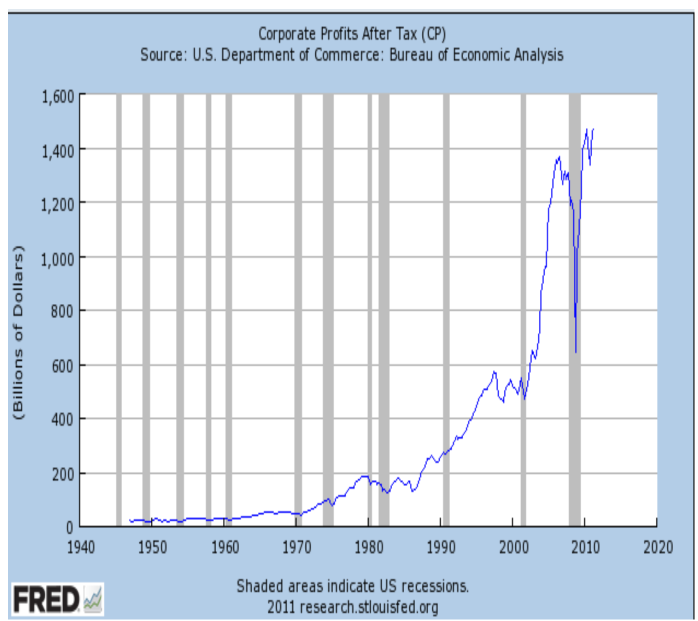
SEPTEMBER 2011

<u>Investment Thoughts</u>: Hurricane Season

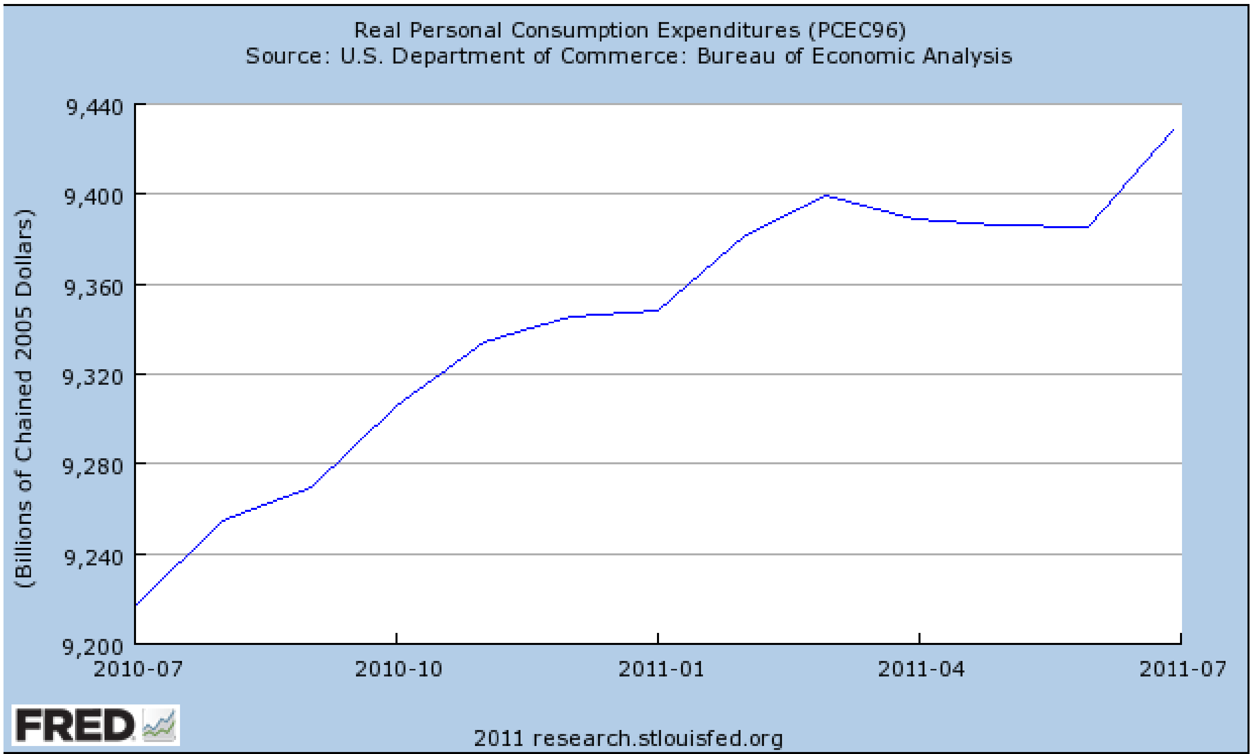
Hurricane Irene surely caused great damage as it passed up the east coast. Dislocations to the economy are being examined and tallied. In financial markets, the month of August has had its own market tempests with dramatic day-to-day volatility of share prices, which has damaged investor confidence in our economy and the future of corporate earnings. Are we really on the brink of recession again?

There seems to be a big difference between corporate health and the consumer's view of the domestic economy. Since the credit crisis of 2008, corporations have used the low-interest-rate environment to refinance and restructure debt. Improvement in labor productivity at a time of lean employment levels gave a disproportionate share of profits to corporations relative to labor. The result has been no real (inflation adjusted) growth in wages, while corporate profit margins expanded and after-tax profits reached a full recovery from depressed crisis levels. In the charts below we note the growth of corporate cash as a percent of current assets and after-tax profits. Reticence to invest that cash may be partly due to tax and medical policy uncertainties. Certainly, capital spending retrenched dramatically after the credit crisis.

Source: BLS, FactSet, J.P. Morgan Asset Management.
Data reflect most recently available as of 6/30/11.

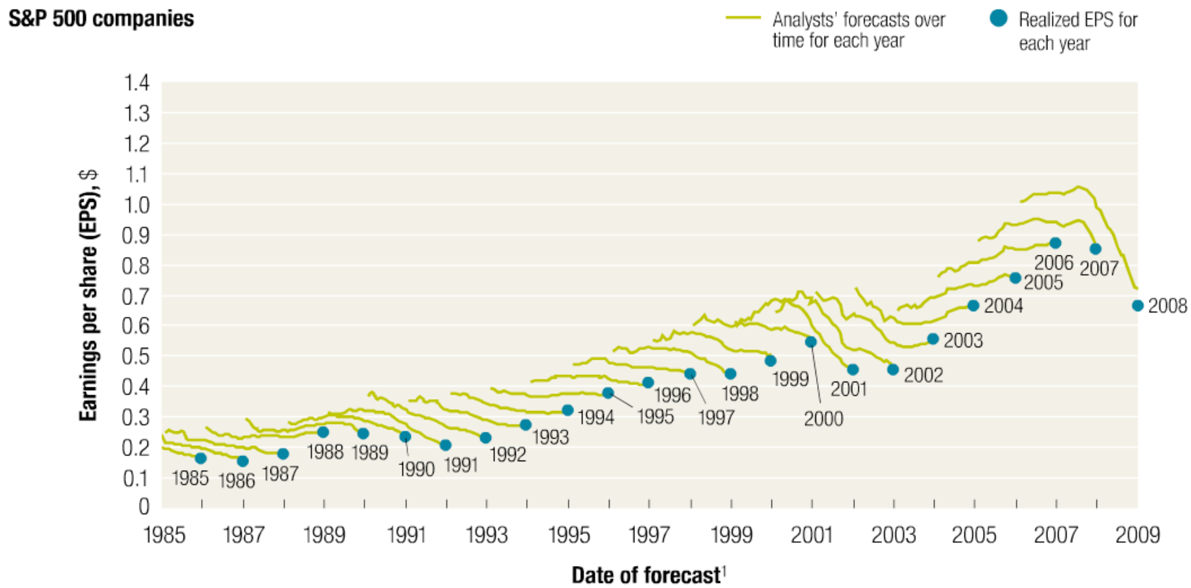


While strong corporations are terrific, consumption is the engine for the U.S. economy. Real personal consumption has risen barely above 2% over the last year (ending in July). Savings rates have increased as the consumer has struggled to rebuild solvency. Financial stress is still high, and it typically tracks unemployment levels. Most measures of money velocity have turned down, reflecting the cautious mood. Goldman Sachs may have removed the sand bags from around their headquarters following Hurricane Irene, but U.S. consumers are only grudgingly drawing down savings for new cars and back-to-school purchases. Jobs will ultimately be the key to rising consumption, yet convincing small businesses to hire seems an uphill battle. Perhaps President Obama's recent choice of labor economist Alan B. Krueger as his economic advisor suggests his focus is now squarely on this urgent problem.



As investors looking to earn "rent" on our money, we need to understand that an economic recovery will not be mounted from the shoulders of the consumer any time soon. The U.S. economy will be sluggish for an extended period along with an extended period of low interest rates. I believe we will also see a sideways stock market characterized by high volatility during the time it takes for jobs and housing to recover. Income producing real estate, dividend growth stocks, and high yield corporate bonds offer the best returns for this environment, in which capital appreciation derived from higher earnings or expansion of the market's price earnings ratio may be elusive.

Buying stocks based on sell-side analysts' projections would lead one to believe the U.S. stock market is cheap, as the low P/E ratio reflects, in my judgment, unrealistic earnings expectations.



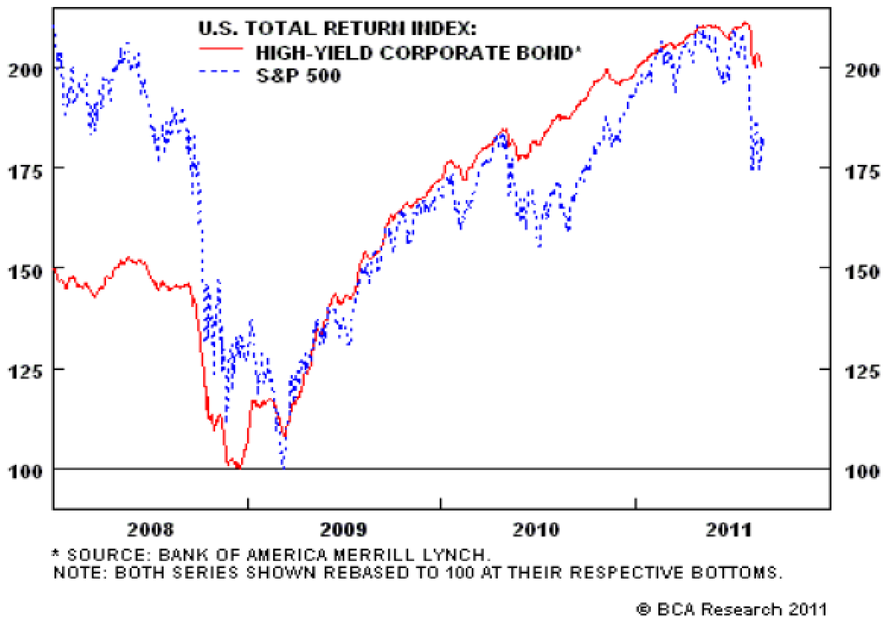
I have quoted McKinsey before on this subject:

“This pattern confirms our earlier findings that analysts typically lag behind events in revising their forecasts to reflect new economic conditions. When economic growth accelerates, the size of the forecast error declines; when economic growth slows, it increases. So as economic growth cycles up and down, the actual earnings S&P 500 companies report occasionally coincide with the analysts’ forecasts, as they did, for example, in 1988, from 1994 to 1997, and from 2003 to 2006.”

As I believe we are in a contraction phase of the business cycle, we need to be even more concerned with forecast error; hence, our penchant for investments where a large part of our expected return comes in cash.

Sustained capital appreciation from the stock market does not seem likely, though the decline of the S&P 500 to 1100 this August has discounted a good part of the domestic weakness and credit risks from Europe. The issue is that the range of policy options to “fix” the economy is dwindling at a time of deep political intransigence. I grant that as the consensus has edged into the bearish camp on the economy, many so-called defensive, or non-cyclical, investments have moved up in price so as to warrant caution. It is too soon, however, to take a more pro-cyclical stance as these stocks have not yet reached undervalued levels.

We have previously considered the use of high yield bonds as a stock substitute, exchanging some market risk for credit risk and high income. Today’s market may offer a good tradeoff. High yield bond prices can sag with recession fears, but have been demonstrably less than stock declines, meanwhile paying high interest. If we look back at the credit crisis (time of unpleasantness) and the selloff in stocks in 2010 and now, it is clear that high yield bonds capture less of the downside and most of the upside. To be sure, a depression with rampant defaults is another matter. They are not for all seasons, but look good for this one.



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Books of interest:

The Era of Uncertainty: Global Investment Strategies for Inflation, Deflation, and the Middle Ground- Francois Trahan

The New International Money Game- Robert Z. Aliber

When Money Dies- Adam Ferguson