WINTHROP Capital Management

## The Winding Journey Toward Economic Prosperity

While we are making progress toward a sustainable economic recovery, there still is much that is broken and the structural problems that exist in the economy and capital markets are effectively detours and road blocks on our journey. Our guess is that it will be a long and bumpy journey. Excess liquidity in the capital markets has helped to raise prices of both stocks and bonds and is helping to mask the risks inherent in the market. As a result, we believe investors have become complacent as portfolios recovered from their low levels in 2008.

On the positive side, in spite of the downward revision in GDP growth to 2.8% last quarter, we believe the U.S. economy is showing sustainable economic growth. This is a testament to the actions of the Federal Reserve which pumped liquidity into the capital markets and took decisive actions to recapitalize our banking system through the TARP program. The Fed's actions helped to restore economic growth faster than if market actions were to simply run their course.

This past quarter we experienced the overthrow of Egypt's president, growing unrest in the Middle East, rising conflict in Libya, and an earthquake and Tsunami in Japan which resulted in a meltdown of two nuclear reactors. With the increased globalization over the past 15 years, geopolitical and economic events around the world now have a greater impact on the U.S. economy and our capital markets. Remember, 15 years ago, the Euro currency did not exist and foreign purchases of U.S. government securities represented a mere 20% of the outstanding debt of the U.S. Treasury. Today, foreign purchases of government debt exceed 65% led by China and Japan. Still, it is important to focus on the resilience of the U.S. economy. While there will be disruptions in supply chains as a result of the tragedy in Japan that will affect certain industries, particularly companies in the auto and electronics industries, we expect these disruptions will not negatively impact growing global demand beyond the near term.

The changes to bank regulations and how our capital markets work has added to the complexity of developing an investment strategy and implementing risk management strategies. With this complexity we are looking for simplicity. Our road map for the US economy and capital markets still looks for three milestones:

1. Financial regulatory reform that has teeth.
2. A credible plan to reduce the budget deficit.
3. A credible plan for the Federal Reserve to withdraw its support of the capital markets through the open market asset purchase program.

Although the Treasury recently announced it would sell its $142 billion portfolio of Mortgage-backed securities that it accumulated as part of assisting troubled banks during the financial crisis, the Treasury and the Federal Reserve have been slow to pull back from the intervention programs established during the financial crisis. Two years later, we are truly disappointed at the lack of progress on any of these initiatives. We see the banking industry going right back to the "business as usual" environment.

Not only is there a lack of initiative to reduce the huge debt burden this country faces, we believe there is a genuine lack of understanding among our political and business leaders concerning the dangers of continuing our current spending policies. In spite of credible work by the bipartisan Deficit Reduction Commission, President Obama did not incorporate their more significant recommendations in his proposed budget for 2011. We remain concerned that the AAA credit rating of the United States is vulnerable. As a result of this lack of meaningful progress, we are extremely cautious on our investments in financial assets and expect U.S. capital markets are vulnerable to heightened risk and volatility.

## The U.S. Economy will Ultimately Prove Resilient

This past quarter, although we experienced growing unrest in the Middle East, the earthquake and nuclear meltdown in Japan, and growing problems in northern Africa we do not expect the U.S. economy to stall. 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 +2.8% with strength coming from the manufacturing and government sectors. We expect GDP growth for the first quarter of 2010 to post a slower +2.5% largely due to weather in February.

Growth in credit and business formation has been slow during this recovery. There are two reasons for this. First, the banks have been so battered that in order to preserve their capital levels, they simply won't make loans to small and medium size businesses. Commercial & Industrial loan growth reported by the Federal Reserve decreased 1.3% over the past year. The second reason is that Healthcare reform has essentially become a tax on small business. With the sharp increase in healthcare costs this past year, small businesses were slow to increase headcount and expand their business. As a result, the combination of the two factors has resulted in a slower more shallow recovery than other periods in our economy.

The corporate sector has remained the bright spot in the recovery. As a result of uncertainty caused by the economic downturn, tax policy and Healthcare reform, companies have been hoarding cash for the past three years as banks cut access to credit. With cash balances at record levels, corporate balance sheets are at their strongest levels since 1959 as corporate profits rose at the fastest rate in six decades according to the Commerce Department. However, at some point they will have to put cash to work either through stock repurchases, investment in the business, acquisitions or dividend payments. In addition, any increase in employment will likely put pressure on margins going forward.

We believe one of the largest risks to the economy remains the fragile state of the U.S. housing market. This is one of many structural problems that currently exist in our economy. As our readers know, the banks have been accused of making mortgage loans to people who couldn't afford to make the payments with sometimes fraudulent paperwork. The banks have yet to agree on a joint settlement that would indemnify them from further litigation. While this reminds us of the tobacco litigation, the settlement will likely take the form of the British Petroleum oil spill in which the culpable parties all put money into a big pool which is intended for the settlement of damages. For the housing mess, it would likely be used for adjustment to principal that would allow homeowners to stay in their homes and effectively rewrite or refinance their mortgage to the lower assessed valuation.

Job growth is an important part of keeping the economy on the road to sustainable growth. As we have discussed, job creation always lags an economic recovery. With last month's nonfarm payroll number of 192,000, we are just now seeing improvement in job creation which could run through the summer months. The challenge is that the economy needs to produce over 150,000 jobs a month for a period of three years for there to be credible improvement in the employment picture.

We expect the economy will experience a continued recovery, but our guess is that it won't feel great for many consumers. Even though technically we'll be in a recovery and the economy will be growing, unemployment will remain high and the recovery will be uneven. We do not expect the impact of the earthquake in Japan to be meaningfully disruptive to our economy.

## Monetary Policy and the Fed's Exit Strategy

We still believe the single biggest factor impacting the financial markets in the near term 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 has been the Federal Reserve's $1.7 trillion program to purchase mortgage-backed securities and Treasury securities in the open market. The result has been an incentive for homeowners to refinance, corporations to access the public securities market at historic low levels of interest rates and the steepest yield curve in history which has allowed the banks the ability to rehabilitate their income statement. We believe that a sustained monetary policy supported by quantitative easing is extremely risky and fraught with unintended consequences which include a heightened risk of inflation, asset bubbles and a mask for real financial regulatory reform. In essence, the asset purchase programs have been so successful at releasing the banks from their capital constraints that they have moved back to their old business patterns. As a result, we have missed the opportunity to implement financial regulatory reform that would avoid systemic risk to our financial system and address the issue of what is "too big to fail."

We believe that we are nearing the point where the Fed will allow a more open discussion of what it's "exit plan" will look like. We expect the first step in the Fed removing itself from intervening in our capital markets will be curtailing the reinvestment of $200 million in coupon and prepayment cash flow in additional securities. In addition, the Fed is likely to begin a plan of selling small amounts of mortgage-backed securities into the market on a regular monthly schedule. The result of these two initiatives will likely be higher short term interest rates. We expect the Fed Funds rate to trade near 0.5% to 1.0% by year end which is still an historically low interest rate.

## Inflation is Showing Signs of Accelerating

We are in a unique period in time. Never before have we experienced such seismic government intervention in the global capital markets and banking system as we have over the past three years. Domestic monetary policy has moved from targeting a desirable level for the Fed Funds rate and the money supply to massive open market purchases of securities that are designed to manipulate the level of interest rates and the shape of the yield curve. This is the new monetary framework for developed nations with significant debt burdens. The severe economic recession in 2009 created slack resources in our economy which has allowed the Federal Reserve to increase liquidity through massive open market asset purchase programs without creating a meaningful increase in inflation expectations. Until now.

With the slack resources in the economy following the recession, we have not been concerned about inflation to this point in spite of the massive federal debt and liberal monetary policy. Our thesis has been that with capacity utilization below 70% and the unemployment rate over 9.0%, the risk of inflation is minimal. Do not be mistaken, the Federal Reserve wants to see inflation. In order for our economy to meet its growth potential, it ultimately needs to absorb the slack resources that exist. And, the primary way that happens is through the expansion of business and credit, and ultimately an increase in consumption.

While CPI is running at 2.1%, core inflation which excludes the more volatile components of food energy is running at 1.1%. Prices for raw materials, oil, gas, copper, cotton and other commodities are all showing year-over-year price increases. As the economy continues to show sustainable growth, we expect employment will pick up; with an increase in employment we expect to see upward pressure on wages which will further compound pressure on inflation.

Inflation is accelerating in other parts of the world, particularly China. Ultimately, inflation will erode the value of an investment portfolio as the buying power deteriorates relative to accelerating increases in prices of goods and services. We believe that the time to build protection in a portfolio is before inflation grips the economy and capital markets. And, we believe we are at a point of heighted risk in acceleration in the rate of inflation.

## Investment Strategy for the Second Quarter 2011

The most important thing to get right when investing is to measure the risk and make sure that, as an investor, you're being compensated for taking that risk. As our long time readers know, we do not believe that you simply park money in stocks and expect prices to rise over the long term. Nor do you invest in 30 year bonds under the assumption that interest rates are stable and remain unchanged. As long as the government is supporting the capital markets through its $1.7 trillion asset purchase program which is resulting in lower interest rates than otherwise a free market would tolerate, investors unequivocally are not being compensated for risk in bonds. But, let's address our investment strategy for equities first.

While equity valuations are cheap when measured by the Price/Earnings ratio compared to four years ago, we are seeing signs that cause us some concern. First, we expect margin compression over the remainder of the year which will negatively impact earnings expectations. This is due to rising labor and raw materials costs which will not be able to be passed onto consumers in their entirety. Second, we are seeing more companies miss earnings projections, which tells us the market is becoming extended and due for a pause. In general, we still believe there is good relative value in the large and mid cap equity areas. On the international side we are cautious on China and Europe and believe the best values exist in Brazil and Japan.

In the fixed income asset classes, we continue to build inflation protection into our portfolios. We continue to invest discretionary fixed income accounts relatively short in maturity, preferring to remain flexible in the event we see a dislocation in short term interest rates. Also, we have started adding TIPs bonds to portfolios where appropriate. The breakeven yield spreads in five year TIPs are attractive. We have seen a run in investment grade corporate bonds that has forced credit spreads to be very tight. As a result, we are very selective and prefer to invest in high quality banks such as JP Morgan Chase and US Bancorp. In addition, we continue to reduce our holdings in high yield bonds given the tight spreads and wonderful performance over the past two years.

The area of the bond market we are most attracted to right now is the municipal bond sector. Municipal bonds are extremely cheap and credit quality, which has been deteriorating, still remains very high. The critical issue when investing in municipal bonds is to do the basic credit work to understand the investment. We recommend staying with general obligation and essential service revenue bonds such as water and sewer bonds. The trouble in the municipal bond market is coming in the special projects which include economic development zones, tax increment financing districts, convention centers, assisted living and stadium bonds.