

Risk Rebounds... But Too Far Too Fast?

June 30, 2009

The Good News: Improved Credit Markets Staved Off Armageddon

While stock markets around the globe sustained their surge from early March, the real news from the quarter was that the credit markets continued to improve after becoming frozen last year. Government intervention—let's disregard potential longer term inflationary concerns for the moment—succeeded in opening up key lending sources, from commercial paper to junk bonds to even securitization markets. We're not yet "back to normal" but we've come a long way.

Better credit markets have had great fundamental and long term benefits: investment grade companies were able to raise capital for projects, financial institutions could improve capital ratios, and some highly leveraged companies could refinance debt and ease looming obligations.

From a short-term perspective, improved credit has also encouraged investors to pull money from safe havens and pursue riskier assets. Accordingly, Treasury Bills and the US dollar (the safe havens during the fallout) posted negative returns for the quarter, while the S&P 500 rebounded 16%, investment grade corporate bonds returned 11%, and junk bonds, commodities, REITs and many emerging markets posted 20%-30% gains.

But What Type of Stocks Led the Rally?

There's no question that many domestic stocks and corporate bonds were oversold, but there's more to understand than that. Our proprietary research engine ("Fundametrics®") provides insight into the nature of this rally in domestic stocks: namely, that the best-performing stocks were those with above average debt levels, lower quality balance sheets, below average dividend yields, and below average lifts to earnings outlooks. In other words, lower quality stocks led the rebound and benefited from "things not being as bad as feared." Battered financial stocks, for example, were up 35% and led the quarter's rally. Which begs the question...

What Risks Remain?

Although credit markets have improved considerably, challenges still lurk for the US and global economies.

US consumers remain stretched. While they have marginally reduced debt levels and lifted savings rates back to mid-90s levels (arguably due to a one-time boost from government stimulus), they are still heavily indebted. Currently, total liabilities are 130% of disposable income, vs. 90% of the early '90s and 75% of the mid-80s. The fall in housing prices (even if they stabilize from here) puts home equity levels at about 41%, vs. 65% twenty years ago. It will take time for consumer balance sheets to stabilize, which means consumer spending (70% of economic growth) will likely remain below the trend of the past decade. Economic growth is likely to be tepid.

Despite better capital ratios, commercial banks arguably are not yet in a position to lend aggressively. Capital ratios are just now falling in-line with more historical norms, and with a stretched consumer and pending work-outs in commercial loans, bank appetite for risk is likely to remain low. This condition reinforces the view that consumer spending will remain below trend.

While the Federal Reserve intervention and government stimulus package have been positive, the government still faces some tough choices. The Fed, for example, intends to keep interest rates low and has pledged further heavy purchases of bonds, if necessary. And if unemployment continues to rise, if wages continue to fall, or if state governments cannot resolve budget crises, will the federal government turn to round two of stimulus spending? The challenge of course is managing the current slack in the economy (deflationary risk) with mounting government debt (inflationary risk). Our view is that deflationary forces may prevail for the coming year, but inflation has a higher probability in perhaps three to five years. Calling when that inevitable transition occurs is impossible, but we are beginning to plan accordingly today.

Finally, analysts call for significantly better corporate earnings growth starting in the fourth quarter this year. To date, actual earnings improvements have not been strong and weak recovery may pose risk to some stocks in this rally.

What Does This Mean for Investment Strategy?

Clearly, we are seeing extreme cycles of investor emotion as the economic challenges unfold. Following those emotions into efforts to "time the market" or to "follow the herd" is dangerous. As our clients know, we do not invest for quarterly returns but for multiple years. We adhere to our investment philosophy and process regardless of what's temporarily in favor.

As contrarian value investors with a disciplined process, we have had above average exposure to materials and industrials stocks, which helps explain our strong relative performance this quarter. Our research is also finding increased opportunity in energy and health care stocks. We have also benefited from the rebound in consumer stocks, many of which we trimmed during their surge and now have average exposure.

At the same time, we have avoided Treasuries, given their low historic yields, and have favored instead better yielding and shorter duration instruments like CDs and agency bonds. For longer term bonds, where inflation poses a risk, we have preferred inflation-protected Treasury bonds (“TIPS”), although we maintain a moderate allocation. Where appropriate, we have diversified into complementary publicly-traded asset classes through exchange traded funds (“ETFs”).

We continue to pay exceptional attention to balance sheets and a company’s independence from credit markets. The goal is to find companies that can weather further shocks and that trade at attractive valuations.