WINTHROP
Capital Management

The Challenges Investors Still Face

It was two years ago that Lehman Brothers was allowed to fail and the US government stepped in to bailout AIG. And, it has been almost two years since the Troubled Asset Relief Program (TARP) was established as a means to prop up our failing financial system, and to lend money to General Motors and Chrysler. Two years later we have made significant progress in structural reform of our financial system and its regulation. Time will tell how meaningful that reform truly is.

The journey to the brink of collapse of our financial system and back has caused damage to our economy and raised the debate of what is important in our domestic agenda. In order to implement the programs to prop up our financial system, the Federal Reserve increased the size of its balance sheet from $1.2 trillion to over $2.3 trillion in the past two years. Now, arguably the level of debt is too high relative to the size of our economy and we are spending more than we collect in revenue. As an example government support and entitlement programs represented 15% of government outlays back in the 1950's, today they represent 60% of all government outlays. As the Bush tax credits are set to expire at the end of the year, we still have no clarity (and many would indicate no fairness) to our tax policy. The current budget deficit of over $1.4 trillion is the largest in the history of this sovereign nation. And, that figure doesn't account for the unfunded pension liabilities which is the rust on our Pinto of a retirement system.

With all the headwinds of our fiscal mismanagement, the S&P 500 posted an impressive return of 10.7% on low volume in the third quarter. At the same time, the bond market, measured by the Barclays US Aggregate Index forced a return of 2.49% for the quarter, and commodity prices rose as gold reached a record of $1300 an ounce, rising over 30% in the past year. We are concerned that the Federal Reserve's intervention in the capital markets is causing excessive valuations, particularly in bonds and gold.

As we have discussed many times in this quarterly publication, financial markets are simply a clearinghouse for the pricing of risk. Markets don't judge whether risk is priced too high or too low, they simply reflect what buyers and sellers are willing to pay for a risky asset. Today, the correlation between movements in the prices of financial assets is very high, reflecting the large amounts of capital being invested in US stocks and bonds. However, stock prices already are reflecting a continued deterioration in the dollar, the optimism of a change in leadership in Congress and additional asset purchases by the Federal Reserve, while bond prices are reflecting a slowing economy and additional asset purchases by the Federal Reserve. We believe the rising price of gold reflects the growing discontent with our central bank's quantitative easing policies and our poor fiscal condition.

We have said all year that for us to become more constructive on valuations of financial assets, three things need to happen. These include:

1. Financial regulatory reform that has real teeth to it.
2. A real plan to pay down the large debt burden incurred over the past two years.
3. A plan for the Federal Reserve to remove itself from intervening in the financial markets.

While there is progress on financial regulatory reform we don't expect to see any initiative to address our budget deficit and asset purchase initiatives until 2011.

As a result, there are two key drivers to the directional move in financial assets over the near term: the elections in November and the Federal Reserve's next asset purchase initiative. In order to have sustained economic growth we need both prosperity and austerity. Right now we have neither.

The Muddle-Through Economy

Third quarter domestic economic growth is weak and we expect it to remain weak well into 2011. With second quarter GDP revised lower to 1.7% from 2.4%, we expect GDP growth in the neighborhood of 1.4% for the second half of the year. This is a very slow recovery. To put this in perspective, if this were just an average recovery the economy would be growing at a rate of 6% by now. Further, two and half years after the start of a recession, the economy is usually 7.5% higher than the prior high level. And, we're not.

Fear and uncertainty are undermining the economic recovery. And, we believe there are serious structural barriers in our economy that are impeding economic growth. These structural barriers include a lack of job growth to meet the demand of unemployed workers, no velocity to money, the huge debt burden, unfunded pension liabilities that many states can't afford to pay and a large level of excess capacity in the manufacturing sector. Until we have structural solutions to address these barriers to economic growth, we believe the economy will continue to languish. One of the structural problems has been the weak capital positions of the major banks. However, with the recent capital requirements released by the Basel III Committee on Bank Supervision, this uncertainty has largely been removed.

At 68% of GDP, the consumer sector represents the most significant portion of our economy. The headwinds facing consumers include an unemployment rate near 9.7%, a general deterioration in wealth and home foreclosures which are still rising. According to RealtyTrac, through August of this year one out of 381 homes was in foreclosure. But, the positive side is that with the decline in home prices, housing in the US is the most affordable it has been in decades. And with a savings rate of 6.4%, the consumer has the wherewithal to spend when they choose. And, even though the Federal Reserve reported a decline in household net worth last quarter, with the sharp rally in equities and bonds this past quarter, we would expect to see improvement this quarter. Real consumer spending increased at a 2.5% annual rate in August and personal income grew by 0.5%. With consumers deleveraging over the past year, savings has increased. As a result, we expect the holiday shopping season could surprise on the positive side; however, an increase in consumer spending is likely not sustainable.

The corporate sector continues to be vibrant. Corporate earnings are strong and so are balance sheets. The shipments of goods, measured by railcar, FedEx and UPS volumes, have been strong both domestic and internationally. Industrial commodity prices have risen back to near record levels with copper reaching a record high last month. And, with low interest rates and tight credit spreads, corporations that can access the credit markets have the ability to extend their debt structure and lower their cost of capital at the same time. However, we expect earnings to start to show weakness this quarter given the lack of meaningful revenue growth and stable operating margins. In addition, the inventory rebuilding that has taken place over the past year has largely run its course which may have a further dampening effect on earnings.

While the government sector propped up the economy earlier in the year, don't expect to see a continuation into the second half of the year. The bulk of the government's stimulus programs are going away in the second half of this year. In addition, governments are slated to cut back spending or raise taxes by an amount that approaches 1% of GDP. Also, the bulk of the census workers which provided a jolt to job growth earlier this year have now been curtailed.

Growth in employment tends to lag growth in the economy. Yet, until we start to see a real increase in employment, it is hard to get too enthusiastic about the economy. It is not clear to us at this point what industries or technologies will be in a position to create the 100,000 jobs a month over the next two years to get the unemployment rate back down below 8.0%.

In the Absence of Monetary Policy we have Quantitative Easing

As a result of the Financial Crisis of 2008, the Federal Reserve implemented a policy of targeting interest rates at zero percent and immediately inflated its balance sheet in order to affect open market purchases of securities. The asset purchase programs, known as quantitative easing, have helped to support the capital markets by effectively transferring the excess leverage from the private sector to the government sector. So far the Federal Reserve has purchased roughly $1.7 trillion of US Treasury and Mortgage-Backed Securities.

Initially, these programs proved very effective in helping to instill confidence in shaking capital markets and allowing financial institutions immediate liquidity in their securities portfolio. However, the artificially low level of interest rates is creating a series of unintended consequences that are dangerous for our capital markets. As free market capitalists, we are proponents of a strong regulatory element and at the same time minimal government intervention in our financial markets.

The zero interest rate policy is creating a carry trade in US Treasury securities which is allowing the banks to borrow short and lend at significantly outsized profit margins. Initially, this was necessary to allow the banks to replenish their damaged capital positions. However, neither the zero interest rate policy nor the asset purchase program is helping to increase the velocity of money, which is what actually generates economic growth.

There are several unintended consequences of these asset purchase programs. In an environment with low interest rates and tight credit spreads, many of the financial instruments investors are using for retirement planning are not working. Money market mutual funds and other fixed income funds are not earning enough investment income to cover their expenses. As a result, the investor is earning a zero percent return. Another unintended consequence of quantitative easing is that some life insurance companies are struggling to profitably fund many products, including annuities using publicly traded securities. As a result, we expect several insurance companies to curtail their annuity sales efforts into 2011. Also, we are experiencing a debasing of the US dollar that in turn is forcing other countries to devalue their currency.

Another effect of this dramatic monetary experiment is that companies are able to access cheap capital in the public markets which is usurping loan demand from the banks. Investment grade corporate issuance reached $238 billion this past quarter and is on pace to exceed $800 billion for the year. This past quarter Microsoft was able to tap the market with a three year maturity with a yield of 0.87%, the lowest yield ever recorded for a publicly issued security. In effect we have created a government subsidy to corporations that can access the credit markets through lower interest rates.

One of the key drivers to prices of financial assets is whether the Fed continues with its asset purchase programs. The Fed has pretty much signaled its intent to implement additional quantitative easing hoping it will be a catalyst for economic expansion. While we expect asset purchases will lower rates further, we expect the impact on economic growth will be negligible since securities purchases do nothing to increase the velocity of money, create loan growth, or expand credit, all of which are necessary for economic growth.

Investment Strategy

It is important to separate the analysis of current economic activity from the analysis of investment opportunities in today's capital markets. The US economy is distressed. At the same time, long standing assumptions which serve as the basis for investing in publicly traded securities (such as our markets are free and open and there is no government intervention or investors earn prospectively higher returns for taking on additional risk) are not real in today's capital markets. As a result, investors need to be disciplined in their tactical strategies, recognizing that financial markets do not move in straight lines.

Within the fixed income sectors we favor being short our benchmarks and overweight credit sectors. Our overriding concern is that the Fed's experiment with monetary policy has forced a significant technical move into the bond market. Last month, prices on high yield bonds hit their highest level since 2007 as investors reached for yield in this low rate environment. Once investors identify better investment alternatives, money will fly out of the bond market so fast that interest rates will snap higher than fundamental economic data should support. Thus, the risk/reward favors the issuer not the investor.

Within the credit sectors, we still believe the unsecured debt of most of the major banks offers excellent relative value. As the banks have rebuilt their capital base they have in effect propped up their entire capital structure by issuing equity. The credit quality of the debt and preferred stocks has improved as a result. Both the Dodd-Frank Act and the Basel III rules will require the major banks to reduce the amount of Trust Preferred securities that apply to Tier 1 capital ratios. This has created an excellent investment opportunity in certain preferred securities of the major banks since the issuer will either tender or call certain qualifying securities.

Some municipal bonds still offer excellent relative value, but our theme remains intact—do your homework. One of the biggest risks to the municipal sector is a change in the accounting for unfunded pension liabilities and the potential for a change in how the rating agencies account for this unfunded liability. Based on our analysis, several states including California, New Jersey and Illinois are currently insolvent.

We are finding value in short high yield debt as well. According to Moody's, the US high yield default rate fell to 5.1% in August from 13.2% a year ago. At the same time, companies have sold over $244 billion in high yield debt over the first nine months of the year. One of the anomalies that exist in the fixed income markets is that the rating agencies give the same rating to a company's six month debt as they do their 30 year debt. However, the probability of default is significantly lower for shorter debt. And, with the unprecedented liquidity and market access, companies have been able to secure liquidity for their short term maturities. We have found good relative value in Ford Motor Credit, International Lease Finance and Sprint.

While we believe the equity market is range bound, we do believe there is still room for equity prices to rise going into year end. Even though we expect to see earnings start to plateau, corporate profits remain strong. The combination of strong earnings, solid balance sheets and low cost debt will support stock buy-back programs. Also, an increase in mergers and acquisition activity over the next six months may provide an additional catalyst for momentum in the market. However, the primary driver to the rally, the expansion of the federal debt, has stalled and the inventory rebuilding cycle has pretty much run its course.

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