



# EQUITY INVESTMENT OUTLOOK

August 10, 2010

## Two Steps Forward, Two Steps Back

As we close the month of July the S&P 500 index is essentially unchanged for the year, down 0.27%. While this sounds somewhat boring and uneventful, so far the year has been anything but. Macroeconomic issues have been at the forefront, ranging from concerns about sovereign debt problems in Europe, the possibility of a hard landing in China, increased regulatory intervention globally, and the possibility of a “double-dip” into recession in the U.S. These concerns, abetted by somewhat tepid economic data in this country, the oil spill, and the May “flash crash”, have resulted in a volatile market that has left many investors feeling exhausted and risk averse.

Parsing the details, we see a somewhat brighter picture. As of early August, with nearly 70% of the S&P 500 companies having reported their second quarter earnings, 75% have surpassed consensus expectations. Similar proportions were recorded in the first quarter. And for those companies which reported disappointing results relative to forecasts, in many cases this was the result of one-off, exogenous or self-inflicted issues rather than being related to the macro picture.

Last month we wrote that confidence was the greatest risk to continued economic recovery and that continues to be the case. Consumer confidence has continued to decline in July and we can see that carry through to many aspects of consumer spending, particularly at retail and in restaurants. The persistence of the high unemployment figures we have seen is probably closely tied to the lack of confidence, although the recent extension of unemployment benefits by Congress will help somewhat in this regard. The spending hiatus resulting from low consumer confidence is having a beneficial impact on consumer balance sheets, as the savings rate is now over 6%. One has to go back to the early 1990s to find a period when savings rates were consistently above this level. While this pressures economic growth in the short-term, a healthier consumer in the long-term will ultimately pave the way for more sustainable long-term growth. A Ned Davis Research study found that historically when confidence has been as low as it is currently, the next 12 month stock market returns have been strong.

There is an unusual divergence between the behavior of consumers and the behavior of corporate enterprises. While evidence of weak consumer spending is abundant, enterprise spending from IT

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to business travel has been strong. We have taken note of this phenomenon and have made adjustments in our consumer-facing positions to reduce our exposure until Mr. and Mrs. Smith are feeling better about spending money.

What would we need to see to feel better about the consumer? We have clear evidence that employers are being very cautious with respect to hiring, but it is also evident from their actions that there is real demand for more labor. The “hours worked” data shows an uptrend that began last fall and has continued through the most recent reading. The last time there was a major upward change in trend of this data series (mid-2003) it signaled a resurgence of economic activity in the U.S. So we know that on average, workers are putting in more hours. We also know from the data that temporary hiring has been on a tear, and surveys indicate that this activity is likely to continue if not intensify.

Putting these data points together we see that more workers are needed and more hours are being worked, yet there is still a great reluctance to hire permanent workers. The reluctance to hire workers is at least in part driven by the uncertainty created by the plethora of changes and proposed changes in federal regulation and taxation. To that end, the potential for a power shift in the November elections leading to gridlock in Washington would be a positive for employment and the market. Moreover, surveys of permanent hiring activity are starting to indicate an uptick in intentions to hire, and this should start to feed through in the employment data barring some sort of unexpected decline in the economy. Capital spending has also started to show renewed strength, which as we have pointed out in the past, is also a leading indicator for hiring activity. (We have exposure in the portfolio to a staffing firm and an online recruitment firm, both of which should benefit from this phenomenon.)

A major positive over the past month is that the sovereign debt crisis appears to have waned. There are two main reasons for this. First, many European countries have successfully sold debt to investors at interest rates which may have been higher than they would like but are not going to be ruinous. Many investors had believed these countries would find it difficult if not impossible to successfully sell their debt, but these sales came and went without much difficulty. Second, all sizeable European banks have now undergone a stress test, and with only a few exceptions, have passed. While there are valid questions regarding the rigor of these tests, GaveKal Research suggests that investors now have clarity as to which firms will be provided with government support in the event of another financial crisis.\* We can see some confirmation of easing investor concerns

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in the CDS prices and spreads on sovereign debt, which have come in significantly from their elevated levels in the second quarter.

The steepness of the US Treasury yield curve remains at near-record levels, and the US economy has never fallen into recession from a curve this steep. Nevertheless, bond yields remain at record lows, reflecting widespread risk aversion and economic concerns. Many companies have been successfully refinancing debt at lower rates or taking advantage of the low rate environment to lower their cost of capital, but in recent years most companies underwent a self-imposed lull in spending if not an outright financial restructuring. As a result, many potential corporate borrowers are either cash-rich today or do not have a pressing need for capital, which creates a headwind to the Fed's efforts to stimulate growth via interest rate policy.

While there continue to be legitimate concerns about a continued recovery, we believe that pressures are gradually easing. With the VIX volatility index at a 3-month low and credit spreads narrowing, the market is telling a similar story. Strong corporate profitability, a continuing accommodative stance by the Fed, and reasonable valuations are supportive of our view. Although we have structured the portfolio for an expectation of an upward trending market, we maintain a moderate amount of risk tools and remain vigilant to emerging threats that could derail the current fragile recovery.

\* GaveKal Research, Ad Hoc Comment: Is It Still Time to Overweight Europe, August 3, 2010.

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