



*This is a summary white paper from our Conference Call: “After the Rally: What Happens Next?” on February 4, 2010.*

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### **A Look at Investing If/When Government Support Goes Away**

After a historic recession in 2008 and much of 2009, we see encouraging news of positive GDP growth two quarters running. The big questions now are whether this early economic recovery will hold, and whether the Fed will raise rates sooner rather than later. While these are fair questions, they are impossible to predict and misleading as a guide for investment decisions.

The better question in our view is what happens when the government stops pumping in all this money to stimulate the economy and credit markets? That is the key to understanding what happens next.

Our goal is not to predict the near-term outcome, or to pick the winners and losers. Anyone who does so with success is more lucky than good. Our goal is to understand how it affects opportunity and risk: specifically, how investor psychology reacts as it unfolds (which creates opportunity) and how much cushion our investment decisions have (which is risk management). In this way, we can improve the probabilities of longer term success in an uncertain world.

Before getting into details, here are our two broad messages for today:

- First, we are entering a new era. The past 15 years were propelled by cheap debt and plentiful cash, which exaggerated our level of consumption and economic growth; in this context, government intervention in the past year helped prop up this growth, but it has not corrected the pre-existing imbalances in debt and income, fueled by low interest rates. In fact, while avoiding Armageddon, this intervention has hastened our journey into this new era by raising federal debt and widening deficits. Despite the optimism in the credit markets today, credit is likely to be more expensive and less plentiful in the coming years. Government policy choices will be harder and face binding constraints. These events will create new and different opportunities and risks in equity and credit markets.
- Second, we are still likely to experience a roller coaster over the next few years. Remember the emotions of the past 24 months (extreme fear and growing hope); you are likely to experience this range of emotions again in the next 24 months.

For the remainder of this document, we'll narrow our focus to where government intervention has had some big impact, and what might happen as it goes away. We'll talk about how this affects our research process. We'll then review some of the key questions many of you have had.

## **THE TOPIC: “WHAT HAPPENS NEXT?”**

Over the past 18 months, the US government has spent an unprecedented \$2-3 trillion dollars (depending on how you count it) to stimulate the US economy, rescue banks, restore credit, and fund deficits. It's akin to taking medicine by the bathtubful rather than the spoonful. The Federal Reserve is now talking about its exit strategy. What happens when the support goes away? Are we ready?

As we said during the initial downturn, it is all about housing prices and credit markets, and that is still true today. These two areas will play a key role in determining the pace of recovery. So, let's focus on housing and credit markets.

## **HOUSING**

The Fed's program to purchase mortgage bonds to help consumers is expected to end on March 31<sup>st</sup>. All-in, the Fed will have purchased \$1.25 trillion of these bonds.

Current headlines imply success: Mortgage rates have remained low. Home prices have started to settle down (now only falling 5% annually, vs. 20% during the worst part). Foreclosure rates have slowed thanks to loan modification programs.

Yet signs are that the housing market is not in the clear yet.

When the Fed stops buying mortgage bonds in March, if it does, it is reasonable to expect rates to move upward—it's just a question of how much. Go to your mortgage broker and you'll find that rates on a 30 year fixed mortgage hover around 5%. Many economists believe an end to the purchase program will send rates up to 5.5%. If rates go to 6%, that would probably be negative for the average mortgage holder and something will have to give, particularly if unemployment and wages languish.

Adding pressure is the number of homes on the market for sale. There are roughly 3.5-3.7 million homes for sale now (record high was 4.6M in July 2008), about a 7 month supply at current sales rates (6 months is more normal; we saw 11 months at the peak). So the good news of a slower foreclosure trend could just be temporary when you consider that delinquencies on reset loans are rising again and banks have a backlog of unresolved

foreclosure cases. Specifically, we've seen estimates of 7.5 million homes are in the foreclosure backlog. Banks have incentive not to push them to foreclosure, because doing so would be a hit to earnings. This could end up being a delay to default rates. If foreclosures indeed rise (even if 20% of the backlog materializes as foreclosures) and the housing market can't absorb the new homes over the next 1-2 years, it means more homes are on the market. That puts downward pressure on home prices.

So, to close: there's no question that the housing market has improved from where it was a year ago. Home prices are down over 30% from peak and new housing starts are lower than they've ever been. Still, it is likely to be a choppy period in the coming years. Mortgage rates will hopefully creep up (rather than spike) and housing supply will hopefully linger (rather than balloon). If the spikes and balloons happen, then the consumer (and the economy) takes a bigger hit. Otherwise, we should be able to limp along at a decelerated growth rate until consumer debt levels gain equilibrium with income levels.

Two quick asides here:

- We wouldn't be surprised to see the Fed extend its purchases beyond March 31<sup>st</sup>, maybe even until the November elections.
- One client asked, when do we get to that equilibrium in housing debt and income? The short answer is that it will take probably years. Twenty-five years ago, debt to personal income was around 80%; it is now around 130%. That's about \$4 trillion that has to be paid back or worked out, or a third of GDP. Depending on how that is spread over a number of years, it could crimp GDP growth by 1% annually.

## **CREDIT MARKETS**

Credit markets have improved substantially since the darkest hours a year ago. Prices on both high quality corporate bonds and junk bonds were at historic lows at that time, and commercial paper markets were frozen. Now, the commercial paper market is off government support, and prices on corporate bonds have risen to pre-crisis levels, if not higher. About \$350 billion has gone into bond mutual funds over the past nine months. Consider that investors bought \$145 billion of junk bonds in 2009, among the highest levels ever. Risk acceptance is back in the credit markets!

This level of interest may be very hard to sustain, however. If the economy grows quickly, then the Fed raises rates and these bonds become less attractive. If the economy struggles, the risk on these bonds increases, their yields rise, and they become less attractive. In other words, either way, for bond investors, the current environment is about as good as it could be. So if the Fed stops intervening in the Treasury market, it probably adds incremental downward pressure to bond prices.

Moreover, the supply of Treasuries is likely to remain high in 2010 and beyond, as the Fed continues to need to fund deficits in excess of \$1 trillion annually (and as high as \$1.6 trillion in 2010). And Moody's indicates that about 1000 companies have about \$800

billion in junk bonds coming due over the next five years, with \$700 billion of that due between 2012 and 2014. There's a good chance credit markets will be more expensive at that time (higher rates, higher risk aversion, and sustained high supply, especially if Treasury is selling bonds at same time, called "crowding out"). This means that some companies could face balance sheet challenges once again in a few years.

What about bank lending, a key element of a functioning credit market? Despite all the government support for bank balance sheets, banks haven't been too willing to lend. This is not necessarily because banks don't want to lend (in fact, the yield curve would encourage them to). It's more that consumer risk profiles remain high.

On a final note, and perhaps most important, what about the status of our national debt? We are currently at about 50% of GDP (excluding entitlements), but projected to reach 77% under the new proposed budget, with current deficits of about -10% of GDP. We aren't the worst off among developed countries—Japan, Greece, Spain, Portugal, and Italy are. This year 2010 should give us some insight into how they manage their extremely tenuous positions—whether they can generate economic growth to manage their deficits, or whether they will be forced into draconian spending cuts. More on this in Q&A.

## **IMPLICATIONS FOR ECONOMIC GROWTH**

Legendary bond investor Bill Gross talks about a "new normal" where GDP growth is lower than that of recent memory, especially in developed countries with a lot of debt. Our discussion here about housing and credit markets would broadly concur with that view. If you want our opinion on the economy, it's that we would not be surprised to see GDP growth actually stronger than expected for the next few quarters (due to pent-up spending needs by companies, plenty of cash on balance sheets, and lag time in deploying capital and remaining stimulus) but that for the next two or three years growth is likely to be choppy.

But research has shown that economic forecasts and stock market performance are not linked. Things like unemployment levels are lagging indicators. We don't find it useful to invest according to these forecasts.

## **SO LET'S PAUSE FOR A CONCLUSION**

Has the market priced all this in? Short term, you do get imbalances in expectations. If we had to guess, we'd say the corporate bond market is priced for optimism, the Treasury bond market is still priced for fear, and stocks are somewhere in between.

Thanks to government involvement, things have either gotten better (credit) or succeeding in softening the pain (housing). Credit markets are humming now and are about as good as it gets. But we are entering a new era, where consumption will be lower

and debt will be more expensive and less plentiful. We as a country are just now beginning to figure out how to manage all this. As the government withdraws (good chance its later rather than sooner), we would expect a choppy few years as housing prices adjust to equilibrium and further deleveraging occurs.

## **IMPLICATIONS FOR INVESTMENT STRATEGY**

So what are we doing at CornerCap about all this? Our starting point, as you know, is that we set a long term allocation plan based on your specific risk tolerance and financial goals and we stick to it. It's impossible to predict the timing and duration of these complex events, and doing so leads to short term decisions, often driven by guessing and emotion, and are usually bad. At the same time, we seek to understand how future events present changing opportunities and risks for portfolios today.

As we have discussed for over a year, we think that safe havens like government debt are likely our third bubble (following the internet and housing). Prices reached historic highs (yields historic lows) in early 2009, offering investors no return unless deflation prevails. Yields have crept up again, and may continue once government intervention ends and further supply comes to market, or growing deficits further alarm US creditors.

On the inflation-deflation question, we think deflation will persist for a time but that the probability of inflation (or, at minimum, higher rates) increases in four or five years. Calling when that transition occurs is difficult, so we must plan for both scenarios to some extent. In fixed income, we therefore typically avoid Treasuries, preferring better yielding instruments like CDs and agency bonds, with nearer-term maturities. Among corporate bonds, we seek to spread risk across issuers and strive for maturities with short-to-medium term durations. For longer term bonds, where inflation poses a risk, we prefer inflation-protected Treasury bonds ("TIPS").

In domestic stocks, given the uncertain economic outlook, we continue to put special emphasis on new buys that have underperformed but have ample cushion—i.e., solid cash positions, good free cash flow, favorable margin trends, and manageable debt loads—in other words, stocks that have the cost structures to weather a choppy economy or that don't get hurt by more hostile credit markets in later years. We also seek stocks which add diversification to what helped us outperform in 2009.

Where appropriate, we have also sought exposure to broad international markets, with a mix of developed and developing countries, through exchange traded funds.

## ADDITIONAL PRE-SUBMITTED QUESTIONS

The most frequent questions you've had for us focus on the implications of massive government stimulus and intervention, followed by what are we doing about it in terms of investment strategy. We discussed these two questions above.

Another common set of questions focused on implications of high debt and deficits.

Specifically, how can investors stomach \$9 trillion in total deficits over the next ten years? Or, to rephrase: What is worst case scenario for US? How likely is it?

The current assumption underlying most developed countries like ours is that we can delay deficit reduction until economic growth resumes and tax revenue expands. Success will likely be achieved if GDP growth can stay around 4% annually, and you'd have to assume that's what the government is working to achieve. If growth is less than that for a sustained period, unemployment is likely to linger and deficits remain relatively large, and you start going down a harder path.

Currently our debt to GDP is forecast to be 75% (where 80% is often cited as the tipping point), excluding entitlements like Social Security and Medicare, with deficits totaling \$8-\$9 trillion over the next ten years. If economic growth languishes for years, it is fair to assume we won't be able to raise any more debt by selling to foreign countries, so the government would have to consider higher taxes and/or greater spending cuts. Japan, Greece, Spain and Italy are at this point right now (where debt is > 100% of GDP and deficits are at historic levels). The government could also print more money (as it has done in the past year) which would create a greater risk of hyperinflation and a weaker dollar. That would be a tough cycle to correct.

One benefit for the US that most other countries don't have is that the world doesn't need their paper like they need US Treasuries and the US Dollar. Countries like China are also dependent on the US economy's return to health, so there are mutual incentives to work out the economic growth equation. (See our fall 2009 newsletter "The Demise of the Dollar?" for detailed discussion).

Bottom line, it's too early to call. As an investor if you go to cash and are wrong, then you lose to inflation and your standard of living falls.

What are the implications of the proposed budget released this week? Particularly as it relates to taxes and portfolio management.

For a discussion about the budget details and how we manage taxable portfolios, feel free to give us a call. But broadly, the result is that our clients who are subject to the proposed tax provisions (those with joint incomes over \$250K) will be

paying 5% more in taxes beginning in 2011 on both ordinary income and capital gains.

But we have things we can do. Tax-efficient portfolio management becomes more valuable in a rising tax regime. For example, increasing the percentage of long-term to short-term gains will produce positive effects for investors. Also, asset location becomes even more important in maintaining a tax efficient portfolio. Tax deferred and tax free accounts are more attractive for taxable bonds and higher turnover equity strategies. We can also take advantage of better tax equivalent yields on muni bonds. This is just a quick sampling of items as part of a broader discussion.

Where is your research taking you? How has it performed during this tumultuous period?

Recall that our investment philosophy is to go where there is fear and doubt rather than where there's comfort. Starting in late 2007, when the first wave of recession started to take hold, we underperformed a bit as many of the stocks we bought were out of favor, like consumer and industrial stocks. Investors were often seeking safety in more defensive names like health care, staples and utilities, which were relatively less attractive to us. When the second leg of the downturn hit, we were hurt by the stocks we owned and not protected by the safe havens, but our discipline led to strong outperformance in 2009.

During the past 12 months, even as we outperformed, we began uncovering attractive health care, staples and utilities stocks that had overhangs to them. We are gradually adding them, both because they are attractive from a relative valuation perspective, and because they diversify away from our winners coming out of the recession.

We saw a similar pattern during the 2002 recession, where our stock selections underperformed the S&P 500 by a few percentage points, only to outperform meaningfully in the period following the recession

The volatility of each recession created good opportunity for long term stock pickers, and we were able to capitalize on this once the recovery started—we just didn't know when it would start.

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