Strategy Update

May 25, 2009

From an overall perspective, there have been two major declines in the equity markets. The first one focused on early October of last year, and the second began in mid-January of this year. The former had to do with the realization that our global financial institutions, private equity funds, and hedge funds were in severe trouble due to over-leveraging and blatant speculation. As the magnitude of the problem gradually became apparent, the world experienced a collective “margin call” of historic magnitude. As prices fell, the margin calls grew immensely.

The responses to the historic decline and deleveraging have been equally historic. Never in modern history has the world thrown so much money at mitigating an economic and financial decline. To a large extent, we have moved the leverage from the private to the public sectors. The magnitude of the public assumption of debt and the devastating effects on the world economy could have been avoided, or severely limited, if our politicians had done the right thing in the preceding twelve months, but they did not.

The public commitments to reflating the world economy are mind boggling and too numerous to list. Needless to say, governments have thrown everything including the kitchen sink as well as all of the sinks at Home Depot into stemming the downward slide. It was too late to salvage the fourth quarter, and the first quarter of this year continues to show weakness. However, there are many signs that the backstops, the stimulus packages, the markets, and the resilience of economies are providing the desired results—or at least heading in that direction. The press loves to refer to these as “green shoots.”

The current debate is about whether or not these green shoots are a sign of Spring or if we have a frost ahead of us. We find that debate counter-productive as nobody knows with any certainty whether or not we will have an L-shaped, W-shaped or V-shaped recovery. However, we believe that the recovery will come. Given the magnitude of the global stimulus and the depth of the fourth quarter decline, there is a good chance that the recovery will be stronger than expected. Look for verbiage like “surprisingly” or “to our surprise” in the printed word. When recovery comes, the pundits and the press will be surprised long after the recovery has begun.

The current focus is on the jobs report. While unemployment is a tragedy for every person and family without a job or income, the fact is that unemployment is what is called a lagging indicator. That means that jobs look a lot stronger as the economy is declining and look a lot worse as a recovery ensues. The peak in unemployment could last into the fourth quarter of this year or even the first quarter of next year.

The leading indicators rose in the recent reporting period to an extent not seen since 2001. It is not yet a trend, but it is a very hopeful sign that the bottom for the economy is at hand—or very near.

Further, geo-political factors are always wild cards. The nuclear test today by the North Koreans was a sobering reminder that we live in a dangerous world. An attack by Israel on Iran, justified or not, will have a significant effect on the price of oil and on financial markets. One cannot invest without being exposed to things that are unknown. If such events occur, the only choice is to endure.

The second decline that began in mid-January was political. California and the federal government, as well as other governments around the world, seem to have transitioned from "we have to save the world economy" to "gee, this unlimited spending is fun." Governments are "running up the credit card" with numbers not seen in some time. The most recent examples might be Zimbabwe, the Weimar Republic, and the French in the South Seas crisis.

As spending program after spending program was proposed and as new revelations emerged regarding deferred spending in the retirement arena, the financial markets resumed their decline. Investors rushed into Treasury securities, even if no return was available. Yields on short-term Treasuries went to effectively zero. It did not seem to matter.

We have rallied about 40% in the equity arena from the bottom of the political decline. We believe that investors are overcoming their fear of undisciplined spending a bit as doubts are voiced over the wisdom of so much deficit spending. We now find ourselves at another fork in the road. If the political fears return, the equity markets could retreat back to the lows set in March. The counter to that could be the green shoots turning into Spring and a recovering economy. It will be a confluence of major proportions. Warren Buffett likes to say that the market is a voting machine in the short-term and a weighing machine in the long-term. The voting and weighing machines are going head-to-head.

We are positioned for the weighing machine, the economy prevailing. As mentioned above, the stimulus has been massive, combined with historically low interest rates. Oil has moved back up and needs to be carefully watched; but oil has been trading with the Euro, not on supply/demand considerations.

In general, there are two types of assets: equities and fixed-income. As our clients know, we view equities to be domestic-based companies, foreign-based companies, private companies (equity and venture capital), gold, commodities, and real estate. Fixed-income is a contract to pay, so the primary differences are in the issuer (Treasury vs. Corporate) and the maturity date of the contract.

Regarding fixed-income, the Treasuries are grotesquely overpriced. This is a combination of several factors. Fear is one. Another is the government buying these securities to suppress rates so that people can refinance their real estate. The last factor relates to undisciplined spending. The government desperately needs to keep interest rates low—at least in the 5 – 30 year range. Just this coming week alone, they will be trying to sell a massive amount of debt. This week's total is a mere down payment on what they will need to raise before September. The government has a printing press, so there is a good chance they will succeed in the short-term, but fixed-income investors are starting to stir. In the last inflationary period, they were called "the bond vigilantes." The amount we raised in the '70s and early '80s was trivial compared to what we face now. Interest rates on Treasuries in the early '80s were in the high teens. If we experience such rates again, the Federal deficit as well as those of other countries will spiral out of control.

We are short Treasuries. We are taking positions that benefit our clients if interest rates rise, causing a decline in the value of Treasuries.

On the equity side, someone cleverly said that one should invest in "anything that hurts when you drop it on your foot". Such things include copper, gold, silver, iron ore, and even fertilizer. If you look at our holdings, you will see a heavy emphasis on real assets instead of paper assets. During the '73 – '81 period, the top-performing asset class was gold. The second best—but a distant second—was smaller-growth companies. Everything else was left in the dust.

Interest rates should rise if the economy comes back. That will be a good sign. If the government loses control over the deficit funding, interest rates will rise exponentially. That will be bad. In either case, shorting Treasuries will be appropriate.

If the economy comes back in a strong way, industrial materials will again be in demand. We have not increased capacity, so the magnitude on price should be substantial. Agricultural commodities will also be in strong demand. The world's population is not declining.

We have also taken positions in high-growth businesses and countries. Diversification of currencies is also important, as it is likely the dollar will begin a downward slide.

As Americans, we hope that the world and our economy come back in a healthy fashion. We must come to our senses on the deficit spending for that to happen. However, as investment professionals, we have to provide a strategy to benefit from the upside, but also to protect against the potential for ruinous inflation.

We believe that the strategy and allocation outlined above will accomplish these goals.