

August 5, 2011

Now What?

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I have a visceral dislike for most big-picture investment punditry, since I find far more value in analyzing companies than in trying to forecast economies and markets. I'm sure you have heard the old joke about there being three kinds of people – those who know, those who don't know, and those who know they don't know. In fact, there's a fourth kind of person, which is someone who knows they don't know, but is happy to tell you anyway. These people are called "Investment Strategists."

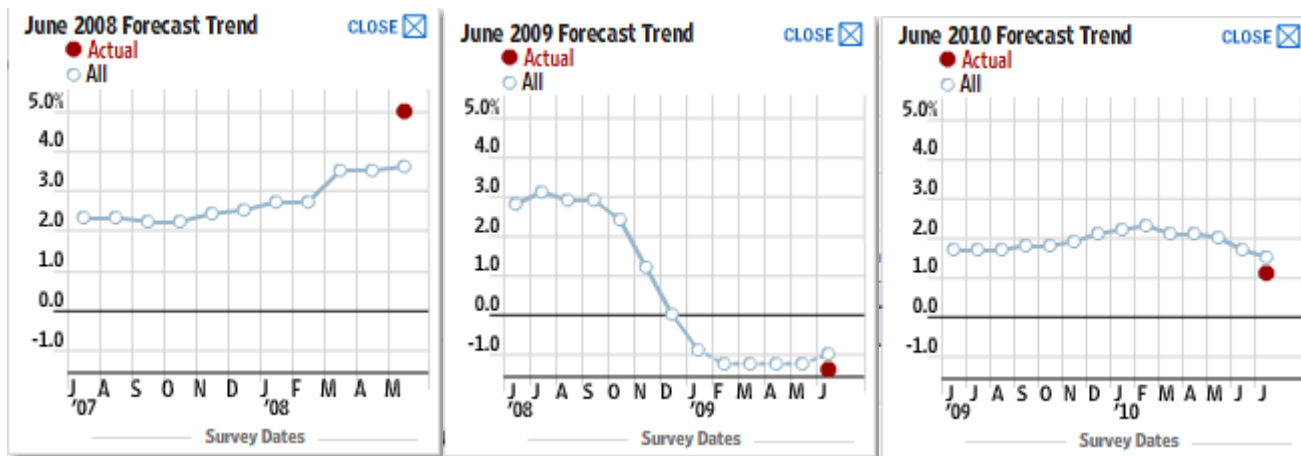
I don't want to imply that one can blithely ignore the larger economic context in which companies operate, merely that it's important to be brutally honest about your – or anyone else's – ability to accurately forecast the future. In aggregate, economies and investment markets are simply too complex to accurately forecast with any confidence.

Don't believe me? Well, a picture is worth a thousand words. The Wall Street Journal surveys 56 leading economists every month about a number of broad economic indicators, and you can see below that these bulging brains have typically been pretty far from the mark in forecasting annual GDP and inflation. They start off too high or too low, and gradually get it right by the time the year is over. (Needless to say, accurately predicting annual GDP in December of the year in question is not terribly useful for an investor.)

WSJ Survey -- Forecasts for GDP Growth



WSJ Survey -- Forecasts for Inflation (CPI)



As you can imagine, I think that basing investment decisions on a specific macroeconomic forecast is likely to result in disappointment. The best thing to do is to survey the current scene, see which data is positive and which data is negative, and set investment policy accordingly. So, let me outline briefly what we're seeing in terms of positive and negative forces for the equity markets, and then summarize what that means for our current investment approach.

The Bad Stuff

- The Eurozone, of course, is a mess. Actually, it's in two related messes, which I think are important to distinguish. There's the sovereign debt issue, which has been exacerbated by the constant dithering of Eurozone officials, and which is now spreading to Italy and Spain. The most immediate concern here is the sharp rise in interest rates for Italian and Spanish government bonds, increasing those countries' debt-service costs and hampering their already sluggish economies. The most direct negative effect of the Eurozone sovereign debt problem is felt by holders of European sovereign debt – mainly European banks, which we happily do not own in client portfolios.
- Unfortunately, the indirect effect of the Eurozone sovereign debt mess is that European economic growth is slowing, and this does have the potential to be an issue for some of the U.S. multinationals that we own. Emerson, 3M, Illinois Tool Works, and UPS all specifically noted a slowdown in European growth in their discussions of second-quarter earnings. Based on their comments, things aren't falling off a cliff in Europe, but growth does appear to be slowing. As the Eurozone accounts for about one-fifth of global economic output, this is not a small issue.
- Our own economy is slowing, and not from a pace that was exactly blistering. Business confidence remains low, consumers continue to pay down debt, and bank credit is not expanding at the kind of pace that would spur an acceleration in growth. Even if the U.S. is not headed for a double-dip recession – which still seems like a low-probability outcome – growth is slowing, and it's hard to say with confidence that the slowdown will be short-lived.
- Unemployment remains high in the U.S., and is likely to stay that way until GDP grows fast enough to create the 200,000 or so jobs per month needed to start making a dent in the number of jobless.
- The recent debate surrounding the U.S. debt ceiling did not resolve the major issues impacting America's long-term fiscal health, such as Social Security and Medicare. Until entitlement spending is slowed or cut, it is essentially impossible for the U.S. to reduce public debt – the math just doesn't work.
- Many large emerging markets are slowing down, which will materially hurt global growth. Although many of these economies are small in absolute terms, their blistering growth rates mean that they punch above their weight in terms of how much they contribute to global economic growth. For example, although China's share of total world GDP was only 14% last year, China contributed 25% of the

world's incremental economic output, because it was growing so much faster than the global average. Brazil is also slowing as that country's monetary authorities battle rising inflation.

The Good Stuff

- Corporate earnings have been very positive, and not all U.S. companies hinted at slowing growth in the second half of the year during their second-quarter earnings calls. In particular, 3M's management felt that conditions would improve in the second half of the year. This comment was notable because the bulk of 3M's products are what we call "fast-cycle" – that is, there's a fairly short period between when customers order them and when they're delivered, unlike a giant electric turbine – so 3M tends to be more sensitive to short-term changes in the business environment.
- U.S. corporate balance sheets are extremely strong – by some measures, the strongest ever. Most large companies have substantial amounts of net cash on hand, and those that prefer to have some leverage have largely refinanced at very low rates. Strong balance sheets are positive in a couple of ways. First, they give companies the financial strength to withstand a serious economic downturn, should one occur. Second, the combination of high levels of cash and low leverage makes dividend cuts very unlikely, and is in fact a good recipe for increased dividend payouts. So far in 2011, companies in the S&P 500 are on track to pay about 11% more in dividends than they did in 2010.
- Fed policy is extremely accommodating, and it seems reasonable to expect that rates will stay low for some time to come. For one thing, raising rates in an environment of sluggish growth and (so far) muted inflation doesn't make a whole lot of economic sense. But perhaps more importantly, the Fed has a strong incentive to keep rates low because 60% of U.S. government debt will be coming due in the next three years, and will need to be refinanced.
- The yield curve remains quite steep. (In other words, long-term interest rates remain substantially higher than short-term rates.) Historically recessions have only occurred when the yield curve has inverted, or short-term rates have been higher than long-term rates. Granted, the Fed's extremely loose policy has to be taken into account, and there's no law saying that historical relationships must always continue to exist, but it's still an interesting data point. (The [Cleveland Fed](#) has more on this, in case you're interested.)
- Valuations are reasonable. Not insanely cheap, but certainly not at levels that would cause valuation to be a risk factor. Using the last four quarters of earnings, the S&P 500 trades at a price/earnings ratio of just over 13. This equates to a 7.4% earnings yield, which compares pretty favorably with investment grade bonds yielding just over 4%. And of course, that P/E of 13 is the valuation of the entire index – there are more than a few companies with materially lower valuations.
- There is still a ton of cash on the sidelines, looking at both surveys of institutional investors, and looking at data from mutual funds. While I don't know exactly what might cause that cash to flow into the market – or when it would shift from cash to equities – it's something to be aware of.

What We're Doing

What does all this mean for our investment approach?

- As I mentioned earlier, steering clear of European financial institutions looks like a good idea, and that's not an area in which we have invested any client assets. We're also wary of "deep cyclical" stocks that are very sensitive to changes in economic conditions, and so we have little to no exposure to companies like Caterpillar or industrial metal suppliers. We do continue to own diversified industrials like GE or United Technologies, which tend to have longer order cycles that rely more on long-term economic trends, and which also have substantial amount of high-margin revenue from services, which is more stable than revenue from product sales. Finally, the slowdown in Chinese growth means we're steering clear of commodity-related companies. Given that China consumes half the world's iron ore, half the

world's coal, 40% of the world's copper, and so on, slower growth in the Middle Kingdom will hit the price of industrial commodities like a sledgehammer.

- We continue to focus on well-capitalized dividend payers. Strong balance sheets offer insulation from volatility in the credit markets, and dividends are a very important source of long-term total return. We are paying special attention to companies' ability to raise their dividends over time, since it is growth in dividends – not a high current yield -- that offers a hedge against potential inflation.
- We are requiring higher margins of safety. Given the increased uncertainty in the global economic outlook, we think it's prudent to look for somewhat higher discounts to intrinsic value when evaluating stocks for potential purchase.
- In terms of asset allocation, we are favoring dividend-paying equities over bonds for income, given the poor current yields available in fixed income securities. When we do need to use bonds to reduce portfolio risk, we are keeping durations in the short to intermediate range. Most importantly, we are not chasing yield, since the volatility-reducing qualities of bonds in a portfolio can be quickly eroded by risky yield-enhancing strategies.

What You Should Be Doing

Finally, how should you be thinking about your portfolio and the equity markets more generally?

- Expect more volatility. With global growth slowing, but to an indeterminate degree, and for an indeterminate period, markets will likely react strongly to incremental bits of information.
- Have reasonable expectations. A more muted economic environment in most parts of the globe, combined with the slow de-leveraging process that must occur in Europe and the U.S., means that sustained double-digit equity returns are unlikely to be achieved.
- If you are using the income from your portfolio for living expenses, focus on the dividends and interest you receive, not the monthly fluctuations in the principal value of your holdings. Declines in equity prices do not presage a decline in dividend payouts unless a company is in poor financial health. We do not expect a rash of dividend cuts similar to what occurred in 2008-2009.
- Bear in mind that the long-term value of companies is determined by the amount of cash they generate over a multi-year period, not by the opinions of traders and pundits that push prices higher or lower on any given day. Sharp declines – or increases – in equity prices can be nerve-wracking, but changes in stock prices do not cause changes in company valuations.

As always, we appreciate your confidence, and welcome your questions.

