

Portfolio Insight

4th Quarter 2010

What could go right?

“Darkest before the dawn” may be a good description of the economic outlook and sentiment this past summer. Prior to the elections, the rhetoric about the outlook for the US economy in the near and long-terms was extreme, divisive and pessimistic. Politicians and voters focused on two major issues. Tea party adherents and fiscal conservatives denounced the government debt and deficits and forecast disaster if the status quo was not changed. Others criticized the weak economy and persistently high unemployment, worried about the negative implications for families in the short-term and societal risks longer term. Most citizens probably considered both issues when casting their votes. In the end, voters demanding fiscal discipline won. Perhaps the economic and social turmoil occurring in parts of Europe provided a wake up call. Americans understand that if the US does not get its fiscal house in order, we could face a similar future. Hopefully, the election results will convince Congress and the White House how important this issue is to the American people.

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But there still remains the second problem of a weak economy and the possibility of unemployment remaining high for a long time. The administration’s previous attempt at economic stimulus has been criticized as mostly a large transfer to states to help them stave off their own fiscal problems, plus a myriad of make-work projects of questionable economic value. The November election message appears to virtually eliminate any further major fiscal stimulus. Thus, the task of reinvigorating a tired economy sits squarely on the shoulders of the Federal Reserve. The Fed did a credible job of avoiding a complete financial and economic meltdown in late 2008, but, as we said in our last *Portfolio Insight*, the job of creating long-term, non-inflationary economic growth is considered outside the Fed’s role by most experts. Growth will come as a result of a combination of Fed policy, responsible

fiscal policy from Washington, and improved confidence among business and consumers.

To stimulate near-term growth and provide a long-term economic benefit, the federal government must take steps to make US business more globally competitive. Some attempts at regulation, so prominent in the first two years of the Obama White House, are likely to be scaled back or abandoned. Corporate tax cuts or tax reform may be enacted. Also, it would not be a surprise to see fiscal spending programs created which reward increases in innovation by US businesses. Such spending can be consistent with the need to control wasteful government spending, if our competitiveness improves. We must foster innovation to provide solutions to some of the problems we face, such as those in energy and health care; to create products which are in demand in the global marketplace; and to generate high paying domestic jobs.

Inflation Fears

Early in August, the Fed announced a possible second round of quantitative easing (QE) and then made it official in early November. This new effort to stimulate the economy with a continuation of extremely low short-term rates resulted in the recent strong rally in the stock market. Economists disagree whether QE will result in an unsustainably high GDP growth rate. If it does, Fed Chairman Ben Bernanke has on numerous occasions declared the Fed can and will quickly and easily reverse this stimulative policy.

However, inflation resulting from QE is a concern to many investors. Most economists are currently more concerned about *deflation* than inflation, and therefore, we are less concerned about any near-term inflationary impact of QE. In our opinion, if inflation rises to 3% from its current 1%, it would not be a cause for concern for either the economy or the stock market. Equities have historically done well during periods of modest inflation, in the range of 2-4% annually. However, there is no shortage of pundits, including commodity traders and gold bugs, who declare that much higher inflation is certain. A few even predict hyperinflation (a condition usually

defined as a rate of at least 50% per month). We think higher inflation is possible within a few years but not a certainty, and hyperinflation is highly improbable.

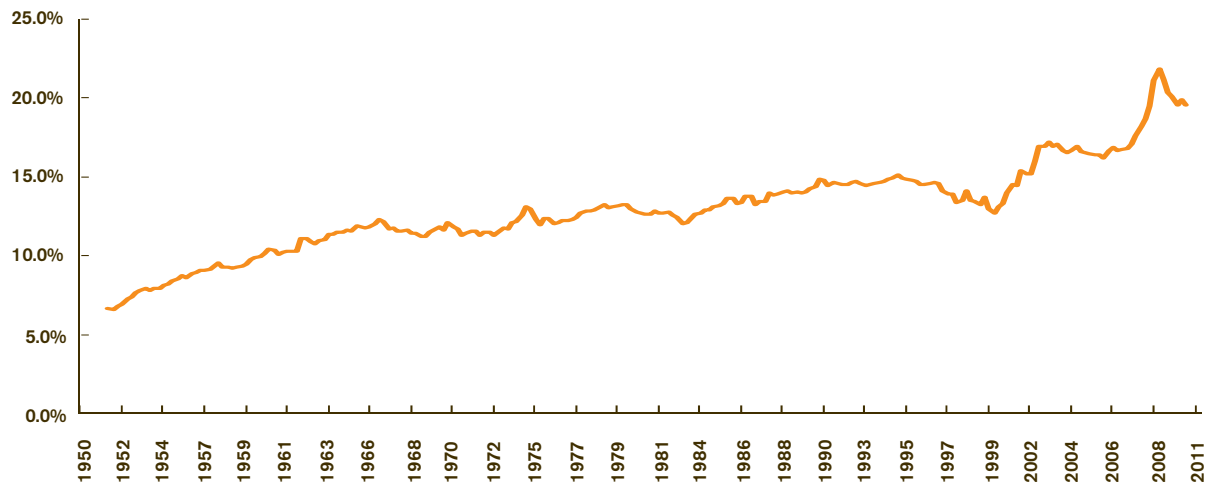
Inflation bears usually point to the Monetarist theory of money supply growth to support their predictions of higher inflation. This thesis postulates that inflation results if the Federal Reserve “prints” money at a faster rate than productive capacity can absorb it. The period from the late 1960’s to the early 1980’s is most often cited as an example. This period of expansionary macro-policy was one of new social programs initiated by President Johnson and included high defense spending for the Vietnam War. These were partially financed by the Fed buying Treasury bonds, thus printing money. During the period, the M-1 money supply grew at 6.5% per year and CPI inflation rose an average of 7.1% per year, with a peak of 13.3% in 1979. This new money found its way through the economy at the same time societal changes also increased the demand for money and credit.

We understand the theory of inflation upon which most high inflation predictions are based, and we know there are numerous microeconomic differences between the 1970’s and now which bring such analogies into question.

many. Schools, roads, office buildings, housing and many other forms of infrastructure needed to be built, all of it using credit, which grew the money supply. Women entered the work force in increasing numbers, creating income growth but also a demand for equal access to credit. With regulations through 1980 restricting the rate that savers could earn on deposits, banks and savings and loans had plenty of reason to lend money at rates well above what they had to pay depositors. All of these credit demand factors, plus supply-side shocks and expansionary macro-policy, resulted in high inflation.

Contrast the aforementioned microeconomic conditions to those of today. Baby Boomers, still the largest demographic cohort in the US, are now entering lower spending years and have little need or desire to increase their already large outstanding credit. In fact, many are reducing debt at a rapid clip and saving more. The current excess levels of housing stock and related mortgage debt will be a drag on the economy for some time, keeping unemployment high. And there is still considerable excess productive capacity in manufacturing and the service economy. These are the very conditions that lead to the worries of deflation—not inflation. When and as banks begin lending more freely, they will be more tightly regulated than in

U.S. HOUSEHOLD DEBT AS % OF TOTAL ASSETS



Source: St. Louis Fed

As the chart above shows, prior to the 1960’s, the Greatest Generation made little use of credit. These children of the Depression came of age in World War II, unconditioned and reluctant to spend what they did not have. This changed as they had families and especially when their children, the Baby Boomers, began entering young adulthood. The Boomers started a spending spree which would last for some forty years. Unlike their parents, the Boomers use of credit grew from miniscule to very high levels over the years. Boomers bought homes, cars and countless other goods and services, much of which required credit—and provided jobs for

recent years and necessarily more selective about to whom they lend. Today, banks have plenty of funds to lend but are reluctant to do so, and credit-worthy potential borrowers are reluctant to borrow. This is another difference from the 70’s and also argues against strong inflationary pressures.

States and local governments will be hard-pressed to borrow as much as they have in past years. It is a certainty that cities, counties, and state governments face tough times in the immediate future. We already see several governors taking on the tough task of reining in spending to match

a reduced tax base. This austere approach is definitely not inflationary. Additionally, if the Federal government begins cutting back on spending as it appears may happen, slowing the rate of growth of outstanding Treasury debt, high inflation in the next few years seems very unlikely.

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Signposts for Progress

As we proceed through 2011, we will be looking to see what Congress and the White House do on fiscal policy. The agenda pursued by the new Congress will likely be far different than that of the last one. We believe President Obama is now heavily influenced by the self-described “shellacking” his party suffered in the elections. Like President Clinton in 1994, President Obama will likely move to the political center. The recent Bush tax cut compromise may be an early indication of this. In addition, a proposed pork-laden omnibus bill was defeated last month by fiscal hawks on both sides of the aisle in Congress, a hopeful signal that perhaps Congress understands the gravity of the situation and the concerns of the electorate. This was particularly notable because it was done by the last Congress--not the new, even more fiscally conservative one. However, the new Congress must act on at least some of the Deficit Commission’s recent recommendations in order to provide a longer term solution to deficit and debt problems of the US.

Opportunity: Equity Markets

In 2010, the US economy was challenging, but we are pleased to report that Chilton Capital Management portfolios had a good year. Our approach to the market is now less aggressive than it has been since the market bottom in March 2009. We have gradually reduced our holdings in emerging companies toward an overweight in more conservative established growth companies. We believe there is still plenty of long-term opportunity in equities. As we discussed in last quarter’s report, the valuation of equities relative to other asset classes is very attractive though less so after the year-end rally. As is evident from mutual fund flows over the past two years, both institutional and individual investors were unwilling to accept the risk of being overweight equities so soon after the recent bear market losses. But there are now signs of change. Yesterday’s cautious investors are switching to the higher expected returns of stocks vis-a-vis other investment opportunities.

If our elected officials at all levels of government adhere to fiscal discipline, we believe the economy can grow at a moderate pace, inflation will remain subdued, and the dollar will be stronger. The “lost decade” for equities from 2000 to 2009 soured legions of investors on equities. This is understandable as the S&P 500 provided a negative total return during that time. However, if the market merely remains flat from now through late 2012, the trailing ten year market return at that time will be approximately 6 % per year. That will likely cause market skeptics once again to believe that patient investors can make money in the stock market.