Market Commentary
by Byron Wien

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Two Gloomy Afternoons

Now that the summer has come to an official end I think most of us in the Northeast would agree that the weather has verged on the sublime. There have been a few very hot days, but not much rain, and the weekends have been consistently memorable. What has been going on in the real world is quite another story. Since the first quarter when real gross domestic product expanded at a 3.7% rate, almost every measure of economic progress in the United States has deteriorated. Unemployment has remained stuck at about 9.5%, the second quarter gross domestic product growth has just been revised down to 1.6% from a preliminary estimate of 2.4%, houses are selling slowly, retail sales are lackluster and capital spending is uneven. Instead of gaining momentum the economy appears to be sputtering, and the mood of investors is apprehensive at best.

Against this background I was very much looking forward to this year's Benchmark Lunches. This is an annual tradition that began a quarter century ago. I organize two discussion sessions on successive Fridays at the end of August for serious investors who spend their summer weekends in the eastern end of Long Island, as well as a few participants who fly in just for these sessions. Close to fifty people attend (about twenty-five at each; only I attend both) and I moderate with a tight agenda. While net worth does not always connote wisdom, the number of billionaires in attendance is in double digits and these people are not shy about expressing their opinions.

As expected, the group was gloomy on the outlook despite the comfort of the surroundings. They saw the United States in a long-term slow growth environment with the near-term risk of recession quite real. The Obama administration was viewed as hostile to business and that discouraged both hiring and investment. Companies and entrepreneurs were reluctant to add workers because they didn't know what their healthcare costs or taxes were going to be. Financial service firms were confused about how the rules emanating from the new financial service regulatory reform legislation would affect their businesses. Almost three-quarters of Americans polled think the country is headed in the wrong direction and Obama's approval rating is in the lamentable low 40's. One participant said that the top 5% of the income ladder accounts for 30% of consumer spending and that is the group Obama seems to be attacking. The already high level of debt currently on the books of the federal government makes additional stimulus spending controversial and the political climate for more stimulus makes it unlikely that a major program could be passed. There are many who question the effectiveness of the first stimulus program.

State and local governments are running hundreds of billions of deficits annually so they are more likely to be cutting back on expenditures adding to unemployment and slowing economic growth. Consumers are in the process of reducing the debt built up during the free-spending era prior to 2008, so their role in contributing to growth (the consumer represents 70% of gross domestic product) is likely to be diminished. Current administration policies have not been effective in helping the middle class in America. Even if the Federal Reserve engages in a vigorous program of quantitative easing, the economy is unlikely to pick up much speed. There is a mismatch between the jobs that are available and the people who have the skills needed to fill them. American labor costs are high and there is an increasing number of competitors around the world making products comparable to ours in quality at lower prices so it is proving hard to expand our exports while our craving for foreign manufactured goods and oil keep our imports high.

Moreover, these are not problems that are likely to be solved any time soon; over the short term they may actually get worse. We seem to be condemned to a long period of slow growth and high unemployment, and the current attitude of investors at the lunch and elsewhere seems to reflect those conditions. A substantial minority feared we were headed back into recession. Only a few investors thought the Standard & Poor's could reach 1200 in the next year. Comparisons with Japan in the 1990s were

dismissed, however, by pointing out that the banks there invested in the stock market and monetary policy was restrictive.

I asked the group if there was a bullish case to be made since periods of profoundly negative sentiment usually created major investment opportunities. Several pointed out that money supply was likely to expand, which was generally good for stocks. Both interest rates and price earnings ratios were low and usually those two don't go together; multiples could rise. Corporate earnings are terrific, corporate balance sheets are in great shape with plenty of cash available for investment or acquisitions. Currently depreciation is running higher than investment, which shows a lack of confidence in the future, but that could change. Merger activity is picking up, reflecting business confidence in strategic deals.

Boards of directors are pushing managements to do something constructive with their cash. The public is selling stock mutual funds and buying bond funds, reflecting their disenchantment with equities, and almost invariably they make this shift at the wrong time. Young investors got burned in the technology bubble and older investors are shifting their portfolios into conservative assets, resulting in a paucity of equity buyers. You can buy high-quality stocks providing reasonable yields, which means the market is not devoid of opportunity. Larger companies are especially attractive. Nobody has made money investing in the indexes for 12 years. A quarter of the stocks in the Standard & Poor's 500 yield more that the 10-year U.S. Treasury. There are plenty of companies out there with a lot of cash waiting for someone to bid for them. You can buy companies with reasonable growth prospects at 12 times earnings while Treasuries with no growth prospects are selling at 40 times the coupon.

Countering the belief that there were a lot of companies that could be bought outright at attractive prices, one prominent deal maker was skeptical. He said that in a slow growth economy revenues might not keep up with costs and profits could erode. He thought that chief executive egos were driving lots of deals. World growth needs to be 4% for deals to be attractive and it is running at 3% now. But perhaps Europe, especially Germany, should give us some hope. Everyone expected austerity programs to create a fiscal drag based on statements made at the Group of Twenty meeting in Toronto in April, but Germany grew at a 9% annual rate in the second quarter, although that could be because the tough aspects of their fiscal restraint haven't kicked in yet and the economy is still coming back from a weak 2009. They also have massive demographic and social (immigration) problems ahead. One pointed out that Germany's policies are good for Germany but not easily transferable to other countries in Europe.

The problems we are facing have been coming for a long time and they will not be solved quickly because so many of them are structural. Our political system is broken, our education system is falling behind and slow to respond to constructive ideas, and our infrastructure is pathetic. The teachers unions stand in the way of educational reforms; the Republicans only care about getting control of Congress and the White House and they lack a convincing program likely to turn the economy around. Tax cuts alone won't do it. Not enough good people are going into government and those who want to are daunted by the screening process and the exposure. Negative campaigns are showing up everywhere and they seem to work, which is discouraging. The infrastructure in Europe and Asia is better than ours and we're slow to make improvements here and lack the serious money to do it.

Surprisingly few thought the "flash crash" on May 6 was a major event discouraging individual investors. Those with exposure to retail brokerage operations did see a serious impact. High-frequency trading has put a premium on short-term trends and tended to exaggerate moves in both directions. Some believed long-term investing based on fundamental research was getting harder to do but that had more to do with the difficulty of projecting earnings in an uncertain economic environment than quantitative algorithms. Investors will return to equities when they believe they are missing opportunities and so far that is not the case.

On the inflation/deflation issue, a few more were on the side of inflation because that would make debt obligations easier to pay back and would be the likely result of significant monetary expansion. As the standard of living rises in the developing world, food and energy costs are likely to continue to rise. There was a vocal minority in the deflation camp, however. To have deflation you need wages to fall and house prices to decline. While the latter is a possibility because of the large overhang of mortgages in trouble, the former is unlikely because businesses have chosen the course of producing goods and services with fewer workers rather than paying workers less. There is some evidence that hourly earnings are actually increasing and house prices are rising, although that may only be temporary.

Most participants thought the Democrats would lose a considerable number of seats in the House of Representatives and the Senate in the November election with a notable segment thinking they would lose control of both. Few were willing to say more than that a shift in power would be a positive for the country because it would end the hostility of the Democrats toward business and the "redistributionist" philosophy in Washington. Most thought a shift in Congress would only mean an extension of the current period of "gridlock," but some believed that government had to play an important role in developing solutions to our problems. Many believed the United States was ready for a political move to the center. A few argued that a parliamentary system might be more effective but everyone recognized that we were not likely to modify our present legislative system in any meaningful way. There was an appreciation of the authoritarian government in China and what it had been able to accomplish.

We debated whether the Chinese miracle would continue. Most believed the government there has proven its ability to regenerate itself with competent leaders and was very effective in both producing growth when it slowed too much and restraining growth when it reached a level likely to produce inflation. The usual concerns about demographic problems, pollution, human rights, the legal system and corruption were mentioned but were not yet considered troubling enough to slow China down. Recent data showing growth at only 7% was not viewed as indicative of a prolonged downtrend. There was a feeling that the air pollution problems and the lack of safe drinking water were likely to become serious issues in the future.

China is doing more about its environment than most countries, but it is starting from a very low base. The Chinese are major manufacturers of wind turbines and solar panels but that is primarily for export. China passed Japan this year as the second largest economy in the world and it appears likely to continue to grow in economic importance. Somewhere in the future it will surely run into difficulties but the bubble that everyone has been expecting in real estate doesn't seem to be about to burst. There are excesses at the high end, but they don't appear to be system threatening. A healthy crop of new engineers is coming out of its universities every year and we can expect to see examples of Chinese technological innovation in addition to the production of quality manufactured goods at attractive prices. A country with this much economic power is likely to want more of a role in geopolitics and this will be a challenge to the established countries in the West.

Of the trouble spots in the world Iran was considered the most dangerous, followed by Pakistan. Most participants believed we should not try to create democracies in Iraq and Afghanistan but should, instead, maintain a surgical strike team of some size (30,000) in those countries capable of attacking Al Qaeda and other terrorist groups whenever their operations were identified. Iraq and Afghanistan are basically tribal and our efforts to change them have proven both costly and futile. The lethargy of the legislators in Iraq and the corruption in Afghanistan were discouraging.

In the case of Iran, the feeling was that its potential danger to the region and America made its possession of a nuclear weapon unacceptable. The United States has told the world that we would not permit the nuclear weapons development program to proceed and if we backed down from that, we would lose the respect of moderate countries in the Middle East and other nations throughout the world. America's military and political stature would decline and without this the world would become a more unstable place. We cannot afford to let that happen. An Iran with a nuclear weapon would start an arms race throughout the region and put the oil reserves there in danger, some argued. I tend to doubt whether the United States or Israel will strike Iran anytime soon, but the discussion made me think that it was more likely than I had previously thought. There were some who believed that Iran was basically a moderate country that wanted to be a part of the modern world and that eventually the oppressive extremists would be overwhelmed by the will of the people but so far there seemed to be only modest evidence of that. The election outrage last year was suppressed and the hard liners seemed to be in firm control. I pointed out that Pakistan was a country not particularly favorable to the United States and they have had nuclear weapons for years. Several participants said that the military controlled the weapons and that the army there was sympathetic to U.S. interests. It was critical to win the support of Pakistani people, and by providing aid to the flood victims we might take an important step forward in accomplishing that.

Overall there was a feeling that to bring about the profound changes that were needed a major crisis would have to occur. Another recession could create severe problems in commercial real estate as well as residential mortgages and the banking system and that might bring on serious reforms. In terms of where to invest if the current slow growth economy continued, vacant office buildings and farmland looked good

to some. Africa was mentioned. Few were enthusiastic on gold. Many liked Brazil and some favored India. Nobody had anything good to say about Japan except to point out that in a deflationary environment, low interest rates are acceptable and the currency is strong because it can buy more. In reaction to the current craze of the banks and others to borrow short term and invest in longer-term bonds of various quality, one participant asked plaintively, “Has there ever been a carry trade that hasn’t ended badly?”

The lunches were over about three-fifteen; I didn't get the feeling anyone there was rushing out to place an order before the close based on what was said.

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