QUARTER IN REVIEW

Rarely have the macro economic circumstances been as crucial to investors' future potential returns and to investment risks.

Globalization and Imbalances

Globalization has increased the interconnectedness of individual countries' imbalances. Attention has focused on the Eurozone and the impact of the Greek sovereign debt crisis on banks, economies and the politics of the European Union, but also on U.S. banking institutions' issuance of credit default insurance and money funds' potential exposure to the various affected financial institutions. In June, we analyzed the potential exposures to banks and money funds owned in our clients' portfolios and found that it was minimal.

> While the media has highlighted the jockeying being done around the need for a compromise in order to raise the debt ceiling, how this may affect global markets has had less discussion.

The U.S. debt ceiling and financing of U.S. deficits, both trade and the federal government's annual budget deficit, are equally interconnected with other countries, principally China and Japan. These two countries are the largest owners of publically traded U.S. Treasury debt, almost 12% and over 9%, respectively. Foreigners own about 46% of the total; China represents about one-fourth of that. Without continued Chinese and other foreign buying of U.S. Treasury debt, interest rates will climb.

Within the Eurozone, Germany is a strong economy and a nation of investors and savers, while the peripheral countries have been spenders. The Chinese save about 50% of their income. Japanese households are no longer the heralded savers of the 1980-90s and now have a savings rate that is only about 2%. On the other hand, Japanese businesses continue to be net savers, over 10%, and Japan runs a current account surplus that allows it to be a net exporter of capital. This is how China and Japan became major investors in U.S. Treasury and agency debt, as well as in U.S. real estate and companies.

Historically, a nation with imbalances in relation to other nations would devalue its currency to adjust relative costs, inflation rates, export/import potential and to reduce the cost of repaying its debts to foreign creditors. Within the Eurozone, nations do not have the ability to devalue. Hence the discussion of default by extending maturities and reducing the principal owed. If Greece were to exit the Eurozone and return to the drachma in order to devalue, the consequences would be significant. This could cause liquidity to evaporate, as was the case in 2008, and would impair the capital of owners of Greek debt, principally European banks. Issuers of credit default insurance, which includes some U.S. financial institutions, would also be affected.

In the 1980s, Brady bonds were issued to refinance Latin American debt with less than the original amount and with longer maturities. In 1997, Russia defaulted, prompting the emerging market debt crisis. In 2002, Argentina defaulted and exchanged 76% of its defaulted debt for lower interest rate and longer maturity bonds at 25-35% of the original debt.

> Country defaults are not new, but do create market calamity.

A key point in the Greek situation is that this is a "voluntary" extension of maturities and, for purposes of bank balance sheets, are not deemed to be a default. Therefore, this does not require a write-down of principal, which would hurt banks' capital ratios. U.S. efforts to depreciate the dollar have had mixed results.

Because the U.S. dollar is the world's reserve currency and has the biggest and most liquid market, when there are problems elsewhere, investors return to the dollar. On the other hand, if the dollar declines relative to another currency, U.S. exports become more attractive (less expensive) and imports into the U.S. become more expensive and, thus, may be less attractive. A cheaper dollar has contributed to a recovery in U.S. exports and to some companies bringing manufacturing back to the U.S. The cost of transportation has provided added impetus, as have escalating wages in countries like China.

Even though other countries (China is a good example) complain about U.S. trade deficits, they do not want their goods and services to become less competitive when compared to U.S. based goods and services. So trade imbalances continue. And, the capital that generates for exporters is reinvested in debt of the importers.

Global markets for goods and services and finance are interconnected. STRAFOR, a global intelligence service we subscribe to, said it well: "Rivers are the foundation of any financial system. The ability to move goods from areas of high supply to high demand and making a profit on the difference is all what economic activity and trade is about, but you have to have a bank."

Regulation

Because the global banking system became overleveraged, regulations governing its operation and requiring more capital are being put in place. Since banks are major owners of sovereign debt, whether issued by their own governments or others, anything that calls into question the credit quality of sovereign debt or the ability to be repaid at face value may result in impairment of capital and require banks to raise even more capital than is being required under the new regulations. Dodd-Frank legislation, designed to address the causes of the last financial crisis, is now a year old. The majority of the rules that will govern how Dodd-Frank is implemented have yet to be written. Many requirements are being phased in over a number of years. The goal is to increase capital requirements for financial institutions and to compel greater transparency and disclosure of riskier transactions and balance sheet exposures. We used some of the increased disclosure in our analysis of banks' exposure to European credits.

The global banking system is what connects all parts

At the end of June, the Basel Committee on Banking Supervision issued its capital requirements, which are designed to make bigger and more interconnected financial institutions hold larger capital reserves. Since the new rules levy higher requirements on more complex institutions, the goal appears to coax financial institutions to simplify their businesses, i.e. to separate investment banking, trading and commercial banking, as was the case before the elimination of Glass-Steagall in the U.S. This may also improve the relative competiveness of regional and smaller banks.

Two Different Economic Views

In the last two weeks, the Federal Reserve Board (the Fed) issued its views on growth and inflation and it differs sharply from those contained in the Bank for International Settlements (BIS) newly released annual report. BIS, located in Basel, Switzerland, is considered the central banks' bank and is the leader of global efforts to coordinate financial policies and banking regulation. BIS has a global focus and has warned that rapid global growth must be slowed to curb inflation. BIS points to a lack of usable excess capacity; the Fed noted low capacity utilization. Emerging country economies that are experiencing rapid growth have already begun to raise interest rates in order to address inflationary pressures. Even the European Central Bank (ECB) has begun to raise interest rates and is likely to do so again this month. Note that the ECB has only one mandate, to keep inflation in check. BIS is advocating loudly for a return to normal.

The Fed is focused on domestic policy; its dual mandate is to foster low inflation and economic growth that produces full employment. In its June 22 statement, the Fed acknowledged the recent slowdown in domestic growth and lack of progress on unemployment, but attributed this to temporary disruptions resulting from the Japanese earthquake and tsunami, and the spike in oil and food prices.

The spike in oil prices has been blunted, at least for now, by the decision of the International Energy Agency (IEA), only the third in its history, to release 60 million barrels of oil from its strategic reserves, since OPEC did not elect to increase its supply. Oil prices dropped, although many believe the drop is temporary. The amount to be released is less than half the amount lost since the start of the Libyan crisis.

There is a widely held view that inflation will not escalate without an increase in unit labor cost, which is unlikely to occur until unemployment is substantially lower. Inflation is low compared to the inflation of the 1970s, but double its rate of a year ago. The Fed indicated that it will keep short-term interest rates low for an indefinite period and not return to normal.

This dichotomy should lead to continued weakness in the U.S. dollar. This is good for exports and repayment of debt to foreigners, but pushes up prices of imported goods or cuts into the margins of sellers of imports, such as retailers. In addition, there are opportunities to profit from higher interest rates overseas and a weaker dollar would augment the return for the U.S. based investor. Finally, the country of domicile has become less important. As a result, U.S. companies with substantial overseas operations have myriad opportunities to benefit from global growth.

Debt, Deficits and Demographics

According to the International Monetary Fund (IMF), the U.S. government debt to GDP ratio will hit 100% this year, up from 62% in 2007. Germany's ratio will reach 80% and France will reach 88%. Meanwhile, in China the ratio was 19.1% at the end of 2010. In Japan, the ratio is over 200%. According to the Congressional Budget Office, this is the highest level since the end of WWII. While painful, and including two sharp recessions, the U.S. government down-sized after WWII and allowed the private sector to reinvigorate. In addition, government spending that occurred in the 1950s was geared towards investment in infrastructure, notably the interstate highway system that fostered economic growth for decades to come.

The annual deficit is the result of spending, as shown in **Table I** from the President's 2011 budget published by the Office of Management and Budget, and tax preferences, such as deductions for research and development, depletion allowances, the treatment of depreciation, mortgage interest deduction, and charitable deductions that reduce tax revenues.

Table I	President's Proposed Budget
Expenditures as % of Total Spending	Fiscal Year 2012
Health Care	**22.62%**
Medicare	12.86%
Medicaid	7.28%
Other Health Care	2.48%
Social Security	20.04%
National Defense	19.27%
Income Security	14.48%
Net Interest	6.31%
Other	17.28%
Total	**100.00%**

Source: White House - Office of Management and Budget

The current annual budget deficit is expected to be about $1.9 trillion, 9% of GDP. The well-recognized challenge is addressing the impact of retiring "baby boomers" and their increased longevity. Spending for retirement and health care benefits for retirees approximates 38% of the fiscal 2012 budget. An aging population is a problem for all developed countries and will be for China before long, the result of their one-child policy. In the U.S., the worker-to-retiree ratio was 8.6 in 1955, dropped to 3.2 in 1975 and has remained in a range of 3.2-3.4 until 2008 when it began to decline to a level that is estimated to reach 1.8 in 2031. The Peter G. Peterson Foundation challenged organizations to devise a creditable proposal with sufficient detail that it could be tested by the Congressional Budget Office. "The Solutions Initiative" resulted in six responses, which are summarized in **Table II** below. Responses cover the range of political views; all contain some combination of tax increases and spending cuts. The eventual political compromise (politics is the art of compromise) lies somewhere within this range of proposals. For those interested in more detail, visit www.pgpf.org.

Table II	Solutions Initiative Plans Projected Budget Levels in 2035 (as percentage of GDP)					
	American Enterprise Institute	Bipartisan Policy Center	Center for American Progress	Economic Policy Institute	The Heritage Foundation	Roosevelt Campus Network
Revenues	19.9%	23.1%	23.8%	24.1%	18.5%	22.9%
Spending	22.8%	23.7%	23.2%	27.8%	17.7%	24.8%
Deficit (-)/Surplus (+)	-2.9%	-0.7%	0.6%	-3.7%	0.8%	-1.8%
Debt Held by the Public (end of year)	59.6%	38.2%	42.3%	81.7%	30.0%	63.6%

Source: The Peter G. Peterson Foundation/The Solutions Initiative Report

Risk Management and Relative Rewards

The stock market recovery from the 2009 lows has been the second strongest recovery (the best was after the '29 Crash) in the period from 1854, but the economic recovery has been the weakest, according to a study by Deutsche Bank highlighted in the *Financial Times* the last weekend of June.

What are investors' concerns? At a mid-June conference in London for professional investors (63% Europeans, 17% North American, 20% from the rest of the world) hosted by the prestigious Bank Credit Analyst, the biggest concern for the coming year was "euro sovereign debt default risk," followed by "a hard landing in China."

By a wide margin, equities were preferred to government bonds or commodities, including gold, and cash, for the coming year, regardless of geographic origin. According to Fed data, households, including their retirement funds and personal trusts, continue to have twice as much invested in equities as in bonds; however, they continue to be net sellers of equities.

Since 2000, bonds have provided higher returns than stocks when measured against the Standard & Poor's 500, a market index dominated by large-cap stocks, as shown in **Table III** below. However, from 2000 to 2007 small- and mid-cap stocks continued to advance. As a result, mid- and small-cap stocks, as represented by the S&P 400 and 600, gained more than the Barclays Capital U.S. Aggregate Bond Index. The difference in returns demonstrates the benefit of active management, disciplined portfolio rebalancing and security selection. Looking forward, returns are likely to be lower than those of the 1982-2000 period when price/earnings ratios tripled and interest rates dropped by 50% (see Perspectives April 2011 and January 2010 for further discussion); equity returns are likely to exceed those of bonds. At the same time, returns will be as varied in the current decade as in the last decade. We believe that we are in a period similar to that which followed the financial shocks of 1929; a period when returns of bonds and stocks, and other financial assets, went up and down, but did not make new highs. In this environment, active management is crucial for risk management and to earn a reasonable return. This is when stock picking pays off; buy low and sell high, because the trend is flat. Today, half of the stocks in the S&P 500 are overvalued and half are undervalued. This is when the discipline to reassess the relative value of stocks, bonds, commodities and cash, and rebalance is important. Much attention is being focused on new strategies that use short selling and various forms of derivatives. The strategies that capture investors' imagination and are marketed as solutions to the risk/return challenge often do not end up rewarding investors, just the marketers and managers. Consider the 130/30 funds and many hedge funds, popular methods to manage risk and earn a return that have often not delivered as billed. Our manager research focuses on firms that have proven themselves and their strategies in various market environments and where risk management is as important as reward. Then our challenge is to exercise the self-discipline to manage various strategies in a portfolio structure that improves the probability of achieving each client's goals over an investment horizon of years, not months.

Table III	Performance of Bonds vs. Large-, Mid- and Small-Cap Stocks January 2000 - June 2011
Barclays Capital U.S. Aggregate	6.31%
S&P 500	0.90%
S&P 400	8.47%
S&P 600	8.35%

Source: Zephyr StyleADVISOR

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