the STRATTON letter

October 2011

A Familiar Storyline…With a Twist

With the S&P 500 down approximately 9% for the year-to-date and around 16% since its July 7th high, the financial media's comparisons with the financial crisis of 2008, headlined by the failure of Lehman Brothers, have been plentiful. Whereas previously, credit deterioration, extreme leverage and the general murkiness of subprime mortgage backed securities clouded the investment horizon, this time around the world is faced with the daunting task of quantifying the potential fallout from European sovereign debt problems. In addition to questions surrounding the timing and nature of a Greek default, doubts about the willingness and ability of policy makers to prevent contagion throughout the European Union (E.U.) and the broader global economy has led to increased fear levels among market participants. As a result, global stock investors have been unable to hide from the carnage. International stocks, particularly the emerging markets, and smaller cap stocks have gotten hit the hardest, while U.S. large cap stocks, on a relative basis, have held up better.

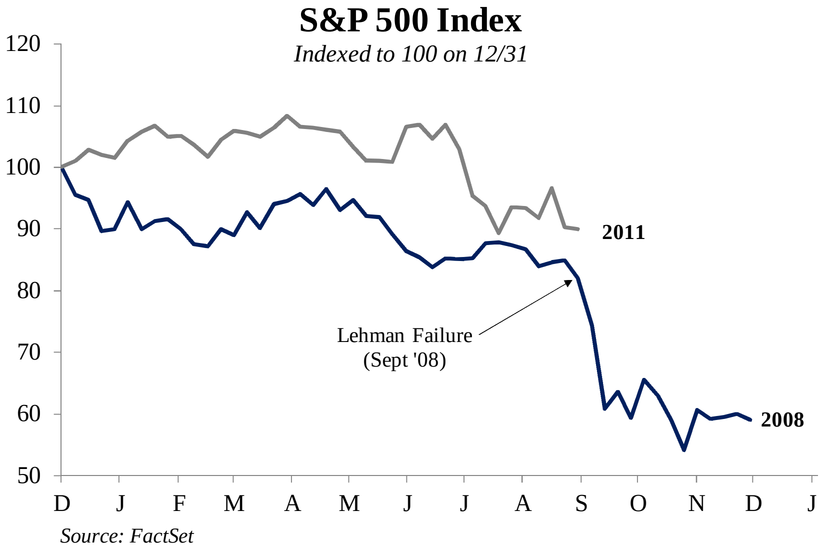
Broad Equity Index Returns Through 3rd Quarter 2011:

	2011 Year-to-Date	Since 7/7/2011
U.S. Large Caps (S&P 500 Index)	-8.7%	-16.4%
U.S. Small Caps (Russell 2000 Index)	-17.0%	-24.6%
Int'l Developed Markets (MSCI EAFE Index)	-15.0%	-21.1%
Int'l Emerging Markets (MSCI Emerging Markets Index)	-21.9%	-27.6%

Source: FactSet

Compounding the European dilemma, and in many ways magnifying flaws of the E.U. system, global growth is slowing. In the "developed" world, high government deficits, policy uncertainty, consumer deleveraging and the fading effects of government stimulus have created economic drags. Currently Europe is entering recession territory, and in the U.S., real GDP growth of 0-2% for the next few quarters seems to be the most likely scenario. More notable, however, is the slowdown in emerging markets such as China and Brazil. Long seen as the growth engines for the global economy, continuously churning out real GDP growth rates of greater than 10%, these economies have cooled somewhat over the past 6-12 months due to a prolonged period of tight monetary policy and slowing demand from the developed economies. Although many of these negative factors have been known by the market for a while now, economists have certainly missed the mark in forecasting the slowdown, continuously revising growth estimates lower as the year has progressed.

With the memories of the 2008 subprime financial crisis still so fresh, a slowing global growth scenario, and Europe's debt problems looming as a significant unknown, it is understandable that many have drawn parallels between 2008 and 2011. In many ways it feels like we are watching a re-run of a bad television program (to some, maybe more like a horror film). As shown in the following chart, to an extent, the stock market thinks so too. While we acknowledge that caution is certainly warranted, we do not feel that we are in for a repeat of 2008. Today's situation is different in a variety of ways, and we largely believe that the extremely negative, fear-driven sentiment, especially toward equities, has created longer term investing opportunities.



✧ THEN VERSUS NOW

We view the following as the major factors differentiating today's economic environment from that of 2008:

Housing has largely stabilized. In 2008 the U.S. housing market, a bubble more than a decade in the making, was in the process of going bust, as were the highly leveraged banks that specialized in originating, packaging, and in many cases repackaging, the underlying loans. The willingness and ability of banks to lend was low and credit metrics were falling off of a cliff. Currently, housing has likely found a bottom in most regional markets. Mortgage rates are at historical lows, inventory has fallen, and the current rate of houses being built is approximately half of annual demand. This is not to say that we expect a quick rebound, but for now it appears that housing will not continue to be the significant economic detractor to which we have been accustomed over the past five years.

Corporations, including most banks, are in better financial shape. After multiple rounds of stress tests, capital raising, reserve building and disposals/write-downs of problem assets, banks are on solid footing compared to 2008. The majority of TARP funds received by the banks have been paid back to the government, with interest. Lending activity in several categories is increasing, most notably in commercial lending to businesses. Corporations continue to hold record amounts of cash, which has risen at approximately a 20% annual rate over the past two years to $2.1 trillion, according to data from ISI Group. Corporate use of debt financing is at low levels, despite the fact that credit conditions continue to be very favorable.

Monetary policy is highly accommodative. In 2008 the Fed was in tightening mode with the fed funds rate at 5.25% going into the recession. Currently the fed funds rate is 0% and quantitative easing efforts have been on the table for almost two years now. QE1 and QE2 have been executed and the current "Operation Twist" is focused on bond purchases to keep longer-term interest rates, and thus consumer/business/corporate borrowing costs, low. The bottom line is that the Fed has and will continue to do all in its power to help the economy. Moreover, after several years of tightening, central bankers in the emerging markets are beginning to cut rates.

✧ MONETARY POLICY IS "NO PANACEA"

In the U.S., while the Fed's easy monetary stance for the foreseeable future is viewed as a positive for the stock market and the economy, at this point there is not a whole lot more that the Fed can do. Operation Twist seems to have been successful so far in lowering rates for things like residential mortgages, but as Bernanke recently told congress, the Fed's efforts to force down rates are no "panacea for the problems currently faced by the U.S. economy."

Faced with a large and increasing deficit, elevated unemployment, and a faltering recovery, the lack of a cohesive policy response from Washington has been a huge blow to business and consumer confidence. In particular, the political circus surrounding the August debt ceiling deal highlighted the lack of leadership in Washington, as well as the preference for politics over the best interests of the nation. Given the current situation, our hope would be for the Administration and Congress to agree on some form of additional near-term stimulus, combined with a long-term fiscal tightening plan. Simply put, the goal for the U.S. needs to be to avoid the current European fiscal situation, however possible. On one hand, in its current fragile economic state, the U.S. can ill afford to slash current spending via extreme austerity measures at the risk of significant contraction. On the other hand, without a long-term plan to reduce the deficit, which likely includes changes to entitlement programs, the U.S. also risks falling into a situation similar to Europe somewhere down the road. Unfortunately the current tone and sentiment out of Washington is so toxic that we do not feel there is much of a chance for swift and decisive policy action in the near term.

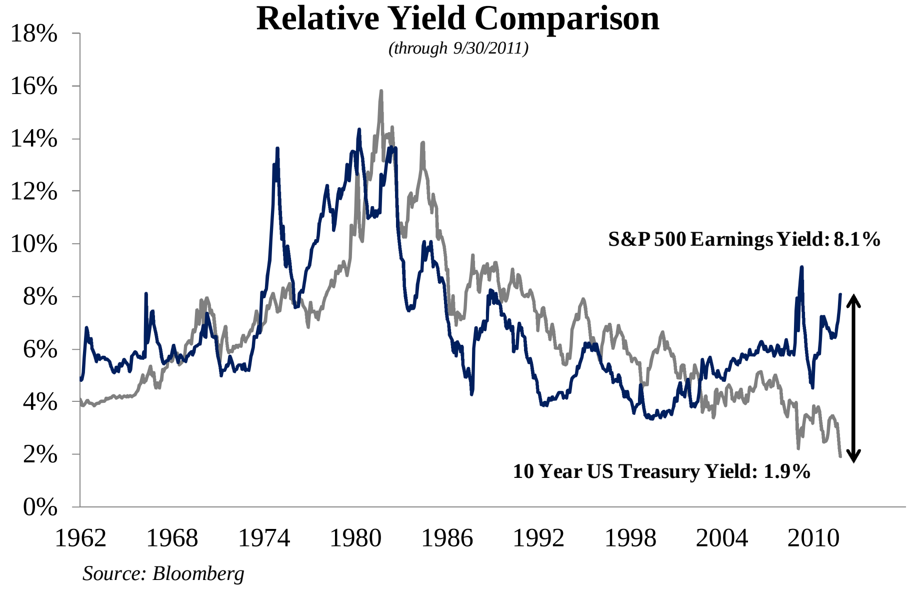
We are cautiously optimistic that another financial crisis is not upon us. However, if Europe were to experience a Lehman-like liquidity event stemming from a disorderly default by Greece or elsewhere in the periphery, it would be negative for world markets as there would definitely be a certain degree of global contagion. Our feeling is in that scenario, U.S. markets would fare much better on a relative basis. Handicapping the probability of such an event, and quantifying the potential impact, however, is another story. After almost two years of dealing with the debt crisis in Europe, other than launching endless rounds of austerity initiatives, policymakers and politicians have accomplished little outside of contributing to the region's already decelerating growth rate. Recently we have been encouraged by the European Central Bank's efforts to shore up liquidity, but it is our feeling that until market forces push Europe enough to really fix their problems, the situation will remain an overhang.

✧ INVESTMENT POLICY

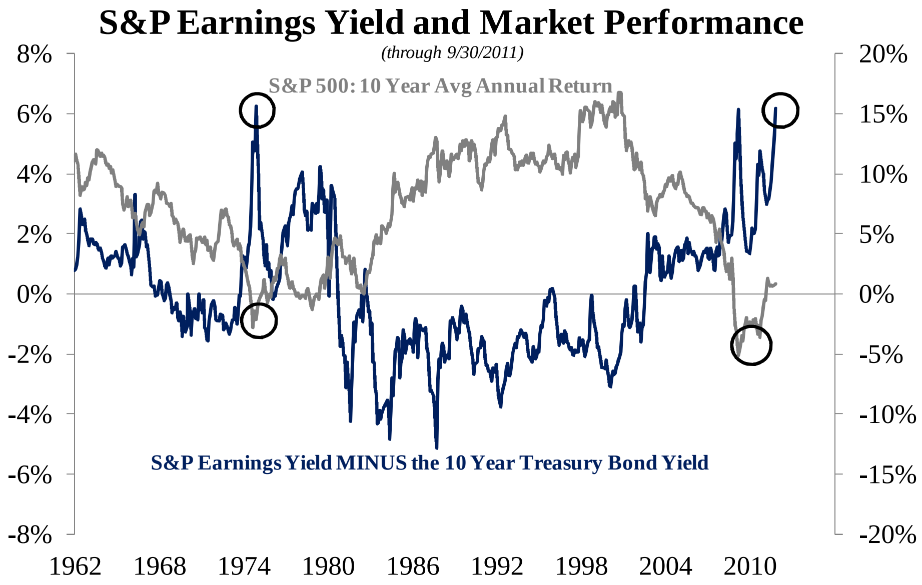
A crisis mentality driven by macro-level concerns, has clearly dominated the market since early July, resulting in a spike in investor fear levels and daily volatility. A subsequent upsurge in high frequency trading has also likely accentuated the market turmoil, accounting for approximately 75% of trading volume in early August, up from "normal" levels of 55% previously. A recent quantitative research piece from Wells Capital Management concluded that 79% of the stock market's recent moves can be attributed to changes in global financial conditions, as measured by the Bloomberg Financial Conditions Index. In the 17 years of the Bloomberg index's history, its correlation with the stock market is at the highest level ever. The conclusion is that the macro-environment is currently the dominant driver of stock returns, while valuations and fundamentals are regarded as an afterthought.

For a long-term investor, the market's extreme volatility and short-term mentality presents quite a challenge, especially in terms of "staying the course." We, however, view the ability to take a long-term perspective as an advantage, and today it can certainly even be considered a contrarian way of investing – essentially, the ability to go against the crowd. To that point, given the uncertain environment, stocks are not an overly popular place to be as witnessed by recent record outflows from mutual funds.

Looking at the longer term relationship between stocks and bonds, however, the argument can be made that stocks are very attractive on a relative basis. The following chart compares the current earnings yield of the S&P 500 (a valuation measure, meaning: earnings generated relative to stock prices) to the yield on the 10 year U.S. Treasury bond. The S&P 500 currently has an earnings yield of 8.1%, versus just 1.9% for 10 year Treasuries.



The second chart shows that the spread, or the difference, between the S&P 500 earnings yield and the 10 year Treasury is at its highest level since 1974, implying that stocks are the most attractive they have been in a while versus bonds. In addition, this chart shows the rolling 10 year annualized price performance of the S&P 500, which as we know, has been relatively poor as of late versus longer term stock market returns (low single digit returns over the past decade). Coincidentally, 10 year stock returns were also very poor in the early-to-mid 1970's period. Conversely, observing stock market performance in the subsequent two decades, stock investors did quite well. While being mindful that past performance is not a guarantee of future results, we think it's important to note that in today's market, similar conditions are in place.



Source: Bloomberg, FactSet

Within the equity market, we continue to have a positive stance on the long-term prospects of the world's emerging economies, as well as the companies that will benefit from growth there. While growth has slowed somewhat over the past year or so, continued 5% to 8% annual real GDP growth in countries like China, India, and Brazil is still very attractive compared to the tepid growth that we continue to expect out of the older, more developed economies. Moreover, emerging market rate cuts and movement towards monetary easing should act as a tailwind for companies with exposure there. In addition, to their benefit, many of these countries have relatively low debt levels compared to the U.S., Japan and Europe. In regard to consumer-related stocks, we continue to focus on the high and low end consumer, while largely avoiding the middle-class, who continues to be under pressure. One thing we are watching, however, is the silver-lining of slower worldwide growth: lower commodity prices. At the margin, lower input prices will benefit consumer spending by acting just like a tax cut, whether it be at the grocery store, gas pump, or the department store. In the Technology space, we think that stocks such as Google and Apple deserve serious consideration from investors. Previously regarded as "growth" stocks, these names currently offer a combination of attractive valuation, solid growth prospects, and cash-rich balance sheets – characteristics that enable investors to play both offense and defense. Finally, for income oriented investors, we find the ability to create stock portfolios with reliable and growing dividends, yielding between 3% and 5% per year, as a good alternative to fixed income.