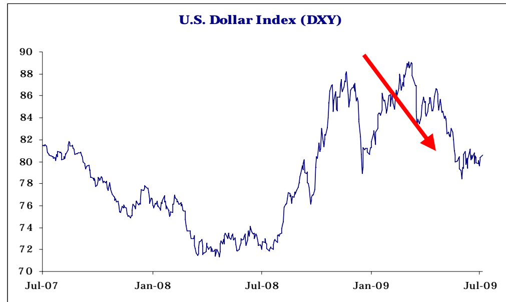
Q2 2009 Commentary

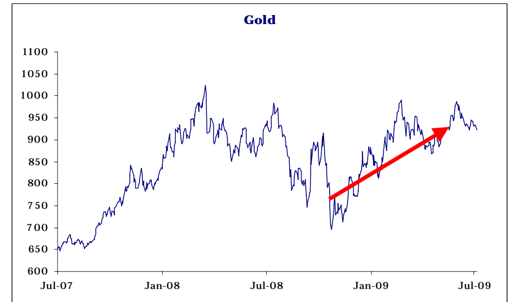
July 20, 2009

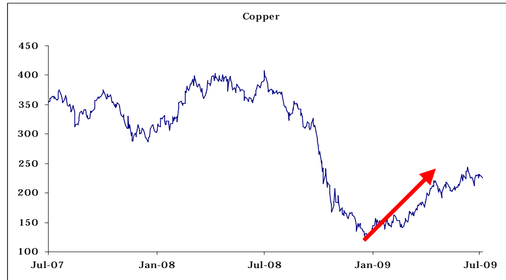
The nascent signs of improvement in financial markets that we commented on in our last letter exploded in equity "melt-up" during the second quarter. The gains registered by stocks in the quarter represented the first positive results in a year and a half. As with previous "V-shaped" recoveries, the intensity of the decline earlier in the year was matched by the rapidity of the rally off of the March 9th lows. The collective realization that we likely avoided a collapse of the global financial system helped ignite the rally. The positive results of the bank stress tests, and subsequent successful capital raises, allowed some of the nations largest institutions to pay back the original TARP funds. This chain of events confirmed the financial system was beginning the slow process of self-healing. As the quarter progressed, the early positive momentum in the equity markets was sustained as incoming economic data showed "second derivative" improvements signaling a possible end to the decline in economic activity.

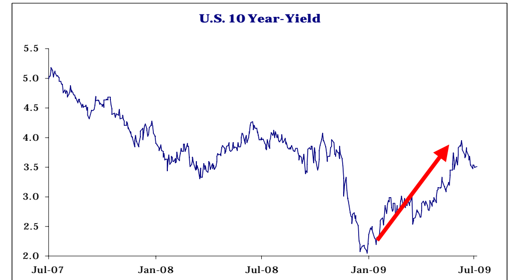
Our strategy, as outlined in previous investment commentaries, gained traction as fiscal and monetary developments continued to align with our "reflation trade" theme.

As we move into the second half of the year, the economic data series continues to turn up. From global leading economic indicators to consumer confidence, readings all portend an eventual shift from stabilization to recovery. While we continue to believe a strong cyclical recovery is in the offing—fed by the massive tidal wave of liquidity and concurrent fiscal stimulus—we cannot ignore the structural changes. Government spending and the Fed's monetization of the national debt has provided support to the economy, but has also distorted the economic picture. We continue to emphasize it is not economics but simply the mathematics of a $2 trillion budget deficit and a massive and growing debt load that drives our investment thesis. These deficit numbers and debt burdens are not sustainable and will eventually have to be rectified by a compromised currency or a surge in inflation. Inflation, as measured by traditional indicators like the personal consumption expenditure or CPI, is not, as Alan Blinder, a former Fed Governor commented recently any kind of "clear and present danger." Typically a general rise in prices affects wages and contracts, eventually leading to a wage/price spiral and aggregate inflation. This scenario seems highly unlikely to unfold in the current environment, given the historically low utilization rates and high unemployment, punctuating the "slack" evident in the economy. Instead it will manifest itself through a rise in commodity and input prices as the U.S. dollar deflates -- the effects of which are best captured in the charts below.









Charts courtesy of Strategas Research Partners

We continue to be positioned to benefit from the emerging trends illustrated above. If the cyclical recovery story falters, we will respond by taking a more defensive posture.