



Michael D. Axel, CFA  
Jacob D. Benedict

The S&P 500 finished 2009 up 67% from its March lows, staging one of the strongest short term rallies in its history. Despite the recent surge, however, annual returns for the decade ending December 31, 2009 ring in at -1.0% versus 17.9% for the two decades ending December 31, 1999. Investors are naturally left pondering two questions: why has the past decade been so disappointing and what will the next decade bring?

It is important to remember that the 1980's and 1990's should not be considered "the norm." They were characterized by a conducive economic environment and stock valuations that shifted from incredibly low at the beginning of the period (around 7.0x) to incredibly high at the end of the period (around 40.0x). The excessive, or "irrational," exuberance witnessed towards the end of the period is directly related to the market's poor subsequent returns. Jeremy Siegel of the Wharton school states, "The horrible decade has wiped out all the excesses of the previous two decades and put us back on track for more normal returns."

In hindsight, the last two decades of the twentieth century benefitted from several notable tailwinds. After a problematic decade during the 1970's, global fiscal and monetary leaders turned to policies that supported private enterprise and lowered economic uncertainty (e.g. deregulation, privatization, necessary monetary tightening). The development of globalization, emerging market economies and the information network ushered in an era of rapid productivity growth, aiding free market policies in holding down interest rates and inflation. Historically low rates encouraged investment and consumption. The period turned out to be relatively peaceful, witnessing few prolonged military conflicts. Indeed, the 1980's and 1990's can be seen as a golden age of business.

But like most human endeavors, participants overfed at the trough. While the dot-com bubble provided a brief set back, artificially low interest rates (a product of Fed policy as well as external factors such as demand for US debt from sovereign wealth funds) and government encouragement allowed the party to continue. For three decades, US debt skyrocketed relative to GDP. Meanwhile, federal and state governments amassed long-term structural liabilities set to balloon in the face of an aging population. The situation was clearly unsustainable.

The US is resultantly now mired in a "balance sheet recession," as described by Japanese economist Richard Koo, similar in nature to the Great Depression and Japan's Lost Decade. During a balance sheet recession, which is fundamentally different from a standard economic recession, private parties (firms and individuals) shift from a goal of profit maximization to one of debt minimization, attempting to repair balance sheets riddled with devalued assets purchased using borrowed money. New business investment and personal capital expenditures fall precipitously, creating a deflationary gap. While increased savings rates and maintenance of balance sheets are prudent individual moves, in aggregate these actions decrease demand for capital goods. Domestic business investment in the third quarter of 2009 fell 20% from year ago levels and deterioration in household demand for automobiles and housing has only been stalled by extreme government intervention. Monetary policy, the chief medicine for standard recessions, becomes ineffective during balance sheet recessions as low interest rates fail to entice private parties to borrow and spend. Government borrowing and spending designed to fill this deflationary gap is the prime prescription, supporting the economy until private agents have successfully deleveraged.

Unfortunately, the US government's capacity to borrow and spend appears strained from years of fiscal irresponsibility. The government's balance sheet already carries loads of debt and current as well as proposed domestic programs are poised to further balloon the federal deficit in the face of a deteriorating demographic profile. Policymakers likely have neither the political capital to continue running massive deficits nor the collective political will to enact tough decisions regarding long-term domestic programs. Accordingly, economic malaise will likely continue until economic participants successfully deleverage.

Meanwhile, the Federal Reserve and Treasury Department have added massive liabilities to the federal balance sheet through their support of struggling financial institutions and homeowners. Recently, the Treasury issued a statement amounting to an open ended guarantee of Fannie Mae and Freddie Mac, which carry on their books hundreds of billions of dollars in guarantees on home mortgages. While some may argue that such actions are necessary, they nonetheless increase future inflation risks once the current deflationary environment abates, or when credit concerns ease and monetary velocity returns to more normal levels. In order to fight future inflation, the Fed will need to raise interest rates, thereby increasing the cost of borrowing and crowding out private investment. However, the Fed's autonomy has been threatened by the recent financial crisis, making such actions potentially difficult to implement.

So while the last decade has indeed borne some of the pain for the excesses witnessed during the 1980's and 1990's, the current economic picture is anything but benign. That being said, we always warn investors against using economic concerns to dictate investment policy. First, it is easy to be overly pessimistic. But betting against the American economy is an imprudent policy; Warren Buffett wrote in his 2008 letter to shareholders:

[N]ever forget that our country has faced far worse travails in the past... America has had no shortage of challenges. Without fail, however, we've overcome them... America's best days lie ahead.

We instead generally utilize our economic views to inform our general opinions on risk (exchange rate risk, interest rate risk, credit risk, etc.). Secondly, and more importantly, valuation is the chief determinant of investment returns, not economic growth (especially to the extent that a given economic view is incorporated into asset prices); Buffett goes on to state:

We're certain...that the economy will be in shambles throughout 2009 – and, for that matter, probably well beyond – but that conclusion does not tell us whether the stock market will rise or fall.

Unfortunately, even assuming an expedient economic recovery, asset prices appear priced to deliver only moderate returns unless euphoria carries the market to bubble levels (which is certainly possible). Quality intermediate corporate bonds yield just 3-5% and tax-free intermediate municipal bonds just 2-3%; 30-year Treasuries yield only 4.6%, a paltry amount given long-term inflation concerns. The S&P 500 trades north of 17x normalized earnings, which is in the top quartile of historical valuations. While not necessarily overpriced, these valuation levels greatly

*“Valuation is the chief determinant of investment returns, not economic growth.”*

reduce the odds of witnessing anything close to the returns seen during the 1980's and 1990's.

In response, we enter 2010 in a defensive stance. This includes focusing fixed income investments on high quality bonds with intermediate maturities, favoring high quality stocks in companies with defensible businesses that generate strong relative cash flows (and are relatively underpriced), investing in various alternative assets expected to exhibit little correlation to stocks and bonds (including commodities and absolute return strategies) and increasing our exposure to international assets and currencies (where possible, in a lower risk setting). We may turn out to be overly conservative in the end, but we feel our stance is appropriate given our current concerns. As always, we thank you for your continued confidence.

Sincerely,

Michael D. Axel, CFA  
Jacob D. Benedict