KLS PROFESSIONAL ADVISORS GROUP, LLC
Complete Financial Management

A TECTONIC SHIFT IN BUSINESS RHETORIC

TRADE DEFICITS ENABLE LACK OF RESOLVE IN ADDRESSING GOVERNMENT DEBT AND DEFICIT ISSUES

A hedge fund manager writes that "black swans abound". An eminent CEO instructs his lieutenants to "assume the black swan". Another analyzes transactions assuming the worst case scenario and will proceed only if it works then. Other executives, professional investors, and financial and economic commentators focus on "seriousness of consequence" – not only the likelihood of occurrence – and recognize that the black swan appears more often than originally thought. The rhetoric is getting real.

The same, unfortunately, cannot be said of the federal government. Spending reductions and tax policy, debt limits and deficits, and trade and currency exchange policies continue to be treated as instruments of political maneuvering. To restore economic stability and catalyze growth these matters must soberly be addressed for what they are – the defining issues of our economic future.

We have previously observed that approximately 50% of S&P 500 profits are derived outside of North America. Profits from developing (emerging) markets have increased dramatically in recent years and significantly increased the rate of overall corporate earnings growth, notwithstanding slower growth of the U.S. economy. Earnings per share and revenue growth for 2011 for the S&P 500 are projected at mid-teens rates.

Although jobs data (creation, employment, and wages) have improved, unemployment remains high. Increased energy and commodity costs threaten inflation and corporate profit margins, and pressure consumer spending. At some point, the slower growth of the U.S. economy could result in an earnings drag that may not be overcome by growth in emerging markets, although, not likely in the near term.

DISCUSSION

In the wake of the financial crisis, the private sector de-levered while the government sector increased its outstanding debt to finance rising deficits. The Fed injected liquidity into the economy and maintained an exceedingly accommodative credit policy. The result was that consumer spending levels were supported, and the U.S. trade deficit with emerging market economies expanded (after pausing at the depths of the crisis).[1] The U.S. private sector benefitted from lower costs of production in emerging markets and low credit costs, muting the potential inflationary impact of Fed and government policies on U.S. consumers.

[1] Although the U.S. trade deficit worldwide (as opposed to the U.S./emerging market trade deficit) has declined since 2007 levels, it has increased as compared to 2009.

The emerging market economies benefitted from debt-fueled growth courtesy of the U.S. (and other developed world economies similarly situated). They are now attempting to address their own inflationary pressures resulting from rapid growth attributable to these trade imbalances. The competition for commodities from these emerging economies and the rise in wage scale may now export inflation back to the U.S. (although high unemployment and moderate income growth may offset this for some time).

Compounding the budget deficit / trade balance dynamic is the absence of rational and mutually supportive currency exchange policies. Because governments have competing interests, each manage their exchange policies to further their own near-term economic, social and political goals. Where an emerging market currency is managed so as not to appreciate versus the U.S. dollar, U.S. trade deficits will expand as the private sector seeks lower costs. Further, where the emerging market country does not reciprocate in trade with the U.S., the U.S. economy does not benefit from the GDP multiplier, i.e., the chain reaction of domestic commercial transactions that results from the funds generated from an initial transaction. Rather, the U.S. dollars now held by foreign governments purchase U.S. debt to complete the loop. If currency does not adjust to check the cycle, trade imbalances persist and growth is exported to other countries.

Ultimately, reciprocal cross border trade and free market currency exchange is required to maintain a stable worldwide financial system. This, however, does not appear to be a near-term prospect. For the U.S., the problems are compounded when trade inbound to U.S. corporations is captured by their foreign subsidiaries. Ultimately the U.S. must be in a position to export goods and services to reduce its trade deficit or must redirect its import trade to domestic sources which must be cost and quality competitive to earn the business. This may result in a step down in wages and a need for less regulation. A step back to move forward may be necessary.

PORTFOLIO CONSTRUCTION

Our client portfolios include investments designed to participate in the growth in the emerging markets as well as to manage some of the currency concerns discussed above. We are mindful that trade imbalances and budget deficits create instability in the financial system at the same time Federal Reserve policies have driven investors to increase exposure to risk assets. We recognize that black swan frequency may be on the rise.

Throughout this period we have sought balance and continue to focus on diversification by asset class, strategy, sector, and sovereignty. We are participating in the near term growth prospects for emerging economies with tactical managers that directly and indirectly invest, as well as long only domestic equity managers that indirectly invest by their investment in multinational U.S. corporations. We have addressed currency exposures by investing with managers that manage currency risk and exploit opportunities.

We continue to participate in the municipal bond market through diversified portfolios emphasizing high quality revenue bonds. These provide competitive returns while mitigating exposure to higher risk assets. The states, unlike the federal government, are balancing their budgets and are getting serious about spending reductions.

Most client long equity portfolios remain overweight the midcap sector which has again outpaced the large cap sector.

The equity markets have demonstrated their resilience in the first quarter of 2011, notwithstanding geopolitical events in the Middle East and the uncertainties surrounding the economic impact of the nuclear power plant event in Japan. The markets have similarly not been slowed by the developed world's debt and deficit conundrum. For the calendar quarter ending March 31, 2011, the Dow Jones Industrial Average increased 7.07% and the S&P 500, Russell 1000 and Wilshire 5000 indices generated gains of 5.92%, 6.24% and 6.18%, respectively. The Russell 2000 Small Cap Index and the S&P 400 Mid Cap Index increased 7.94% and 9.36%, respectively. The MSCI EAFE index gained 3.37%. Finally, the MSCI EM (emerging markets) index gained 2.05% reflecting losses in January and February in response to foreign government policies targeting inflation and moderating growth.

Finally, each KLS account is managed separately; please discuss your individual account performance with your KLS account manager.

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