

July 2011

REVISING THE AMERICAN DREAM

A complete recovery from a financial crisis typically takes a while. Housing usually doesn't start to recover for six years. Equity prices take three to four years, on average, to recover. While economic output tends to bounce back quickly, recovering in about two years, unemployment levels usually remain elevated for approximately four years. In addition, government debt levels typically balloon, driven by a combination of collapsed tax revenues, as well as monetary and fiscal stimulus efforts.

These are the findings of noted economists Carmen Reinhart and Kenneth Rogoff, whose work includes analysis of global financial crises over hundreds of years. This also accurately describes the experience of the U.S. economy since 2008. Largely in-line with our expectation of a "square root" shaped economic recovery, characterized by unspectacular GDP growth, the economy continues to be sluggish compared with previous post-recession recoveries. While the stock market and corporate profits have recovered nicely, housing and employment statistics remain weak with no imminent signs of material improvement.

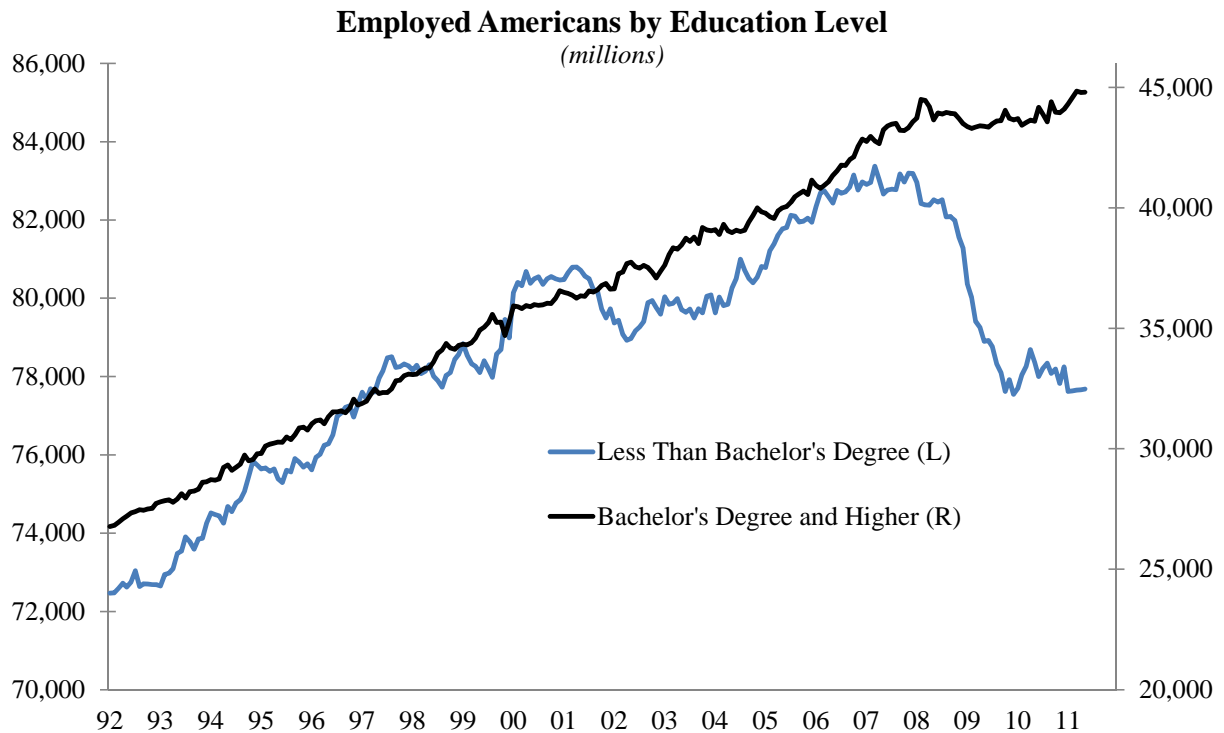
The result of persistent weakness in housing and unemployment is significant pressure on America's middle and lower income households, who are bearing the brunt of the pain. While it can certainly be said that sub-optimal economic growth and the resulting lack of opportunities is bad for almost everyone, the median income-earning household in the U.S. (annual income of approximately \$50,000) faces massive challenges on several fronts – in addition to softness in the housing and job markets, higher commodity prices combined with stagnant wage growth have negatively impacted real income levels. While many of the "typical" middle class jobs have been experiencing structural decline for years now, such as good paying production and clerical jobs, fallout from the recession, combined with new technology have accelerated this phenomenon. For many Americans, the "American Dream" has been downwardly revised. What was previously thought of as a combination of homeownership, steady and safe employment, and a comfortable retirement by age 65, the current vision more likely includes a mix of the following: managing and reducing debt, adapting to a reduced level of wealth (mostly housing related), maintaining employment, and hopefully planning for some form of retirement.

✧ **STRUCTURAL CHALLENGES IN THE JOB MARKET**

Part of the elevated unemployment rate is due to companies' hesitancy to hire because of continued economic uncertainty. Still operating somewhat in "survival mode," corporate managers and business owners are gun-shy about adding permanent human capacity for fear of having to reverse course should the economy weaken. Rightfully so, hiring (and laying off) workers is time consuming and expensive. Instead, over the past few years companies have gotten continuously more creative about maximizing profitability via stringent cost control efforts. For example, we have observed an increased preference for hiring temporary workers rather than permanent ones. Also, companies have tended to favor investment in capital equipment and software to efficiently expand (i.e. automation of processes). The decision to favor expansion via capital equipment over hiring incremental workers has been much easier to make due to the

fact that, according to the Commerce Department, equipment and software costs have declined 2.4% since the recovery began, versus labor costs rising 6.7%. Unfortunately, the higher labor costs have largely been driven by increased healthcare benefit costs, rather than higher wages. Given the apparent relative cost advantage of expansion via capital equipment, it is understandable that business spending on equipment and software has risen 26% since the recovery began versus just a 2% rise in spending on employees. While this behavior has negatively impacted the job market, it is our longer-term view that hiring will eventually pick up. As companies find themselves on increasingly stable economic ground, the realization of strong profits should lead to desire for additional profits and expansion, which would provide support to the jobs situation. A June survey conducted by ISI Group confirms this, as business hiring plans are currently at a 5 year high.

The bigger issue facing the job market, however, is the nature of the unemployed. Two years after the end of the recession, May's unemployment rate of 9.1% is still relatively high. More disheartening is the broader underemployment rate of almost 16% which takes into account part time workers who wish to have full time jobs, as well as discouraged job seekers who have essentially given up. A common characteristic among the jobless is the lack of a post-secondary degree. The following chart shows employment trends for two groups: those with less than a bachelor's degree and those with a bachelor's degree or greater. It can be observed that total employment for those with a college degree or greater has held up better and now is above pre-recession highs, whereas employment for those without a college degree has fallen sharply with minimal rebound.



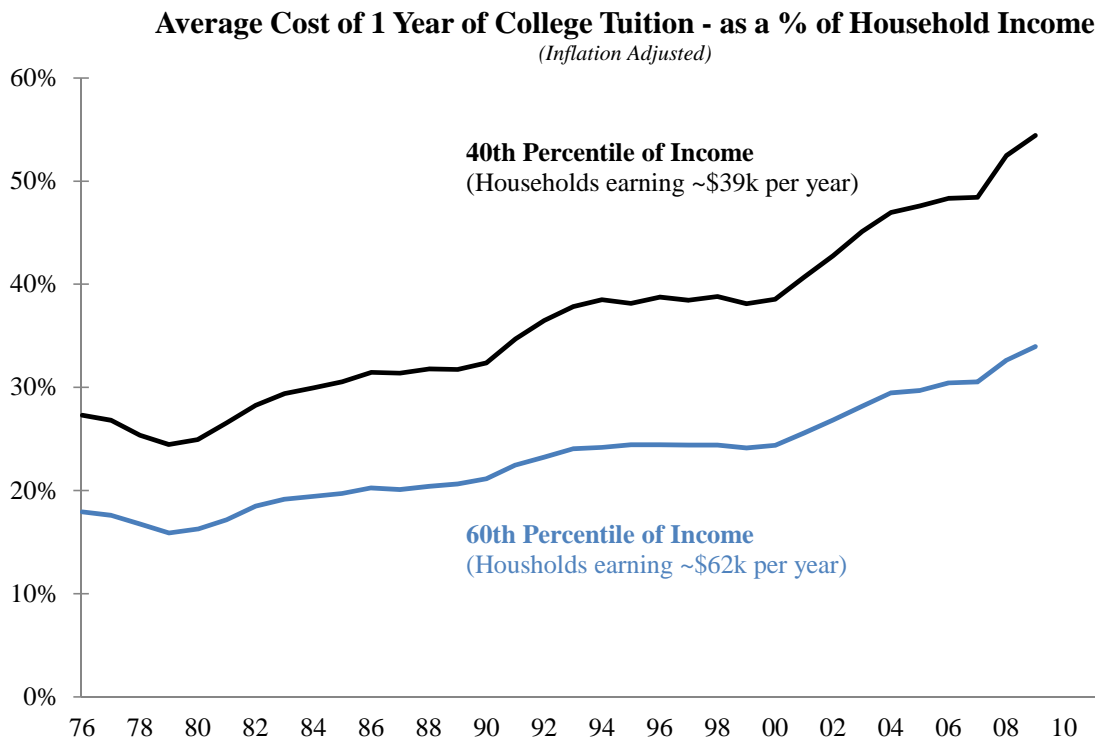
Source: Bloomberg

A recurring complaint from companies is that many workers today do not possess the necessary skills to work in modern manufacturing. Anecdotal evidence suggests that the demand for workers is there, but compared to manufacturing jobs of the past, the qualifications have increased substantially. Many manufacturing jobs have become highly technical, requiring computer, science, math and even accounting skills, for which someone with only a high school degree is likely unprepared. We seem to be witnessing a scenario where technology, to some degree, is evolving faster than workers. Unfortunately, while there is no quick fix to this issue, longer-term policy actions that encourage more high-tech vocational skills development would be viewed positively.

✧ MIDDLE CLASS SQUEEZE

It's hard to argue against the notion that income disparity and concentration of wealth have increased in the United States over the past 40 years. A recent report from the New America Foundation highlights several statistics that support this phenomenon. Currently, the top 1% of income earners in the U.S. earn over 20% of the nation's aggregate income, up from 10% in the 1970s. Moreover, the wealthiest 1% of Americans, as measured by household net worth, currently own about 35% of the nation's wealth. Several studies point to swiftly rising corporate executive compensation as the main driver of the increase in wealth and income at the top. Moving down the income spectrum, for illustrative purposes, the top 20% of income earners account for about 40% of total consumption in the U.S. Our broader concern, however, is that the multitude of factors currently impacting the health of the middle (and lower) classes have exerted enormous stress on a large percentage of the country's population, and in turn pose a threat to the long term health and potential of the overall economy.

Structural employment issues, as previously noted, are negatively impacting the ability of less educated and unskilled workers to earn a decent living. Compounding this issue is the fact that education costs have skyrocketed since the mid-1970s, making a college degree increasingly unaffordable for many people. Currently the average cost of one year of college tuition is \$21,000. For households with incomes in the 40th and 60th percentiles, this makes up 54% and 34% of their annual income, respectively, as illustrated in the following chart from the New America Foundation's April report. The message is that college costs relative to incomes have increased substantially over time, especially for lower earning households.

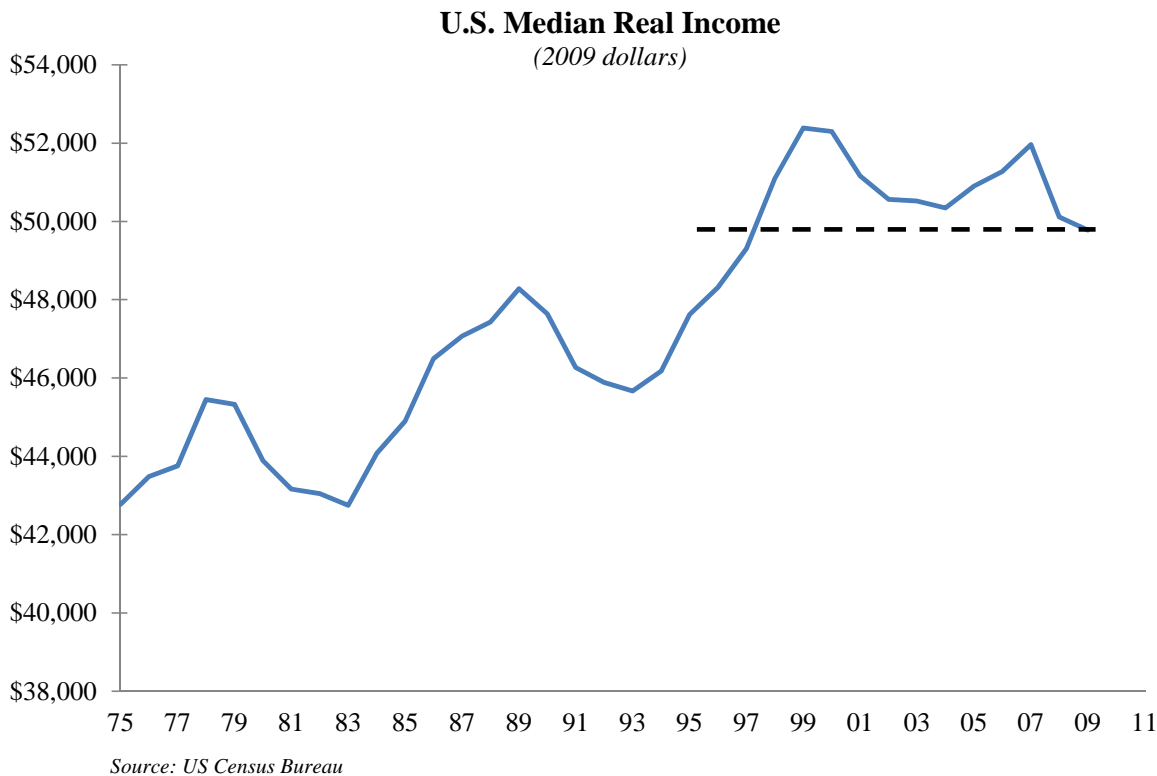


Source: National Center for Education Statistics, US Census Bureau

Also, while far from breaking news, housing continues to be a drag. This, however, is especially true for the middle class as a much greater percentage of that segment's wealth is tied up in their homes. A study by the National Bureau of Economic Research found that for families up to the 90th percentile of net worth (which includes all but the top 10% of richest Americans), home values represent 50% to 60% of total wealth. For more affluent households, home values represent just 10 to 20% of total wealth. With 23% of residential mortgages currently underwater, according to the real estate firm CoreLogic, many

people are stuck in their homes. Moreover, this hinders workforce mobility as workers with little or no equity in their homes are unable to afford to move to geographic locations that may provide the best employment opportunities.

In terms of wages, real median income has been flat for the past 13 years. This essentially implies that the standard of living for the median wage earner has not improved since the late 1990s, which can be observed in the following chart. Higher commodity costs, combined with stagnant wages, have had a notably negative, tax-like impact on discretionary spending by middle and lower income consumers, as they are forced to spend more on basic necessities.



As an example of this tax-like effect, the retailer Target Corporation recently noted changes in spending habits among its fairly diverse customer base. In an investor presentation, the company cited continued healthy spending by its higher income customers. This was in stark contrast with spending behavior by its more moderate income customers, who, as food and energy prices have increased, have noticeably reigned in their spending on more “discretionary” items. Furthermore, this dynamic extends to lower income customers, who are increasingly unable to afford basic necessity items. In some cases government payments are kicking in to make up the difference. Depressingly, as of this past March, 44 million Americans were using food stamps, which is up 11% versus the previous year, and represents over 14% of the population.

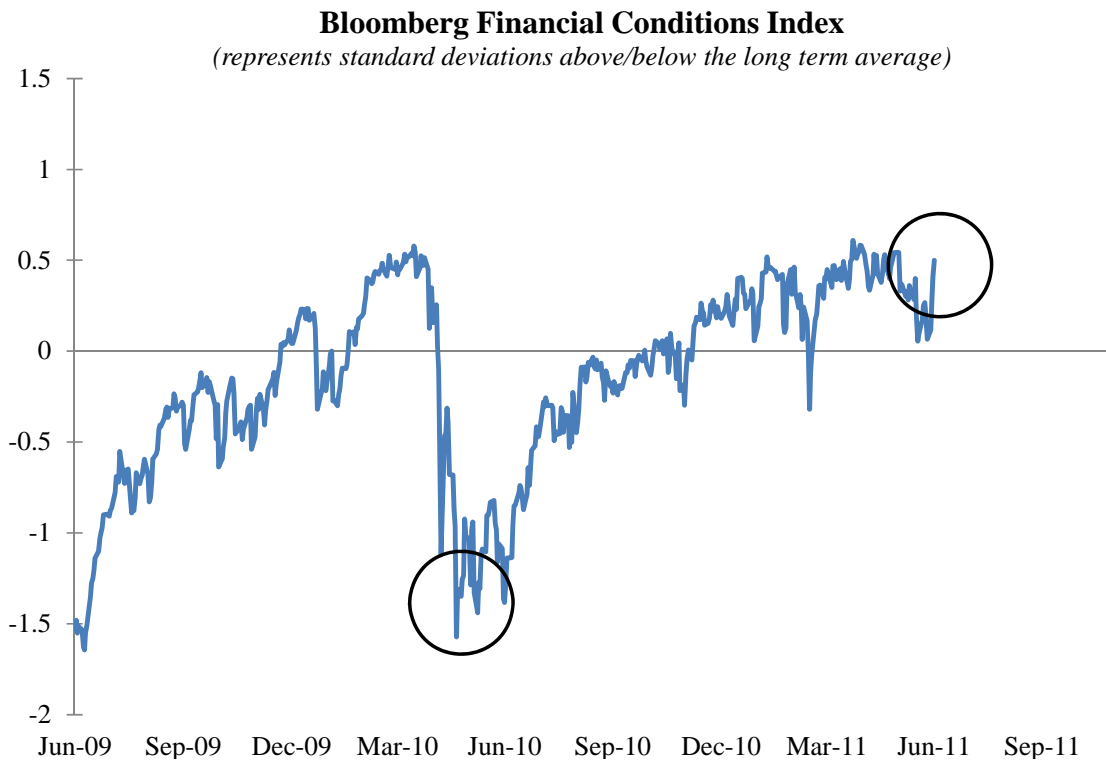
As the stock market has rebounded so has the nation’s aggregate net worth, creating the perception of a broadly rising wealth effect. Unfortunately not much benefit has been realized by the middle class as the bulk of its wealth is tied up in housing, and not in stocks. While there is no quick solution to the structural challenges facing the labor market, history suggests the workforce will eventually adapt. For example, over a century ago almost half the U.S. population was employed in the farming industry, which today is highly mechanized, automated, and much less manual labor intensive. Technological advancements are a net positive for consumers as they lower prices and ultimately raise the standard of living over time. Unfortunately, they can also cause economic disruption over the shorter-term.

✧ THE BRIGHT SPOTS

While the state of the average American consumer has certainly weakened over the past few years, the opposite can be said about the state of Corporate America. The profit picture and health of U.S. companies is one of the brightest areas within the economy, a theme we have consistently highlighted. According to JP Morgan, cash earnings of U.S. corporations grew at a 29.9% annual rate over two years through the end of 2010. For 2011 solid earnings growth of 13% is currently expected, aided by several tailwinds, including, continued strong international results, improving demand in the U.S., and the lagged effects of a prolonged zero interest rate environment. Economists are also currently predicting acceleration in the rate of real GDP growth to above 3% for the second half of this year, as high energy prices and supply-chain disruptions related to the Japanese nuclear disaster recede.

Corporate balance sheets continue to look the healthiest in years, helped by massive cash reserves and attractive financing terms. One good example of this would be Google, a company that currently sits on \$37 billion of cash. In May the company raised \$3 billion in its first debt issuance ever, selling bonds with 1, 3, and 10 year maturities. On the 10 year bond, the company will pay 3.73%, which some liken to Google essentially getting “free money,” and compares to the 10 year U.S. Treasury rate of 3.15% at the time. The ability to easily raise capital is enabling many companies, such as Google, to meaningfully increase financial flexibility, securing capital at ultra-low rates for a variety of potential uses in the future, such as acquisitions, dividends, or stock buybacks.

With the second round of quantitative easing (QE2) complete, monetary policy at the Fed now seems focused on keeping interest rates low for the foreseeable future. It’s encouraging to note, as seen in the following chart, that financial markets appear to be in much better shape today than they were at this time last year, after QE1 had ended.



One policy proposal that bears watching, and is currently gaining momentum in Congress, is a one-time tax holiday on the repatriation of corporate earnings held overseas. Currently it is estimated that U.S. companies are sitting on \$1.4 trillion of undistributed foreign earnings, which is essentially cash generated from overseas operations. This number is growing at a double-digit rate annually as global growth has continued to be strong, especially in emerging markets. Moreover, U.S. companies now derive approximately 25% of their earnings from abroad, a percentage that has doubled since the late 1990s. Rather than repatriate these earnings (i.e. bring them back to the U.S. for general corporate use, investment, or shareholder friendly activities) the cash has been building within the companies' foreign subsidiaries because if "brought back home" it would be subject to the 35% U.S. corporate tax rate. The tax holiday proposal, if agreed upon, would give companies an opportunity to repatriate the cash at a much lower tax rate, possibly in the 5% range. It is estimated that such a tax holiday could carry a greater positive impact than the Fed's quantitative easing programs, because the U.S. economy and equities in particular, would be direct beneficiaries of the proceeds. JP Morgan notes that historically 67% of excess corporate cash goes toward dividends and buybacks. Should between \$500 billion and \$1 trillion be repatriated via the proposed holiday, it is estimated that this could translate to between \$350 billion and \$670 billion of additional stock buybacks and dividends.

✧ INVESTMENT POLICY

From an economic standpoint, the recovery thus far has been one of the weakest on record in the U.S. Given the drags related to housing and employment, our continued expectation is for domestic growth to remain average at best. From an investment perspective, however, U.S. companies are operating from a position of strength, especially multinational corporations with exposure to high growth international markets. With interest rates still at historical lows, rather than own bonds, it is our preference and recommendation to own shares of companies that can utilize this cheap capital to achieve higher returns on their investments.

From a broad valuation perspective, with S&P 500 companies currently trading at less than 16x 2010 earnings and 14x estimated 2011 earnings, stocks do not look expensive. We feel that a long position in equities is far from a popular investment strategy, given that both retail investors and institutional investors, such as corporate pension plans, continue to be underexposed to the asset class as a whole. As the low interest rate environment drags on, we think investors will be forced to increasingly turn to equities to earn a reasonable rate of return, much less close funding gaps that have been augmented by a broad reluctance to shift back into equities, even after the financial crisis had faded.

Within equities, there are currently a few common themes across our portfolios. One is a preference for companies that are beneficiaries of a continued healthy capital spending environment which will likely be sustained by easing credit conditions, attractive financing terms, and operational expansion supported by strong corporate profits. Within the U.S. consumer products and retailing space, given the host of challenges facing the middle class consumer, we prefer to focus on companies that cater to either the high-end or the low-end of the income spectrum. For example, within the Financial sector, we expect a continuation of strong spending trends, and thus results, at American Express given the affluent profile of their average customer. On the lower end, earnings trends at deep-discount retailers should continue to be strong as consumers with less discretionary income are being forced to stretch their dollars further, and as a result, are "trading down" for certain goods and services. Finally, we continue to favor companies that are beneficiaries of global growth, which we expect will continue to be driven largely by emerging markets. Many of our holdings within the Energy, Materials, and Industrial sectors fit this profile.