

Portfolio Insight

1st Quarter 2010

Economic statistics from the US for 1Q 2010 were generally favorable for the equity and credit markets. Domestic growth continued, with inflation remaining at low levels. There is a divergence of opinion as to the outlook for the balance of the year. Some economists forecast a slowdown in economic activity while others concur with much of corporate management in expecting continued, moderate growth. Our view is that either of the camps may be proven right. Barring any major dislocations like the 2008-2009 housing/banking debacles, we expect US equities to perform well. However, additional gains are likely to be modest and periodic corrections will occur.

Major banks around the world are in the process of absorbing the losses of the past two years. Most are now fairly capitalized and able to expand lending when and where credit is needed, if they can be reasonably assured of being repaid. Households in the US continue to show signs of improvement with modest increases in consumption and gradually strengthening

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balance sheets. Unemployment is still high, but economists are no longer calling for increased job losses. It is now a matter of how long it will be until the economy starts to grow jobs. That may be soon. Most businesses are well funded, have strong cash flows, and are in a good position to add employees as business picks up.

In contrast to the apparent health of the private sector, we remain worried about the public sector, specifically federal, state and local government debt levels both in the US and in other developed countries. Around the globe, governments have proven that they, too, can be irresponsible spenders. Generous social programs, growth of government services, war, recession, and resultant economic stimulus are just a few of the culprits. In the US, both political parties own the problem.

For example, medical expenses are likely to expand enormously in the future as result of the medical entitlements enacted by Republicans in 2003 and Democrats this past month.

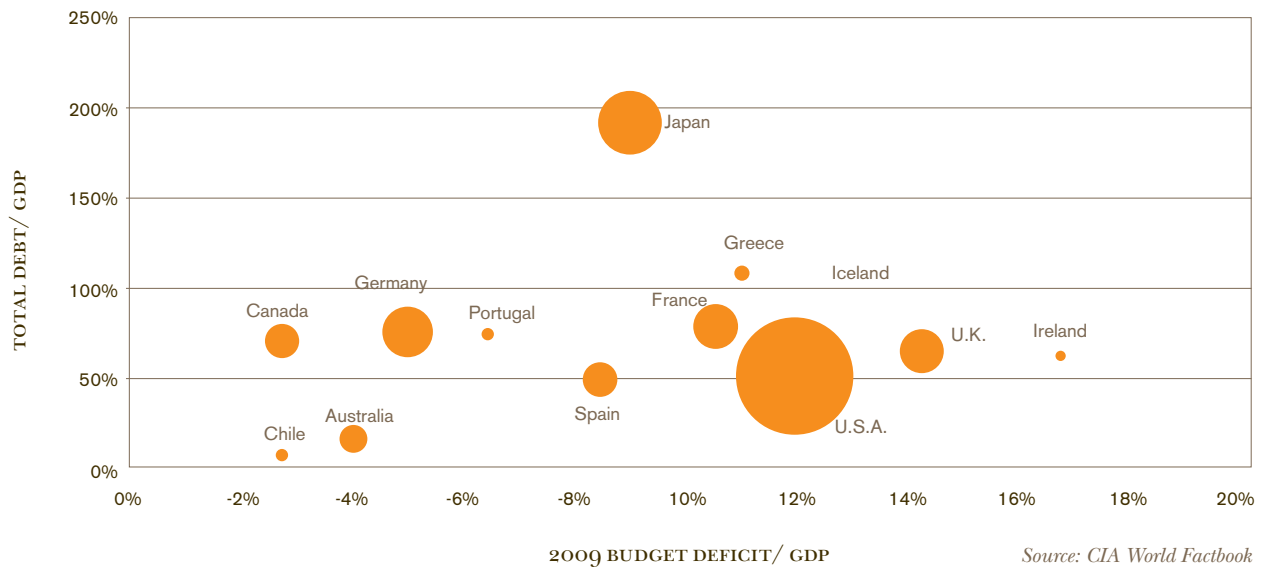
Whatever the specific reasons for public sector debt levels, the problems are real, troubling, and likely to worsen unless changes are made. On the graph at the top of the following page, the *Total Debt to GDP* ratio measures a country's current indebtedness vs. the national resources it can tap for debt service. The 2009 *Budget Deficit to GDP* ratio measures how big the annual addition to the country's debt load really is.

Global capital markets have paid increasing attention to the outliers on this graph. In 2008, Iceland's largest banks collapsed under the weight of bad debts, dragging down foreign depositors. The British government and other countries promptly engineered a rescue in exchange for Icelandic austerity measures. More recently, Greece appears to be the current battleground, after reckless spending on pensions for state workers cut the Greek government off from traditional borrowing channels. Financial markets await a decision from the German government whether it will bail out its weak cousin for the sake of preserving the EU. It remains to be seen whether the Germans will be able to impose austerity measures on the Greek government and whether the Greeks will adhere to such conditions after they receive their bailout.

Numerous articles are debating whether the other "PIGS," (Portugal, Ireland, and Spain) will follow the Greek government into a debt crisis. Japan's fiscal situation is close to terminal due to its massive accumulated debt and aging demographic trends.

Here at home capital markets seemed to be slowly rendering their assessment on the massive issuance of short term US government debt over the past year, as the Federal Reserve absorbed the debts of Fannie Mae, Freddie Mac and Lehman. Bloomberg recently reported that 2-year notes

SOVEREIGN DEBT RISK
(BUBBLE INDICATES RELATIVE SIZE OF GDP)



from Berkshire Hathaway, Procter & Gamble and other ultra-blue chip companies were trading with slightly lower interest rates than US Treasury obligations of like maturities. It has been extremely rare in the modern era for corporate debt to trade with lower interest rates than the corresponding sovereign debt.

Over the near-term, policy makers in developed countries are faced with the difficult task of keeping economies growing in order to avoid deflation. In doing so, however, they risk creating inflation. Given a choice between the two, policy makers will inevitably favor inflation over deflation, and equities in such a scenario will likely provide better returns than fixed income. Recent surveys indicate that over the past several months most individual investors have avoided common stocks in favor of bonds. This is not surprising given that it is normal behavior to avoid that which has most recently caused distress.

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Excessive debt levels raise economic risks. Non-financial corporations reduced debt over the past decade. Households and financial corporations embarked on the same process more recently, one that will continue for several more years. Governments now must do the same. It remains to be seen if democracies will vote to endure that pain. If governments are not able to accomplish a halt in the projected rise of debt to GDP over the next decade, the results could be dire: a deep recession, inflation, or worst case, bankruptcy.

In this environment, we believe caution is warranted for fixed income securities. We favor relatively short-term treasuries, medium quality corporate debt (1-4 year maturity), and selected Texas municipal bonds, with maturities of 5 years or less, (Texas appears healthier than most other states). We also prefer debt instruments with certain features, such as puts, conversion rights, or floating-rate coupons that can mitigate the risk of a future rise in interest rates.

The process of deleveraging results in a depressing effect on economic activity. This is one reason that we foresee a long period of below-trend growth throughout the world's developed economies. However, below-trend does not mean no growth. While Europe is likely to find internal growth challenging – its fiscal and monetary issues are unprecedented in recent history – and Japan continues its own long and (thus far) unsuccessful economic stimulus, the US appears to be in the early stages of a cyclical recovery.

On the equity side, previously articulated criteria are largely unchanged. Companies with low debt levels and/or innovative products that will not require a robust economy for their own growth represent core holdings across all of our clients' portfolios. We continue to believe that businesses that are innovators and market share takers are likely to offer the greatest opportunity for capital appreciation. We are also invested in businesses with exposure to certain commodities and demographic trends.