Investment Update

January 4, 2010

No Respect?

The stock rally of 2009 is in the books. At the outset, this remarkable turn-around resembled the bear market rallies that preceded it, was declared out of gas numerous times along the way, and mistrusted by many to the end, leading some to assert this the most hated stock rally in history. An amusing notion that probably reflects the chagrin of many who felt underinvested.

In our Investment Update last quarter (Meritage Q3-2009), we offered several reasons why the legitimacy of this rally gained support over the year. We also documented the logic for the bear case. Not a lot has changed three months later. The economy continues to recover while many of the concerns that gave investors pause are still in place. More important, two conditions that have made it difficult for bulls and bears alike not to stay fully invested remain intact:

- Zero interest rate policy (ZIRP) – the Fed's pledge to keep interest rates low for an extended period of time. This translates to a highly liquid environment that supports prices in numerous asset classes (stocks, commodities, energy) all over the world. These conditions have historically fueled speculative activity.
- Strong earnings growth – corporate America's determination to cut costs during the recession was far more aggressive than expected. With depleting inventories and a slight pick-up in demand, worker productivity has soared, enhancing margins and resulting in several quarters of better than expected earnings. This earnings tailwind is expected to continue.

What Worked

It may be too simplistic to say that what worked in 2009 is what suffered most in 2008, although that would be a good place to start. In many sectors, stocks and bonds were priced for depression last March. The avoidance of that depression (at a cost yet to be determined) had the greatest impact on those investments expected to fare the worst, namely, the lowest quality, weakest companies. This group was given a reprieve and led the recovery from the March lows. Leadership has gradually broadened over the course of the year as the market has become more discerning of earnings quality. This change is welcomed by investors like us who don't chase low quality just because it's working.

For the full year, the broad equity market turned in a very strong year. The performance edge went to smaller-cap stocks, growth stocks and international stocks, especially those of emerging growth countries. The S&P 500 finished the year ahead by 26.5%.

The story played out similarly in bonds. The "fear trade" that favored U.S. Treasuries in 2008 reversed course in 2009 as the lowest quality, higher yielding bonds provided equity-like returns. For the full year, the 10-year Treasury bond lost over 6% and the 20-year plus Treasury index declined over 20%. Those who didn't think much of a 2% annual return for lending the Government money for 10 years were right, as the 10-year Treasury now pays 3.85%. As investors became less concerned with the insolvency risk of most corporations, high-grade corporate bonds performed well as the yield-spread (difference in interest rate yields between corporate bonds and Treasuries) returned to more normal levels. The Barclay's Intermediate Gov't/Credit Bond index gained 5.2%, while intermediate tax-exempt bond indices advanced in the 5.5% to 7.5% range.

Our quantitative process continues to produce strong investment candidates. In particular, both our Value and Growth equity styles remain over-weighted in the Technology sector, due to the large number of companies in this group that meet our multi-factor criteria. These factors include attractive cash flow characteristics, reasonable valuations and little or no debt on their balance sheet. Technology stocks also fit a couple themes that we are comfortable with - a wide international foot-print and beneficiaries of the deferred capital-spending investment cycle.

In Government We Trust (?)

We'll devote a little more commentary than usual to the role of government policy, as it has become inexorably intertwined with the longer-term prospects of our economy. We'll highlight a few of the key points, trying to focus more on how policy plays out from here rather than second guess decisions that were made while staring into the abyss.

- In their effort to restore confidence in the financial system, the Fed committed unlimited resources to save the banking system. With this generally accomplished, banks are now being criticized for earning spreads from low risk government bond investments rather than making loans, not to mention the return of fat profits and bonuses. Many have expressed concern that the unintended consequence of financial bailouts is a propensity to resume high risk activities because the Government will be there in the case of failure. The relevant policy debate now centers on financial reform dealing with the determination of what is too big to fail, derivative transparency, consumer protection and other measures. The Senate will take up their version of this bill and the reconciled outcome will very likely, by design, have a disruptive effect on competitive market forces.

- Much debate about the prospects of stocks this year centers on the Fed's strategy of removing liquidity and raising interest rates. As we addressed in last quarter's note, there are significant risks in both increasing rates too soon and in leaving them low for too long. From a political perspective, the risk taken is usually the mistake you can best live with on a short-term basis. That means keeping rates low, guarding against a possible double dip recession, and putting off dealing with the potential untoward effects of inflation, currency devaluation and excessive speculation. Not a comforting thought.

- Longer-term, the most critical policy issue impacting all aspects of our economy and capital market will be how and when the government addresses the soaring debt. This is the elephant in the room that has been obfuscated by the greater good of rescuing the economy. But that will change when ZIRP runs its course and the private economy gains firmer footing. Then the prospect of higher taxes on all forms of income and higher inflation may make investment gains hard to come by. The projected cost of servicing the debt already overwhelms tax receipts, creating a more urgent need to develop a plan to address this pending deficit crisis.

Outlook 2010

The markets and investor sentiment have come a long way in a year. Given the extreme steps taken to trigger this recovery, the prevailing unease is not surprising. At its core is the gnawing feeling that the focus has been on the symptoms, not the underlying causes. Taking on trillions in debt to rescue an overleveraged economy doesn't seem like a sound long-term solution. Perhaps, at best, we've just reset the clock to another time.

This does not leave us bearish for 2010, but quite cautious. On the plus side, equity valuation in general is not extended. Deflationary forces (excess production capacity, minimal wage pressure) are still prevalent, dampening inflation for now and keeping pressure off the Fed to raise interest rates too soon. The retail investor, as measured by mutual fund flows, has begun to shift assets out of safe, but non-earning money market funds. The real beneficiary of this shift so far, has been bond funds, but is an additional positive factor for stocks as well.