the STRATTON letter

OCTOBER 2010

RISK ON, RISK OFF

On September 20th, the National Bureau of Economic Research declared that the recession that began in December of 2007 had ended in June of 2009. Registering 18 months in total, the Great Recession was the longest recession since World War II. Since the beginning of the current expansion, the S&P 500 has appreciated by more than 27%, the unemployment situation has improved somewhat from its worst levels, and economic growth has averaged approximately 3%, which is above the long term trend. The current problem however, is that it doesn't *feel* as if we are truly out of recession. While 2010 has been characterized by a broad stabilization of the U.S. economy, indicators remain range-bound at levels that are clearly sub-par.

One could easily make the argument that even an economic stabilization should be viewed more positively given the traumatic events of the past three years. Unfortunately the tone that currently dominates the markets is one of uncertainty regarding global growth, and as a result, macro themes have dominated performance among asset classes. Whether the focus is on European sovereign credit issues, the inflation/deflation debate, or mixed messages from an increasingly gridlocked Washington, investors have been subjected to a volatile back-and-forth environment. Put another way, on most days market action can be described as either "risk on" or "risk off". "Risk on" days typically see investors piling into assets such as stocks, commodities, and high-yield debt. "Risk off" days are characterized by a flight to "safer" assets like U.S. treasuries, high-grade corporate debt, the U.S. dollar, and the Yen.

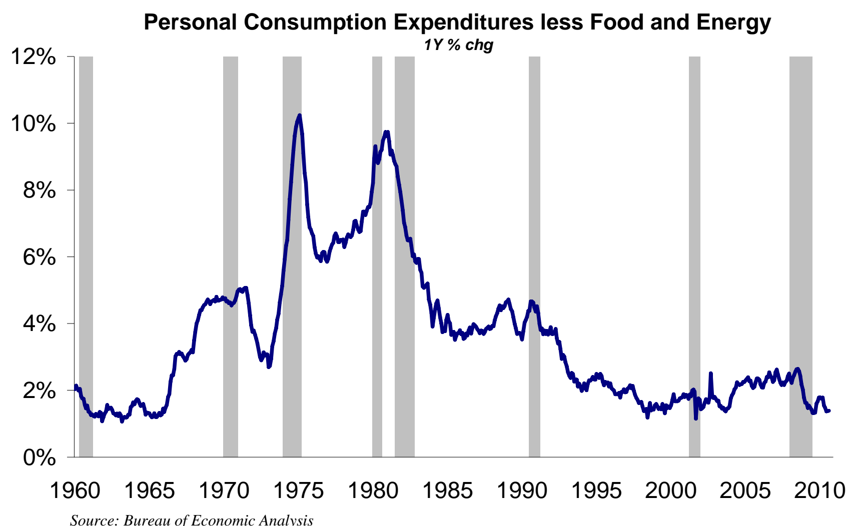
✧ EFFECT ON STOCK MARKET ACTION

One product of the market's current bipolar nature is that within the equity universe stocks have become much more correlated than in the past, trading in nearly lockstep fashion at times. Of course this presents a challenging environment for equity investors who base their investment decisions on valuation and fundamental analysis of individual companies. At the peak of the financial crisis, correlation of stock price movements hit a high of 80%. Despite drifting lower for much of 2009, it has spiked back up more recently, reaching 74% at one point in August. This is a far cry from the 27% average correlation level of S&P 500 stocks from 2000 to 2006, according to Barclay's Capital. While we do believe that some of the increase in correlation is structural in nature due to the huge increase in popularity of exchange traded funds (ETFs), we do not think these correlations will remain elevated forever. As uncertainty continues to give way to better visibility, the current herd mentality will dissipate and stocks will resume trading on their fundamentals. In the meantime, this environment provides a good opportunity for investors to establish positions in companies that are not getting full credit for their financial strength and earnings generation power.

✧ QUANTITATIVE EASING PART II

The most recent economic data can be categorized as mixed at best while overall trends point to a deceleration of the economic recovery. Improvement in the level of unemployment has stalled and the national outlook for housing remains anemic as large inventories will be an overhang for the foreseeable future. Despite the stock market's September rally, consumer confidence continues to languish at low levels. Economists have been ratcheting down their growth estimates and now expect real GDP growth of 2.7% this year and 2.5% in 2011.

Minutes from September's Federal Open Market Committee Meeting highlighted an additional concern: inflation is too low. Specifically, the Fed's preferred measure of inflation, the PCE deflator, is below the optimal range of 1.5 – 2.0%.



Previously the focus had been the level of unemployment and the pace of the recovery but by acknowledging the fact that current inflation levels are below a range consistent with a healthy economy, the Fed opened the door to future policy steps. To investors, this is confirmation that the current pace of the recovery is unsatisfactory and that Chairman Bernanke is committed to taking action if the economy does not accelerate soon. Known as "quantitative easing", it is widely believed that the Fed's efforts will include large scale purchases of fixed income securities, namely U.S. Treasuries. If undertaken, this will mark the Fed's first significant balance sheet expansion since late 2008. As it would be the second round of quantitative easing since the financial crisis, market observers have dubbed this potential initiative "QE2". The desired outcome will be increased liquidity in the system and additional support for low interest rates, which should provide incremental fuel for recovery.

In the near term, the Fed's accommodative bias is positive on several fronts. Interest rates will likely stay low for an extended period which is supportive of the housing market in the form of low mortgage rates. Borrowing costs for both consumers and businesses will likely remain at historical lows. All else equal, the U.S. dollar will weaken which will support the recovery through increased exports as U.S. goods will be cheaper abroad.

Longer term, continued easy monetary policy poses a threat to the purchasing power of the dollar and creates a potential inflation problem, which is exacerbated by the large and growing deficit. At this point, however, inflation risks are low. We also acknowledge while even the best monetary policy actions will not create a higher standard of living for the long term, we do think that the actions of the Fed will work to avoid a period of lasting deflation such as experienced during Japan's "lost decade".

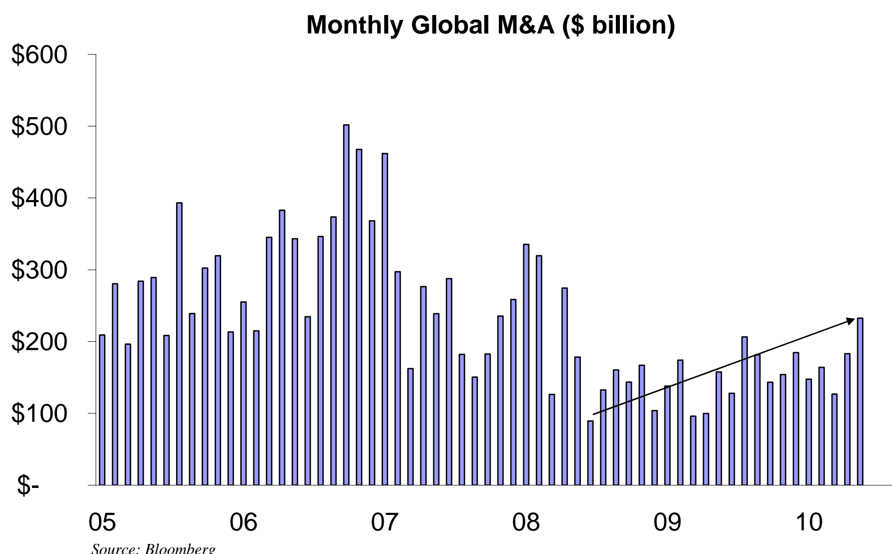
✧ WASHINGTON GRIDLOCK

The environment in Washington has certainly played a leading role in perpetuating the uncertainty surrounding the market and business in general. Congress's inability to make a decision regarding tax policies that will take effect in just a few months, as well as ambiguity related to a host of new rules and regulations, has created a situation where business owners are "frozen at the switch". Hiring and investment decisions have been put on hold due to lack of visibility, which is hardly what the economy needs in its current state. Without a credible plan to deal with the deficit or clarity regarding future taxes, the government will continue to deter investment in the private sector. Typically the stock market favors gridlock in Washington, as the inability to pass new legislation lends itself to the status quo, and thus predictability. In this case it is the opposite.

After the November 2nd elections, while the most likely scenario looks to be an extension of the Bush tax cuts, there is still the possibility that Congress deadlocks on the issue or President Obama vetoes the bill. It is important to note that even if a resolution has not been reached by December 31 and the Bush tax cuts do lapse, Congress could fashion a retroactive tax fix.

✧ CORPORATIONS PUTTING CASH TO WORK

One driver of higher stock prices more recently has been a pickup in merger and acquisition activity. According to Bloomberg, global M&A activity in the third quarter of 2010 increased 62% year-over-year and 31% from the second quarter. Total activity this year, which stands at almost $1.5 trillion through September, is up 20% versus the first nine months of 2009. It can be observed in the chart below, which shows monthly global M&A, that activity has slowly been picking up since late 2008.

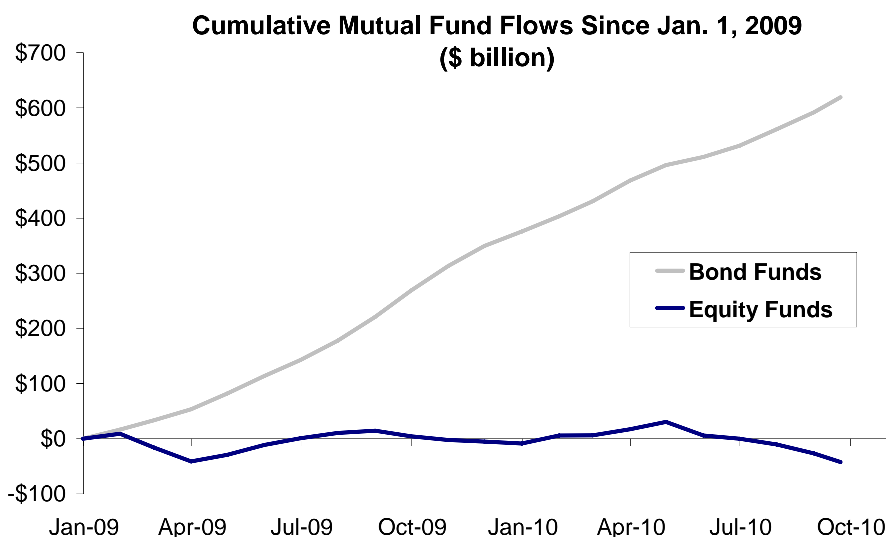


The increase can be attributed to strong corporate balance sheets, easy access to low cost debt, attractive valuations, and corporate management teams slowly recovering from the shellshock of the financial crisis. Cash is currently sitting at record levels, and in the past a high level of liquidity has been a harbinger of future M&A activity. As organic growth opportunities may be lacking in many sectors, corporate managers will likely turn to acquisition opportunities to help stem top line weakness. While we do not expect a massive ramp up in activity or a smooth increase in the trend, as deal making is inherently lumpy by nature, we do expect activity to grind higher as boardroom psychology increasingly embraces the favorable environment.

In addition to acquisitions, companies have been increasingly putting cash to work in the form of share buybacks and dividend increases. According to Standard & Poor's, S&P 500 companies spent $77.6 billion on share repurchases in the second quarter, marking the fourth consecutive quarter of increases. That is more than three times the amount spent during the year-ago period, and represents an increase of 40% from the first quarter. One third of S&P 500 companies have increased dividends this year, and some companies, such as networking technology giant Cisco Systems, have initiated a regular dividend. To highlight the amount of "dry powder" available, J.P. Morgan estimates that if cash levels among S&P 500 companies were to normalize to 7% of assets, down from the current 11%, it would result in spending of $428 billion.

✧ INVESTMENT POLICY

Bond yields have remained at record lows reflecting deflation fears as well as an increasing likelihood of a second round of quantitative easing by the Fed. These factors have created a "yield at any price" mindset among many bond investors. Even as stocks have posted solid gains since the end of the recession, investors have continued to reduce equity exposure and plow money into bonds.



Source: Investment Company Institute

The current extreme level of risk-aversion has created an environment where investors prefer to overpay for a bond rather than underpay for a stock. Assuming continued economic stabilization and a prolonged near-zero interest rate policy, we expect the hunt for a reasonable rate of return will eventually lead investors from bonds to higher yielding assets. Rather than lend money at low rates via investing in bonds, we recommend that investors should own companies that can borrow at low rates and earn higher rates of return on the capital. It is our belief that within the equity universe, investments in undervalued stocks with superior fundamental characteristics will be well rewarded over time, despite the current macro-driven environment.

One way to participate in the equity space with somewhat reduced risk is through a "higher quality" portfolio focused on dividend growth and yield. Companies with the ability to regularly pay and grow a dividend should be viewed favorably due to the stability of their underlying earnings as well as a focus on returning value to shareholders. This strategy has provided relatively consistent returns despite the current "risk on/risk off" market environment. The longer-term secular story is also compelling as demand for dividend paying equities will be supported by an aging population and the corresponding shift in preference from capital appreciation to income.