



BOSTON INVESTMENT ADVISERS

## SECOND QUARTER 2011: OUTLOOK AND COMMENTARY

Let's break for coffee.

– Alan Greenspan, June 2005 (after a presentation to the FOMC by the head of the Atlanta Fed on the property bubble in Florida, whose bursting, he said, was “an accident waiting to happen”)

Regulators [in 2008] were caught “flat-footed” by a breakdown [in the financial sector after the real estate bubble burst] that we thought was more than adequately reserved against.

– Alan Greenspan, March 2011

I can calculate the movement of heavenly bodies but not the madness of men.

– Isaac Newton (after he exited early and profitably from the South Sea Bubble but returned later to his ultimate ruin)

### I. Introduction

Virtually since the beginning of the year, Americans have been transfixed by a series of geopolitical and even geological tremors that have shaken various parts of the world. Revolutions across the Arab world on a range and scale last seen in Europe in 1848; earthquake, tsunami and nuclear disaster in Japan reminiscent of WWII; and continuing fiscal and political crisis in Europe that threatens the viability of one of the world's reserve currencies—it has been a drama of historic proportions. Yet, like the little engine that could, the economic recovery and revived vigor of the stock market (and welcome quiescence of the bond market) in the U.S. are almost eerily reassuring. Let's take a closer look.

### II. The Economy

Measured growth proceeded in the last quarter of 2010 as U.S. GDP rose at a 2.8% annual rate, following the third quarter's 2.6% pace. While these numbers prompt no cheering in the bleachers, they and consensus expectations for 2011 strongly suggest that the dreaded double-dip recession has been avoided. Recent battlefield reports from the labor market have been encouraging as the economy produced well over 200,000 jobs in March. Even at that pace, however, job growth cannot make a material dent in the official unemployment rate, which at today's 8.8% has fallen a point from its peak but remains stubbornly kite-high over any level that could be considered normal. And one does not even want to think about unofficial or wider measures, which include those who have given up looking for full-time jobs.

In the meantime, the deleveraging of the beleaguered household sector proceeds as household debt as a percentage of disposable income has descended from an all-time high of 130% (remember those

unsolicited telephone calls offering another credit card?) to 116%, though most observers believe that it must get down to at least 100% for us all to breathe freely. The lugubrious business of foreclosure (one quarter of all residential mortgages are presently underwater and one third of all sales are “distressed”) and credit card default will help, but more positive is the current personal savings rate of over 5% (during the madness of the bubble years it had dropped to or below zero), which should add to the momentum.

Of course, just as the private sector (the personal and especially the financial sector) is deleveraging, the public sector is—appropriately—moving in the opposite direction.<sup>1</sup> Of course, fiscal policy has turned neutral as all federal stimulus programs have run their course and, in the current poisonous political climate, will not be replaced. (Actually, government in total now pursues a de facto contractionary fiscal policy as state and local governments stare at bare cupboards.) Although not officially part of the federal government, the Federal Reserve is further expanding its balance sheet, in an effort to further stimulate the economy, through the program previously described in these pages and known as quantitative easing, but this phase, called QE2, is expected to end in June.<sup>2</sup> Whether it will be extended is unknown but will at least be decided in terms less raucous and rancorous than those heard in the halls of Congress.

In the meantime, the Fed continues to apply considerable balm to the economy in the form of near-zero short-term interest rates. The chance that it will decide to tighten before next year (or even the following) is very small though the recent rise in some commodity prices (especially oil, given all the turmoil in the Mideast) has led observers to call for a pre-emptive strike at incipient inflation, as the European Central Bank did only yesterday. Certainly, despite recent signs of rising “inflation expectations” among the public, after highly visible, even painful, increases in food and gas prices, there is no chance whatsoever of an outbreak of a wage-price spiral (given the parlous state of the labor market and the impotence of private sector trade unions). Therefore, any tightening of monetary policy would seem at best premature.

Yet that judgment proceeds against a cyclical backdrop of the yin and yang of the ordinary business cycle whereas arguably that judgment should be made against a more secular post-financial crisis backdrop. Here the worry is that the ratio of ensuing publicly-held Treasury debt (much of it, of course, held in China) to GDP will rise inexorably to the fateful level of 90%, above which history teaches us that slower growth will almost inexorably ensue. The apprehension of that phenomenon alone may cause our old friends, the bond market vigilantes, to make their own pre-emptive strike and force rates to rise across the yield curve, not just the short end. In effect, this would mean another financial crisis, whose solution would almost certainly be devaluation of the dollar through inflation (an option blessedly available to the issuer of a reserve currency). For consumers this is a most unhappy prospect as it would greatly raise the prices of imports. For taxpayers inflation would be even worse as financing the government’s debt, now hardly noticeable at a time of low rates, would become crushing as rates spiked and we approached a “debt trap.” We all live in dangerous times.

### III. The Capital Markets

Although the stock market paused and retrenched during the quarter, it finished strongly and basically continued the rally that began last August when Ben Bernanke whispered the magic words, “quantitative easing.” Since then the S&P500 stock index has advanced 24% (as of this writing). Is there a causal con-

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<sup>1</sup> Interestingly, the amount of debt shed by the post-crisis financial sector (\$2.9 trillion) has almost matched, dollar for dollar, that assumed by the federal government (\$3 trillion).

<sup>2</sup> Equally interestingly, the aggregate amount of Treasury bonds purchased by the Fed last quarter under QE2 of \$320 billion almost matched the Treasury’s net new issuance. Conspiracy theorists take note!

nection? Is there a God in heaven? All one can know for certain is that clearly the Fed wanted savers (in CDs and money-market funds) to become investors (in stocks or gold as the flavor du jour), and on the margin they have done so. While money has not flooded into the market (as measured by net in-flows into stock funds), they have been positive for months and seem—anecdotally—to be drawn from those whose panicked exits two and half years ago left them standing by when the market turned. Their re-entry marks a kind of capitulation.

Of course, this rally really began when the market bottomed in March 2009. Since then broadly speaking stock prices have more than doubled. While there are still a few bears out there among the cognoscenti, the prevailing sentiment among professionals is one of cautious optimism. Of course, the primary reason (at least after low interest rates) is the strength of the U.S. economy, as described above, and especially the corporate sector (discretely putting financials aside). As reported in these pages for many quarters now, corporate America's profitability has been truly remarkable, with high productivity growth bringing high margins.

Now, however, a crucial missing element has begun to leave some fingerprints: final demand. With surprisingly strong consumer spending (among the naughty ones who have not repented fully of their former profligacy), corporate revenues have begun to rise. (For the S&P500 group of companies, revenues rose 8.1% in the fourth quarter.) This has contributed to further profit growth just when productivity growth had lost its impetus as knife reached bone. In fact, there is anecdotal evidence that many companies, which in general have a great deal of underutilized capacity, will begin to rehire only when they feel—virtually in corporate chieftains' guts—a revival of consumers' animal spirits and their reappearance in the malls, physical or virtual. Thus a virtuous circle may be reborn.

That earnings growth—for the S&P500 14% over the second half of 2010 (annualized)—provided the fundamental justification for the stocks' advance in the first quarter of this year. True, stocks are not cheap, with the S&P now trading at 23 times “normalized” earnings (i.e., their 10-year average in real terms) versus 16 times for their long-term average, but again relative to the principal alternative, high quality bonds, they look awfully attractive. Thus, the so-called equity risk premium, which tells us how much stocks are likely to outperform bonds as defined by the difference between forecast earnings yield on the S&P and the yield on the 10-year Treasury bond, is now 5.5 percentage points, two points higher than its 50-year average. Of course, it has not hurt that the Fed has the pedal to the metal (short-term rates at nearly zero, QE2 scooping up bonds at any price), but for now *laissez les bon temps roller*. And, yes, in addition to the Fed's largesse, one senses a great deal of what is politely called momentum (less politely, herd behavior) at work. The Big Mo is clearly visible in the very low rates of measured volatility in the market, with the CBOE's VIX index both flat and low at 17 presently. Yet that is what makes markets, as Isaac Newton painfully learned.

Still, one must spare a word of caution for the bond market, which floats on the largesse of the Federal Reserve and the toleration of the bond vigilantes. Thus, eyebrows among the cognoscenti universally rose when PIMCO, led by bond market kingpin Bill Gross, recently announced it had exited wholly the U.S. government securities market. That seems a trifle overdone, but it is a marker that none of us can ignore.

Jerome W. Anderson  
April 8, 2011

## Our Pledge to Clients

We will treat your portfolio at BIA as if it were our own.

We will invest for the long-term while always striving to maximize returns and minimize risk.

We will seek to minimize your investment expenses.

We will not accept any payments or anything of value from third parties that might influence our choice of investments for your portfolio.

We will invest our personal assets in parallel with yours.