonable price-risk transparency in the capital markets, we believe three things need to happen.

1. First, the administration and Congress need to articulate a rational plan to address the bloated debt level. The federal debt outstanding is over $12 trillion which represents roughly 85% of the country's GDP. Further, watching Greece haphazardly fumble through its mounting debt problem, and ultimately continue to borrow in the debt markets in order to pay off its short term debt does not instill investor confidence. The United States is no different in this regard. The Federal Reserve intentionally grew its balance sheet in order to affect the programs supporting the bailout. Now, it's time to start reigning in our debt.

2. The Federal Reserve needs to remove itself from supporting our capital markets. Until the Fed moves off of its zero interest rate policy and removes itself from the markets, we do not believe that the markets are pricing risk efficiently. Remember, the capital markets are simply a clearinghouse for risk. With the government acting as the marginal buyer of securities and parking $1.2 trillion in the capital markets, interest rates simply remain too low. The policies initiated by the Fed over the past two years have been one big experiment called *quantitative easing*. Yet, while the Fed has been successful in propping up our financial system and keeping credit flowing, it comes at a huge cost with increased debt levels that we will have to pay for eventually.

3. Finally, we need to see meaningful financial market regulatory reform that addresses the speculative excesses and moral hazard that currently exists in our financial markets. We are reluctantly surprised at Senator Dodd's version of the financial reform bill; however, we need to see definitive initiatives that address credit default swaps and derivative transactions. Without control over the leverage in the financial system and a meaningful set of rules that are in sync with the complexity of the transactions and securities in our markets today, the risk inherent in the financial system is simply too high.

The U.S. Economy is showing signs of strength

By the numbers, the U.S. economy is stronger than we had expected at this point in the recovery. Fourth quarter growth in GDP was revised to +5.6% with strength coming from the manufacturing and government sectors. We expect GDP growth for the first quarter of 2010 to post a solid +3.5%.

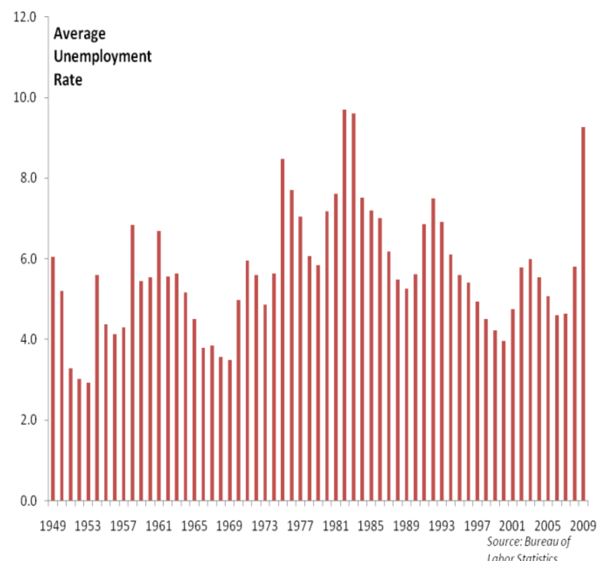
Businesses trimmed their inventories to bear bone levels during the recession. Now, the rebound in inventories is helping to fuel a recovery in the manufacturing sector. We expect that as companies gradually react to a revival of consumer spending, the restocking of inventories will provide an additional catalyst for GDP growth in the coming months. The manufacturing sector will also get an anticipated boost from a recovery in the auto industry as auto sales are expected to increase through the early summer.

Many argue that GDP is a flawed number since it reflects economic growth in U.S. dollars. Richard Koo, the Chief Economist for Nomura Research Institute, posits that if GDP were measured in gold, the U.S. economy has actually been contracting for the past eight years. The total GDP of the United States is roughly $14 trillion and total assets in our capital markets (including stocks, bonds, and real estate) exceed $54 trillion. The United States is in a balance sheet recession marked by deflation and deleveraging which will crimp investing and spending for the next decade.

The Consumer Sector will be challenged

The consumer will be challenged by high unemployment, slow job growth, slow wage growth and a stagnant housing market.

The economy lost over 8 million jobs during the financial crisis. While job growth always lags an economic recovery, it remains a huge concern and a critical element to the durability of this recovery. Estimates show that it may take as long as 15 years for the employment deficit to fully recover. The Labor Department's March Job report showed the economy produced 162,000 jobs. The bright spot was the gains in manufacturing which produced 17,000 new jobs and steady increases over the past three months. However, it is distressing to see the number of long-term jobless, those that are out of work for 27 weeks or longer, increased to over 6.5 million. This represents 44.1% of those out of work which is up from 24.6% the prior year.



The housing sector is typically one of the first sectors to rebound after a recession. Yet, recent data on pending home sales and foreclosures point to a housing market that still looks weak. Roughly 13.6% of borrowers had missed a payment or were in foreclosure at the end of 2009. The industry is still working through a glut of inventory which threatens to keep pressure on prices which have already declined over 30% from their peak. While the recent Case-Shiller index of home prices increased 0.3% for January, we do not expect to see a sharp rise in home prices. Ultimately, until we work through the large inventory glut of homes, the housing sector will be more of a drag on the economy than a spotlight for growth.

Monetary Policy and the Fed's Exit Strategy

We believe the single biggest factor impacting the financial markets in 2010 is how the Federal Reserve will navigate its exit strategy from the capital markets. During the height of the Financial Crisis, the Fed implemented a number of programs designed to unlock the frozen capital markets. The funding for these programs came through a dramatic leveraging of the Federal Reserve's balance sheet. In effect, the excess leverage in the capital markets was absorbed by the government through these massive securities purchase programs. In addition, the Fed lowered short term interest rates to zero percent, virtually providing the cost of capital to banks for free. This program called *Quantitative Easing* was similar to Japan's monetary policy over the past 10 years.

One of the major pillars of support for the capital markets was the Federal Reserve's $1.25 trillion program to purchase mortgage-backed securities in the open market. Through this program, the Fed has attempted to keep interest rates low for homebuyers and created an opportunity for those homeowners with punitive resets on their adjustable rate mortgages to reset at lower levels. Even though the Mortgage-backed Securities Purchase Plan ended this past month, we expect future open market purchases of mortgage-backed securities will be made directly through Fannie Mae and Freddie Mac. In addition, the U.S. Treasury has announced that it will place $200 billion on deposit with the Federal Reserve so that it can affect market transactions. So much for the free exchange of capital in our markets.

Another step in the implementation of the Fed's Exit Strategy will be the Fed increasing short term interest rates from zero percent. The ultra low short term interest rates has provided a steep yield curve that in turn has allowed the banks to reap significant earnings off a marginally low cost of capital. We expect the Fed Funds rate to trade near 1.0% to 1.5% by year end which is still an historically low interest rate. With the slack resources in the economy, we are not concerned about inflation at this point in spite of the massive federal debt. With capacity utilization below 70% and unemployment at 9.7%, the risk of inflation is minimal in our opinion.

Structural Problems in the Economy – the Way Forward

As a result of the excess leverage and lax regulatory oversight of our capital markets, our economy has structural barriers that we believe will impede economic growth for some time. The excessive level of debt is one structural barrier. The government's federal debt outstanding totals $12 trillion, which represents 85% of GDP. However, the ballooning debt of state and local governments is another $2 trillion and the unfunded pension liabilities total another $2 trillion. Our real level of debt compared to GDP is already over 100% of GDP. This is further complicated by the increasing cost of entitlement programs and an aging baby boomer population.

Another structural barrier is the persistently weak capital position of the banking industry. While most of the top 19 banks that received TARP funds have paid them back, we are concerned with the lack of transparency and disciplined accounting taking place on bank financial statements. As a result, troubled loans are understated and earnings are overstated, propped up by an artificially steep yield curve and diluted mark-to-market accounting.

The structural problems in our economy, including the massive level of debt, unfunded pension liabilities, weak financial system and poor regulatory infrastructure of our capital markets will ultimately act to limit economic growth in the future. In addition, the gridlock in Washington DC has provided little help to small businesses in the way of access to credit and incentives to expand. Still, without a plan to address the bulging level of debt, we expect the AAA credit rating of the United States is at risk of a downgrade. We do expect to see progress on regulatory reform of our capital markets this next quarter. Sadly, we believe the lack of vision from the Obama administration, the partisan politics in Congress, and the strong lobbying groups which keep the financial services industry entrenched will prevent comprehensive and meaningful reforms that are necessary to protect our capital markets and investors.

Investment Strategy for the Second Quarter, 2010

Three months ago we wrote that we expected to see multiple contraction as the Fed moved closer to tightening monetary policy. However, so far this year the P/E of the S&P 500 has expanded from 14.8x to 15.5x 2010 earnings. We are forecasting twelve month horizon returns on domestic equities in the range of 6.0 to 8.5%. At current valuations, the equity market appears to have discounted a sustained economic recovery. Today, over 90% of the companies in the S&P 500 are trading at their 52 week high and, the number of companies increasing their earnings guidance has increased to the point where it now equals the number of companies that are lowering guidance. So, against a backdrop of reasonably strong economic growth and sharply lower labor costs, we expect the first quarter earnings will continue to show strength. In addition, the steep yield curve will continue to help earnings in the financial sector. We are still looking for growth in revenues to support a more robust earnings outlook – so far, we haven't seen it. And, we believe that any multiple expansion will be limited the closer we move toward Fed tightening. In the equity market, we still like the manufacturing and transportation sectors which play into the recovering economy theme.

In contrast to last quarter, heavy borrowing from the U.S. Treasury continues to push interest rates higher. The yield on the 10 year US Treasury finished the quarter at 3.85%, an increase of over 20 basis points in the last two weeks of the quarter. Foreign central banks purchase over 65% of Treasury securities today, up from 15% 20 years ago. However, the recent reluctance of foreign central banks to buy US Treasury securities puts more pressure on higher interest rates which eventually could choke the recovery.

With an expected increase in interest rates, bonds will be challenged over the next six to twelve months. We recommend fixed income investors should look to barbell between one year and five year maturities and void the three year part of the curve. Short municipal bonds offer better relative value than many investment grade corporate issuers and should be considered from a diversification standpoint. Credit problems in the municipal bond markets are beginning to bubble up as Chapter 9 bankruptcies increase. However, high quality general obligation bonds and essential service revenue bonds with good credit fundamentals are still worthy investments. We recommend caution investing in non-essential service revenue bonds including hospital, toll road, assisted living and nursing home financing bonds.

Preferred stocks have performed extremely well over the past year. We are still believers in the asset class and generally prefer investing in regulated industries with those issuers who have solid balance sheets. In the utility sector, we still believe Alabama Power and Georgia Power offer good relative value. In the bank sector we prefer those issuers that have paid back their TARP money and are showing some earnings growth. JP Morgan, US Bancorp and PNC Financial offer good relative value in today's market.

Given our opportunistic nature and the carnage that has wrecked through the capital markets, we are looking for certain opportunities in distressed credit and distressed real estate in this market.

Finally, we have bought a small position in gold. Gold is an emotional investment which pays no dividend. However, our monetary regime which is based solely on a paper currency since 1971 has been stressed beyond its limit. We believe the United Kingdom, Europe and other developed nations with excessive debt have also stretched their monetary regimes. Our investment in gold is a tool for risk management, not an inflation hedge.

This report is published solely for informational purposes and is not to be construed as specific tax, legal, or investment advice. Nor is this document intended as a solicitation or an offer to buy or sell securities or related financial instruments. The report should not be regarded by recipients as a substitute for the exercise of their own judgment. The comments are based on current market conditions. Different market conditions and assumptions could have materially different results. Neither Winthrop Capital Management nor any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report.

© Winthrop Capital Management 2010