



INVESTMENT
COUNSEL

MARKET OUTLOOK

Fourth Quarter 2011

In the past year, Cisco Systems initiated a dividend and Microsoft increased its dividend nearly 25 percent.

Both companies have tens of billions of dollars worth of cash on their balance sheets. We note these items because they crystallize the challenge and the opportunity in the financial markets.

The challenge is low growth expectations. As we have mentioned before, the rate of growth coming out of the last recession has been significantly lower than the rates we saw in the past coming out of similarly deep recessions. The recovery of lost jobs is likewise setting new records for anemia. Despite an aggressive peacetime implementation of Keynesian economic policy prescriptions, job growth is not even keeping pace with population growth. Aggregate unemployment rates, those that include people who have given up looking for a job, approach in the United States 20 percent of the work force. It seems the only people spending money these days are those getting money from the government and the super-rich. In such an environment, company managers are unwilling to invest their cash reserves in projects because the expected return on investment does not justify the risk inherent in the project.

Overlay the general expectation for low growth rates with widespread uncertainty about rules and regulations, and you have another significant explanation for the lack of business investment in either plant or people. The rush of government spending was accompanied by a push for increased government involvement in business activities. The dramatic change in health insurance contained in the large health care bill signed into law last year is the clearest example of this, but rules on oil drilling, environmental impact, debit card fees and a host of other legal and regulatory changes result in uncertainty for corporate planners in the United States and around the globe.

The markets this year have been driven by this atmosphere of fear and uncertainty. Events in Europe have added a new emotion: dread. Where in the United States we have political and monetary union, Europe has only monetary union.

If in the United States we have one or two profligate state governments, the Federal government has powers over them that the European Commission does not have over profligate European member governments. The free and easy movement of people and businesses within the United States is in stark contrast to the deep cultural differences contained in the 17 countries that constitute the European Union. The most extreme market gyrations this year have revolved around the prospects for resolving the European PIGS: Portugal, Italy, Greece, and Spain. When it seems we have found a way to get the Greek debt problem headed toward a solution, the world markets rejoice with a strong up day. When we hear news of a deadlock or retrenchment in making a deal, the markets sink at the prospect of the end of the Euro.

While the stock market volatility is explained as an argument between those hoping for some renewed growth and those dreading a global crack-up, the bond markets are even odder. Common sense would argue that the cost of money, which is another way to describe the basic function of interest rates, should be higher when uncertainty is higher. Left to its own devices, the yield curve should be steep. Long duration investments should command significantly higher rates than short term loans, as compensation for the uncertainty of the long-term picture. If, on the other hand, we are collectively uncertain there will be a long term future, then we should see a flat or inverted yield curve, as investors factor in their expectations for economic weakness or even contraction. (The U.S. has never suffered a recession without an inverted yield curve.) Interest rates are set in the market as the equilibrium price for loans at various maturities; they are a series of points where supply and demand curves meet. If the future is positive but cloudy, then the suppliers would naturally be expected to insist on a higher price. The “demand-ers” would accept these higher rates because they expect positive outcomes. If, on the other hand, “demand-ers” see few positives, they will not pay a high price for the loans that suppliers would like to make.

These natural market forces are currently overwhelmed by central bank activity. After two tours as pilot of luxury

ocean liners, the QE I and QE II, Chairman Ben Bernanke is now leading us in a re-make of the old Chubby Checker classic, “The Twist.” Whatever the appellation, the result is disruption of market forces. Markets are in the short term voting machines and in the long term weighing machines. Persistent government intervention has the effect of distorting the scales of the long term weighing machine. Stock market investors take as a primary signal the state of the bond market. As that signal is distorted by government actions, market participants have to adapt. It seems most have thrown up their hands in despair of being able to establish long term projections of earnings growth and are now focused on the short term. The market impact is that we have days where the investor community flashes “risk on” and then days where it flashes “risk off.”

We remain long term investors despite the short term problems. People care too much about their money and their future to leave it in the hands of central planners. The next wave will likely be one in which private enterprises are more attractive than government-backed enterprises. The government can directly affect the bond markets through its open market activities, and it has been keeping bond rates lower than they otherwise would be. In the equity markets, its impact is felt keenly in those industries most affected by its bond market activities, but also in industries where government policies are set at the federal level by the executive branch. Guided by these expectations, we have been looking to equities as a source of income, seeking companies like Microsoft and Cisco that can initiate and sustain a solid dividend policy. We have a strong portfolio of global enterprises which can direct their corporate investments in those areas of the world where they are treated well. Strong balance sheets mean these companies can go to the bond markets and obtain capital at historically low rates, or they can forgo the bond markets entirely and fund their plans from internal capital.

The bond markets present an interesting challenge. Financial repression is the term being used to describe a policy in which the government constrains fixed income investment so as to provide the government with low interest rate financing for its deficit spending. The objective is to get the government a cost of funds that is below the inflation rate. The result would be negative real returns for fixed income investors. In a free

market, fixed income investors would not accept a negative real return. We used to call these activist investors “bond vigilantes.” They seem to have taken an extended vacation, but we think they will return. When they return in force, interest rates will rise despite the central bankers’ preference that they not. We accept that rates are historically low and there is not much we can do about it, so we buy bonds with market yields to meet the investment policies we have in place for balanced and fixed income accounts. Simultaneously, we pursue defensive strategies to keep invested but also ready to move when rates begin to rise. We have avoided Eurozone bank debt. For the past year we have been dancing with the federal agencies that issue debt constantly. These agencies, led by Fannie Mae and Freddie Mac, issue various debt instruments with complicated features like rate step-ups and call dates as the agencies’ analysts seek capital to fund their activities. We find these securities to be attractive, often with above-market interest rates, and accept that the issuer will likely call the bond in less than a year. There has been a steady parade of these agency bonds through our portfolios, and it will likely continue: out goes the old bond as it is called and in comes a replacement with similar characteristics.

It seems this year that the traditional emotional poles of fear and greed have been replaced by fear and dread, but we do not fear or dread the future. Rather, we see significant opportunity in the global equity markets, and we are moving to profit from what we think is going to be an excellent decade for investors. Fear and dread have pushed equity valuations to lows that make no sense if the world is going to recover; we think it will recover and we are selectively adding to quality companies currently trading at historically low valuations. Fear and dread have combined to distort the bond market, but we believe the market will reassert itself.

There is no denying these are difficult times for investors, as the news from day to day is difficult to absorb. We look through that difficulty and see a much brighter picture a few years out. This is the time for investment discipline, for holding on to solid companies that the markets refuse to reward with fair multiples, for holding on to bonds from solid issuers, for making new investments with free cash, all in expectation of renewed activity in the private sector led by capital investment and followed by increased employment. It will get better.

Charles L. Abney III, CFA ■ Tres R. Carpenter, CFA ■ Krista L. Cosgrove, CFA ■ Stacey D. Ewing, CFA
Clayton F. Jackson, CFA ■ John B. Shepard, CFA ■ Kevin C.H. Yang, CFA ■ Bradford S. J. Young, CFA

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