

Fundamentals Matter

In search of confidence

During the second quarter of 2009 investors were searching for confidence. Confidence in a near-term time horizon for attaining a sustainable and growing economy. Confidence that such will translate into a growth trend for corporate earnings, and confidence that such earnings will not be materially burdened by legacy or impaired assets still reflected on the balance sheets of major financial institutions.

We too wish to have confidence. However, the fundamental underpinnings of a sustainable economic recovery are not yet in place. The rate of decline has moderated, but the headwinds of individual, corporate, and eventually governmental de-leveraging remain.

During the second quarter of 2009 the S&P 500 gained approximately 15.93% (3.16% ytd); the Dow Jones Industrial Average returned approximately 11.96% (-2.01% ytd). The Russell 1000 and Wilshire 5000 Indices gained approximately 16.5% (4.32% ytd) and 16.79% (4.45% ytd), respectively. The Russell 2000 Small Cap Index and the S&P 400 Mid Cap Index gained approximately 20.69% (2.64% ytd) and 18.75% (8.47% ytd), respectively. Though uncertainty remains, the equity markets embraced the possibility of sustainable recovery as financial institutions earned profits on yield spreads made possible by the artificially low cost of capital sponsored by the Federal Reserve and the Treasury. The market also finally confronted the actuality of bankruptcies in the automotive industry and put this news behind it. Although absolute unemployment rates have increased, the rate of increase has declined. Finally, several of the larger banking institutions have passed their stress tests, raised substantial amounts of private capital and repaid TARP funds. The equity markets reflected these developments as a strong positive.

On the last day of the quarter the equity markets declined reflecting newly released data with regard to declining consumer confidence. Throughout the quarter, foreclosures on residential real estate continued and increased after a voluntary moratorium by some banks on foreclosures ended. Finally, although there have been some pockets of improvement, home prices have remained under pressure and declined during the quarter.

Looking forward

Concern over asset valuations reflected on the balance sheets of financial institutions remains. Real estate, real estate loans, and related real estate securities are still under pressure. The P-PIP Program has not yet been launched and there have not yet been sales of troubled assets by the banks to these government-sponsored partnerships. We continue to have reservations about the viability of this program and whether asset sales will generate a new round of losses for the banks.

As consumer de-leveraging continues, the ability of consumer spending to drive the economy is limited. Further, uncertainties surrounding the unintended (if not wholly unforeseeable) consequences of an unprecedented global government stimulus program present a separate set of substantial risks that are difficult to quantify. Given the economic overhang of these issues and the rich valuation of the equity markets at approximately 21x 2009 “top-down” operating earnings for the S&P 500, we believe good judgment favors protecting the downside and we remain underweight in our clients’ equity allocation.

Regulatory environment

Complicating the outlook for corporate earnings and economic recovery is the uncertainty surrounding changes to the regulatory environment. Will increased regulation stifle growth and innovation? Will Congress simply regulate against past abuses and fail to enact a framework that will contemplate and effectively address future systemic threats?

The framework proposed by the Administration creates an overarching regulator of systemic risk. It also seeks to regulate risks fueled by compensation excesses and short-term compensation arrangements. And finally, it seeks to provide certain consumer protections.

Banks have special status in that they are able to raise low-cost capital due to FDIC guarantees. The Federal Reserve and the FDIC have resolution authority with respect to these entities and may address problems when they arise. They may also set capital standards to best protect against future problems. We believe that there should be a significant increase in bank capital requirements. Most importantly, any new system of regulations should be grounded in economic consequence. For example, excluding unrealized gains in credit-default swap and certain derivative agreements when assessing adequacy of bank capital would immediately crystallize the issue. Where these contracts are entered into as a hedging strategy purportedly to protect balance sheet assets, excluding these unrealized contract gains for bank capital requirement computations will cause the institution to better focus on the underlying assets and independently determine whether they wish to invest in them. It will discourage speculation by these institutions and it will reduce overall leverage in the system. We recognize that a consequence of this may be lesser profitability and access to risk capital for the U.S. based banks subject to the regulatory scheme.

The goal of improved regulation should be to curb systemic risks by eliminating speculative behavior by a subsidized industry, and reducing overall leverage that creates asset bubbles. A goal of regulation should not, in our view, be to reinvigorate the securitization marketplace but rather should focus on incentivizing alternative forms of collateralized lending including covered bonds (bonds issued by financial institutions, collateralized by specified assets and guaranteed by the full faith and credit of the institution and not merely its conduit or structured investment vehicle). The focus of the new regulatory framework should not be on generating liquidity for the commercial paper market and supporting money market funds through government programs but rather on prohibiting money market funds from investing in asset-backed commercial paper that does not have the full faith and credit guarantee of the issuer corporation. In short, the issuer must stand behind its structured products and debts sold into the public marketplace. The interests of the parties as to risk management must be fully synchronized. Absent this, regardless of regulation, there will be imbalances as to information and sophistication levels that will again put investors at risk.

With regard to regulation aimed at protecting consumers, we observe that regulation of pricing and contract terms for credit cards, loans, and health insurance may greatly impact the appropriate pricing of risk, potentially leading to future financial crises. Competition within a framework of regulated capital requirements best synchronizes the interest of consumers and business.

Conclusion

The fundamental and regulatory issues will not likely be resolved in the near-term. As always, we will continue to use our best judgment to navigate the risk/reward environment in managing the portfolios of our clients while giving consideration to their personal circumstances.

July 2, 2009