

## Strategic Investment Outlook

January 2012

By any standard 2011 was a very challenging year. Financial markets were driven more by investor emotions vacillating between hope and fear than by any real economic trends. Evidence of this is compelling. In 2011 the stock market experienced the highest correlations between individual stock returns ever recorded. The following comment from Bianco Research LLC makes this point better than any other we have come across:

“If one correlates each of the individual stocks in the S&P 500 to the index itself over a 50 day period, the average correlation hit 86% in October and is still near 80% today. No other period since the inception of the index has yielded a higher correlation, not during the Great Depression, rampant inflation of the 1970s, the stock market crash of 1987 or even during the financial crisis of 2008. This suggests 80% of a stock’s movement can be explained by a stock market index rallying or declining. The other 20% of a stock’s movement can be explained by the unique fundamental characteristics of that company such as management, product, a strategic plan and/or financial health. Similar record correlations can be found between the S&P 500 and currencies (the euro), commodities (crude oil), foreign markets (emerging market and European stocks) as well as interest rates (corporate and Treasury yields). In the entire history of the S&P 500, there has never been a day in which all 500 stocks in the index go up or all 500 go down. There have been 11 days in which 490+ stocks all move in the same direction on a given day. Of those 11 instances, 6 have occurred since July 2011.”<sup>1</sup>

In simple language, the stock market in 2011 generally lacked any theme, was extremely volatile and basically went up or down according to the sentiment of the day. In such a market it was hard for an investor to distinguish himself through careful stock selection. Stocks, non-investment grade bonds and commodities rose or fell en masse. This should not last forever. Eventually differences in the fundamentals of individual companies should result in differences in the performance of their securities.

From a fundamental perspective, 2011 was anything but simple. Early in the year it looked as if the U.S. economy might be heading towards a self-sustaining recovery. But in the 3<sup>rd</sup> quarter, unforeseen political bickering over the debt ceiling, coupled with an increasingly serious euro crisis, unnerved investors and caused equity markets to collapse and investment grade bonds to rally sharply as a “safe haven.”

Improving economic data in the 4<sup>th</sup> quarter allowed markets to recover somewhat. But as we enter 2012, investors remain nervous, skeptical and jumpy, with good reason.

The political process in the U.S. remains mired in partisan posturing. Politicians seem unwilling to address the real structural issues that must be resolved in order to create the confidence we need for strong growth. Our leaders can talk all they want about the need for fiscal restraint, either through higher taxes or lower spending, and they can advocate further monetary easing, but none of these measures may do much to solve our problems unless the economy grows. In our view, we can grow our way out of the fiscal imbalances, but we cannot tax our way out or spending-cut our way out. Growth, not austerity, is the most potent medicine for ailing economies. It is not clear that the authorities in Europe or the U.S. have a handle on how to foster growth.

We are not so arrogant to believe that we have the answer either. But we do have a sense that at least in the U.S. the solution must include a credible effort by Congress and the administration to tackle the structural fiscal issues we discuss below. This would go a long way towards establishing confidence in the business community that, in turn, could lead to a greater propensity to invest and hire.

Secondly, there should be a focus on infrastructure investment such as roads, bridges and so forth that both address a real need in this country and also employ a large number of people. Given that a fair percentage of our unemployed are laid-off construction workers, construction-related infrastructure investment should be a government priority.

## **Expectations for 2012**

We expect 2012 to be another year of slow growth and potential crises. Currently, the euro zone is probably experiencing a mild recession. Growth in China and other emerging economies appears to be slowing. Things are perhaps a bit more upbeat in America as recent economic statistics point to modest economic expansion. Housing appears to have bottomed. While it is unlikely to turn up sharply, at least it is no longer a drag. Unemployment has dropped to 8.5%, but unfortunately much of the improvement reflects discouraged workers dropping out of the labor force rather than any real pick up in hiring. We are still losing jobs on balance.

Consumer spending has been surprisingly good, but only because the savings rate has declined, not because personal incomes are up very much. At a time when the consumer needs to de-lever and rebuild his balance sheet, a lower savings rate would seem both unsustainable and unwise. Therefore, we expect renewed spending restraint in the coming year.

Most businesses are in good shape financially but capital spending is running at only about 80% of internally generated funds<sup>2</sup>. This suggests that managers lack confidence in the prospects for growth. A lot of spending is focused on productivity enhancements, which do not bode well for near-term job creation. Moreover, we see nothing in the way of a great new technology which would unleash a surge in new investment opportunities.

With the euro zone faltering and growth in emerging markets slowing, U.S. exports are not likely to be a growth engine this year. Perhaps more important to our outlook, government stimulus spending is scheduled to wind down in 2012, so fiscal policy is poised to become more restrictive. Add to this the inevitable uncertainties of an election year and the political landscape cannot be encouraging.

Monetary policy will likely remain highly stimulative, but will not, in our opinion, have a significant incremental effect. Interest rates are already low (negative in real terms) and money creation quite robust. But since the private sector is in a deleveraging phase, cheap money is not likely to cause businesses or consumers to borrow more money. In fact, a lot of new debt issuance by businesses has been for the purpose of refinancing higher-cost older debt, not to finance new investment.

Only the public sector has been adding net new debt, and obviously this cannot go on endlessly. At some point the piper will want to get paid. Either government will have to make the necessary structural changes before the markets riot, or a financial crisis may force radical solutions. As we are seeing in Europe, the markets eventually grow tired of governments that keep piling on debt. With the U.S. government adding over \$1 trillion of new debt per year, the question increasingly seems to be when, not if, the U.S. will face such a market reaction.

Politicians at the federal level seem totally incapable of facing the need for serious structural reforms to our entitlement system, namely health care and social security, and to our tax system. Eventually they will have to tone down their partisan posturing and tackle the structural issues in a substantive manner. Fortunately we are beginning to see progress on such issues at the state and local levels. Perhaps this can establish a national mindset that will encourage Congress to stop dithering and “get with the program.”

## **Investment Outlook**

Given the likelihood of slow growth and great political uncertainty, the investment climate is less than robust. Bond yields are already quite low, so investment grade fixed income returns at best may approximate the coupon rate and at worst may turn negative if interest rates start to rise. With the recent CPI data at 3%, real interest rates are already negative across the entire Treasury yield curve. Equity returns could be modestly better than fixed income returns, but it is hard to envision them greater than high single digits. This is because profit growth is likely to be modest and current valuations are not extremely cheap.

Within that framework, we are managing the Fund using three themes that we believe should prove rewarding in both the equity and fixed income markets. The first is a focus within equities on undervalued, yet rock-solid companies with the ability to grow dividends over time. Stocks of highly-rated companies, yielding 2.5%-3.5% and histories of raising their dividends every year, may look quite attractive for an income-seeking investor when compared to the 10-year U.S. Treasury bond with a static 2.0% yield. Assuming interest rates stay low and economic growth subdued, the earnings, cash flow and dividend streams of blue chip companies with below average cyclicalities should continue to attract investor attention.

The second equity theme has been and continues to be a core element of our investment strategy, namely a focus on companies undergoing significant fundamental improvement via turnaround, merger or restructuring that can lead to accelerating earnings and cash flows. To the extent such companies are currently out of favor and unloved and, therefore, selling at cheap valuations, their stocks can prove immensely rewarding as they experience both earnings acceleration and a contemporaneous increase in their valuation multiple.

The final theme relates to our fixed income strategy. Given that real yields on Treasuries are already negative, we believe that any continued rally in Treasuries would need to be fueled by sustained artificial demand from Washington. Therefore we continue to favor higher yielding corporate debt. We are particularly focused on shorter-term bonds that should be able to withstand the potential hit that longer maturity bonds may take if and when interest rates move higher.

We believe that 2011 was the exception not the rule in terms of stock and bond market correlations and that gradually stocks and higher yielding bonds will once again perform based more on their individual results and outlooks and less on the market's en masse "risk on," "risk off" vacillations. Despite our near-term caution, which reflects a very uncertain economic and political climate, we are increasingly convinced that equities are poised for solid longer-term returns. Over the past ten years, stocks generally underperformed bonds. This is highly unusual. Stocks are now reasonably priced and so long as the economy enjoys nominal growth, profits are expected to expand, setting the stage for decent equity returns that should enable stocks to outperform bonds once again, especially if interest rates begin to rise.

We want to thank you for the faith you have put in us and wish you all a healthy, happy and prosperous New Year.

Sincerely,

  
John Osterweis

  
Matt Berler

  
Carl Kaufman

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<sup>1</sup> Bianco Research, L.L.C., "Correlation In The Markets," Newsclips/Daily Commentary, 7 December 2011

<sup>2</sup> The Bank Credit Analyst, Vol. 63, No. 7 (January 2012): 37

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*The S&P 500 Index is an unmanaged index which is widely regarded as the standard for measuring large-cap U.S. stock market performance. This index includes the reinvestment of dividends. The index does not incur expenses and is not available for investment.*

*Correlation is a statistical measure of how two investments move in relation to each other.*

*Cash flow measures the cash generating capability of a company by adding non-cash charges (e.g. depreciation) and interest expense to pretax income.*

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