Denial – It's not just a River in Egypt

Whenever she didn't think that I owned up to something that was ultimately my responsibility, my administrative assistant would tell me "dude, denial is not just a river in Egypt." In a tone laced with sarcasm, it was her way of calling me out and telling me to rethink whatever the issue was that we were trying to address. (Much of the time when she was frustrated with me she called me "dude"). Today, as we look across the landscape of challenges facing our economy and capital markets, we believe Americans and Congress are in denial of the severity of these problems. Our inability to come to grips with these problems will ultimately result in a slowdown in economic growth and a fractured economy.

While the memory of the financial crisis of 2008 is becoming more distant, the road back toward economic prosperity has not been smooth. The uncertainty created from the massive reregulation resulting from the financial crisis has hurt business formation, employment growth and consumption. As we have articulated before, we believe we need to see three things occur before we experience sustained economic growth and become more constructive on the economy and investment in financial assets.

First, we need Financial Regulatory reform that has teeth. The process of financial regulatory reform is taking too long, creating uncertainty which in turn is impeding credit expansion and business growth. Banks are hoarding capital waiting to see the results of new capital requirements and new rules for business practices including derivatives trading. Until we have clarity on the over 100 new rules that are being written by regulators as a result of the Dodd-Frank Act, we believe credit expansion will be muted.

Second, we need to have a credible plan to reduce the budget deficit. Back in 1950, only 15% of government outlays went to entitlement programs; today that figure is over 50%. It is interesting that the work product produced by the bipartisan Deficit Reduction Commission never found its way into the President's 2011 proposed budget and was not the foundation for meaningful talks on reducing the deficit last year. The political process to develop a plan to reduce the deficit illustrates the denial that we are facing in dealing with our excessive spending and inability to raise tax revenues.

Third, we need to have a credible plan for the Federal Reserve to withdraw its stimulus from the capital markets. The Fed currently owns over $1.7 trillion in U.S. Treasury and mortgage-backed securities. The result of the Fed's asset purchase programs has been lower interest rates, a historically steep yield curve and negative real interest rates. Our central bank has manipulated interest rates to be low in an effort to stimulate economic growth and allow the banking system to heal from the financial crisis. This intervention in the markets is distorting the price of risk in the market. As a result, investors are not compensated adequately for the risks they are taking investing in many parts of the bond market.

When we first articulated these three initiatives two years ago, Congress and the Federal Reserve weren't even to the point of addressing them. Now, two years later, our leadership is making some progress on each front. However, we are all in denial if we believe we can afford to maintain our current quality of life. As a society we are living beyond our means and spending money we don't have. Global monetary policies are extremely liberal which has helped asset prices to recover. However, we remain extremely cautious on our investments in financial assets and expect US capital markets are vulnerable to heightened risk and volatility.

The Economy with all its Structural Problems

If we sound repetitive, we apologize, but we believe there are structural problems in our economy and capital markets that will impede economic growth until they are addressed. The size of the U.S. economy measured by Gross Domestic Product (GDP) is roughly $14.2 trillion. We expect the economy should grow by 2.2% to 2.6% over the next six months; however, we expect economic growth to slow through 2012 as initiatives to cut government spending on both a state and federal level begin to take hold. As we explore the muddling economy, we will also discuss some of the structural problems that are imbedded in our economy and capital markets.

First, the lack of job creation is a structural problem in the economy. During the recession, over 8 million people lost their jobs as the unemployment rate increased to 10%. From 2005 to 2007, the economy was producing on average 150,000 jobs a month as the unemployment rate hit a low of 5.1%. Today, we estimate that job growth needs to be over 150,000 per month for three years in order to get people back to work. Yet, the U.S. economy added a dismal 18,000 jobs in the month of June as the unemployment rate rose to 9.2%. Further, a recent poll by the U.S. Chamber of Commerce showed that 64% of small businesses survey had no intention of hiring full time workers over the next twelve months.

Paradoxically, corporate America, after massive layoffs during the recession, is extremely healthy today. With second quarter earnings being released this month, we expect another solid quarter of earnings in spite of supply chain disruptions, severe weather, and rising commodity prices. Companies are sitting on the largest cash balances proportionally since the 1950s and operating margins are robust in spite of the rise in energy costs. The uncertainty in the economy, tax policy, healthcare reform and lack of credit has forced many companies to sit on cash and not invest in equipment to expand their business. The result is that there is little job growth that would normally correlate with business expansion.

In contrast to the manufacturing sector, which has been the bright spot in this recovery, the consumer sector, which represents 70% of GDP, remains in tatters. High unemployment, high levels of debt, a depressed housing sector, and a lack of credit are just a few of the challenges facing consumers. The surplus of unsold homes and the gridlock over foreclosures remains another structural problem in our economy. According to Case-Shiller, with housing prices near their lowest levels, an estimated one out of every 25 of home owners have mortgage loan balances that exceed the value of their homes.

Before the financial crisis, consumers relied on credit cards and home equity loans to maintain spending when they needed money. Now access to much of this credit has been cut. At the peak of the economic boom in the third quarter of 2007, the Federal Reserve estimates that U.S. households had effectively borrowed the equivalent of 127% of their annual income to fund purchases of homes, cars and other goods. This is up from 84% in the 1990s. It is estimated that today consumers have worked their debt-to-income levels down to 112%. In order to get back to an average of 84%, households would either need to pay down another $3.3 trillion of debt or see their incomes rise by $3.9 trillion. The debt burden of the household sector is another structural problem in our economy.

To be fair, there are some bright spots in the economy. Exports, particularly in the manufacturing and agricultural sectors have increased. This is in part due to the booming emerging market economies as well as the weak U.S. dollar. In addition, according to the American Bankruptcy Institute, fewer Americans filed for bankruptcy protection in the first half of 2011 than the same period a year earlier indicating consumer bankruptcies have slowed. Still, the risks to the economy far outweigh the positives right now. Given our muddling slow growth outlook, one of the major risks is that the economy is exposed to exogenous shocks such as a bank crisis in Europe. Any shock has a heightened effect on our economic growth and thus, our capital markets.

The Historic Role of Banks in the Financial System

Before we discuss the structural problems inherent in the capital markets, it would be useful to review the important role of banks in the U.S. financial system. The banking system has always been the backbone of the U.S. financial system and economy. By taking in deposits, banks offer a safe place for households and corporations to place their money while earning a small rate of interest. In turn, banks are able to take the proceeds and make loans which allow for a modest profit. With the AAA rating of the U.S. government standing behind the banking system, depositors are guaranteed their savings balance in an amount up to $250,000 which results in an inexpensive and stable source of funds for banks to make loans.

The world has changed. Banks are still integral in the financial system and the economy; however, after the repeal of Glass-Steagall Act in 1999 and the subsequent financial crisis, we believe there has been less of an incentive for banks to earn profits through underwriting loans. Instead, management has been able to supplement earnings through other initiatives including securities underwritings, capital markets trading and derivatives transactions which do not require the same level of capital commitment as loan underwriting. The result is that now, when businesses are looking for capital to expand, the very institution that was designed to provide the capital no longer has the business incentive to provide the capital. Banks now look at themselves as distribution systems. The business model of the larger banks involve cross selling other bank products with an attempt to maximize the fee income from their clients.

While the overall capital levels in the banking system are higher than before, the overall health of the banks is still fragile. Banks are sitting on large portfolios of foreclosed real estate and the pipeline of foreclosures remains strong. And, while the rate of bank failures in the U.S. has slowed from the pace of the past two years, the list of “problem” banks tracked by the FDIC reached 888 in May, the largest number since the list began.

Lack of Loan Growth is a Structural Problem in the Economy

In the recovery phase of an economic cycle, the central bank typically lowers short term interest rates as incentive for borrowers to refinance or obtain loans which in turn allows businesses to expand which in turn allows the economy, at the margin, to grow. This expansion of credit is held in check by the size of the banks’ capital position and by the excess reserves which the banks hold on deposit at the Federal Reserve. In other words, banks can only make loans to the extent they have the capital to support those loans.

According to the Federal Reserve, banks hold over one trillion dollars of reserves on deposit with the Federal Reserve. Clearly, there is enough capital for banks to be growing their loan portfolios and extending credit. But they are not. Loan growth to businesses and consumers since the recovery started is actually down -4.1%, the worst measure in a period of economic recovery on record.

There are several reasons for the contraction in bank lending today. First, there is reluctance on the part of banks to put capital at risk and make loans when they still don’t know the extent of regulatory reform on their business. Executive management is not incentivized to put their capital (and ultimately their compensation) at risk when they can earn 0.25% on the reserves that are held on deposit at the Federal Reserve risk free. Another reason is that the demand for loans is significantly diminished today. From 1990 to 2010 consumer loans at U.S. banks quadrupled from at total of $800 billion to over $2.5 trillion. There has never been such a period of massive credit extension in our capital markets than the past twenty years. And, the hangover we are now feeling after the party hurts and we expect that this will last for another two to three years.

Investment Strategy for the Third Quarter, 2011

An important milestone in addressing the addictions that persist in our capital markets is the end of the Federal Reserve's quantitative easing programs. As a result of the financial crisis, the government created two asset purchase programs totaling over $1.7 trillion that were designed to purchase US Treasury and mortgage-backed securities in the open market. This allowed banks a market to sell securities and create liquidity for them to turn around and make loans (which they really didn't do much of anyway). The end of the last asset purchase program was June 30th and the Fed indicated that at this point there will not be a third program. As we've discussed before, the results of the Fed's quantitative easing is mixed and we believe the political will to initiate another program is simply not there.

Since these programs have distorted the price of risk in the bond market by artificially lowering interest rates, we expect that the risk to higher rates is higher now. However, this risk is balanced somewhat by our outlook for slow economic growth which should put a cap on how high interest rates will go. Our expectation is that we experience a rise of short term interest rates of 100 basis points over the next twelve to eighteen months. Our bond portfolio strategy reflects short durations and an overweight to corporate and municipal bonds in anticipation of higher rates.

As we have stated before, we do not expect a meltdown in the municipal bond market. In fact, we have been enthusiastic buyers of municipal bonds and expect that with slower issuance and inevitably the risk of higher tax rates on wealthy individuals and corporations, municipal bonds will benefit.

While we believe the equity market is fairly valued given the exogenous events working through the capital markets, the fundamentals for domestic stocks are clearly strong. Revenue growth is modestly positive, operating margins remain healthy and companies continue to hoard cash. Equity valuations have discounted a heavy price for uncertainty. Merger & Acquisition activity will likely remain high, which should help provide an additional catalyst for equity prices. However, as the Administration searches for ways to raise revenue for the government, companies will likely pay through the loss of deductions and potentially even higher taxes. We believe risks to the downside are higher for stocks given current valuations, our muddling economic outlook, the political environment in Washington DC, and the global debt/banking crisis.

In our investment process, every security has an objective and there are both strategic and tactical initiatives in every portfolio. We do not believe in a buy-and-hold strategy investing in today's broken capital markets. Whether it's the European debt crisis, the imminent restructuring of Greece's debt, the slowing Japanese economy, the unrest in the Middle East and Northern Africa, or the rising commodity prices, the risks that any outside event negatively impacts the economy are heightened given its fragile state.

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