Conundrum Investing

Despite a lot of volatility during the year, the S&P 500 powered ahead by 15.1% in 2010. We think the **current battle in the stock market centers on the contradictory conditions of rising financial risks versus improving economic news.** Right now the market seems to be ignoring the many serious financial strains still in the system and is simply embracing the improving economic momentum.

Clearly the star of the current recovery is American Corporations which are flush with cash, financially strong and growing. Despite massive monetary and fiscal stimuli the economy is at best muddling through. Credit remains weak. Housing is sluggish (almost 25% of homeowners with mortgages owe more than their houses are worth), and unemployment is still very high. Since the recession officially ended last summer, final demand has only grown at an average annualized pace of 1.2% per quarter, an incredibly weak performance by historic standards. Corporate profits, however, have experienced a V-shaped recovery. U.S. companies' profits rose in the third quarter to an annual rate of $1.7 trillion, the highest on record. They are now sitting on $2 trillion in cash, or 7.4% of companies' total assets—the largest share since 1959.

It does seem strange that corporations are doing so well amidst such a weak recovery. This outstanding performance is attributable to impressive productivity gains, as well as the fact that a large amount of profits are earned overseas where economic growth is robust. Incredibly, businesses are now producing the same GDP as in 2007 before the financial crisis with 7.5 million fewer workers. The Economist Intelligence Unit forecasts that average economic growth in Asia will be 6.7% in 2011, before averaging between 6.5-7% a year in 2012-15. GDP growth in emerging markets of Latin America, Eastern Europe and the Middle East is expected to be in the range of 4-5% in 2011-15.

In many ways not much has changed in the risk profile for the stock market over the last year except that prices are much higher. Our economy is still struggling with too much debt and too much contagion risk. Europe has been dealing with a debt crisis all year. Professor Rogoff, a former chief economist of the International Monetary Fund, believes a significant restructuring of private and/or public debt is likely to be needed in all of the debt-distressed eurozone countries. Banks across Europe own large pieces of this debt so any restructuring would risk another down leg of the global financial crisis. According to the OECD (Organization for Economic Co-operation and Development) borrowing needs of all sovereigns are projected to hit almost $19 trillion in 2011! Raising large volumes of funds at lowest cost with the ability to refinance again in the future remains a great challenge for several countries.

Adding to debt worries the US municipal market suffered a significant sell-off late in 2010 as investors started to worry about off-balance sheet liabilities. Many cities and states are in poor financial shape. Federal stimulus support is set to run out in 2011 while tax collections remain weak due to high unemployment and lower housing values. More problematic are the huge unfunded liabilities. A study by Northwestern University's Kellogg School of Management suggested total unfunded state and local pension and healthcare liabilities are near $4 trillion. While historically very rare, municipal bankruptcy is permitted in 26 states and could be considered by city officials to restructure labor contracts and debts. According to the Lex column of the *Financial Times*, "(f)aced with unthinkable service cuts, it may only be a matter of time before a large US city takes the plunge. Such a precedent could open the floodgates by making debt refinancing unaffordable for others."

While investors should be happy that taxes will not increase next year**,** the uncertainty created by the absence of a credible medium-term budget plan could undermine the effect of the latest stimulus measures. In addition, real tax policy reform and help for homeowners with negative equity need to occur for the recovery to be sustainable. Congress will need to make progress on these fronts in 2011 or the financial markets might start to revolt.

Despite many significant risks high-quality stocks are extremely attractive and should provide more downside protection if a correction develops as it did in the spring of 2010. Blue chip stocks are so cheap that many are able to borrow at far lower rates than their stock's dividend yield. For example, in mid-November P&G sold $1 billion in bonds due 2015 at a 1.97% yield. Because interest is tax-deductible, the company's effective cost of debt is roughly 1.4%, assuming a tax rate of about 30%. P&G's dividend yield is around 3%. Borrowing to buy back shares is a pretty easy way to increase shareholder value for P&G, a tactic many Blue Chip stocks are employing.

The range of possible outcomes for the economy and stock market is still wide. We believe QE2 is simply a continuation of the boom-and-bust regime that has dominated global financial markets for the past three decades. Fundamentals are good now but are unlikely to be sustainable. Printing money to support asset prices cannot go on forever and usually ends in disaster like it did after both the technology and housing busts. Therefore, we don't believe this is a time to be aggressive. **We are maintaining our strategy of emphasizing steady-growth businesses, with strong balance sheets, healthy dividends, attractive valuations and exposure to emerging economies.** If investors have learned anything it should be that corrections can happen quickly with not a lot of warning. Therefore, we think it is prudent after a tremendous rally to hold some cash and high-quality fixed income securities with short maturities as a hedge to have available to invest during any pullbacks.

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