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Thinking with Leaders

MARKET UPDATE

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Edge Capital Partners is an independent financial firm whose objective advice helps individuals and institutions realize their goals in the areas of investment management and corporate finance. The Edge Research Team's thoughtful and timely reports are based on extensive independent research and analysis of firms, financial developments, and macroeconomic trends.

Last month our Research Team traveled to London, New York, Boston, Dallas, Los Angeles, and San Francisco to visit current and prospective investment managers. These managers invest in fixed income, equities and real assets in both long-short and long-only strategies. During our meetings we discussed the outlook for these asset classes in light of the economy, public policy, and financial regulation.

The past three years arguably have been one of the most challenging environments in which to generate risk adjusted returns. A deep second half drawdown in 2008 was followed by a significant rally in 2009. This year, equity indices have been characterized by significant monthly gains and losses with high volatility; yet, many indices are largely unchanged since the beginning of the year. On the heels of the 5% drawdown in August, September has been quite the opposite with the S&P 500 returning nearly 9% during the month. The market has covered a lot of distance without much forward progress. Because of the uncertainty in both the economy and financial markets, we think it is timely to share with you crucial insights gleaned through the conversations with our global investment managers.

Economy & Public Policy

Over the past three years financial markets have been highly correlated, with assets moving up and down in unison depending largely upon changes in economic expectations. Investor decisions largely have been based on the health of the global economy and the impact of public policy at home and abroad, with less regard to company fundamentals. Unfortunately, the health and future direction of the US economy is uncertain and recent economic data has waffled between growth and no growth. We monitor the economy and investor expectations closely and therefore were eager to hear what the portfolio managers had to say about their expectations.

Relative to consensus, managers were generally bearish on the US economy in 2011; most expect GDP growth between 1.5% and 2.5%. Although their estimates indicate the probability of a low-growth environment, there was unanimous belief that the US economy will avoid a double-dip recession. One portfolio manager used the phrase "contained recession" to describe the stagnant nature of the US economy. Those familiar with our research know we are somewhat tepid on the US economy and expect real GDP growth of 1% to 2% in 2011. By comparison, the Federal Reserve recently lowered its expectations for GDP growth to 2.5% for 2011.

The managers unanimously believed that the US government will have to take an active role through monetary or fiscal policy action, either in late 2010 or early 2011, to keep the economy in a growth phase. Through recent actions by the Fed and the $800bn stimulus package announced in early 2009, the government has lifted the economy out of a recession and into stabilization. Recent economic data, however, calls into question the prospects for future growth. Managers believe the decline in GDP growth from 3.6% in the first quarter to 1.7% in the second quarter of 2010 reinforces the need for additional intervention. As the United States begins to wean itself from federal stimulus, it is logical to wonder if the legs of the economy, particularly the consumer, can support the burden. Many of the managers do not believe private demand is strong enough at this juncture. Although they believe the need for additional stimulus is justified, what is less certain is how it should be applied. The Federal Reserve has left interest rates low and has increased its balance sheet to over $2Tr (from less than $1Tr pre-crisis) through the purchase of various securities, mainly mortgages, in an attempt to continually provide liquidity and contain interest rates. At a recent conference we attended, the debate was whether the US needs another round of "shock and awe" stimulus or a gradual injection of "saline" to keep the economy moving until things improve. Most agreed, however, that markets are pricing in some stimulative action by the Federal Reserve. If investors begin to sense the Federal Reserve is procrastinating, they may decide to exit riskier, more economically sensitive, assets.

Many of the managers focused on domestic markets expressed concerns about the current state and direction of public policy. Much of the criticism centered on the administration's intense focus on non-stimulative actions such as healthcare reform and the lack of concentration on job generation and taxes. Interestingly, the discussion on taxes focused on the lack of clarity regarding the renewal of the Bush tax cuts and not on whether taxes should be raised or lowered. The investment managers reasoned that the lack of clarity on capital gains and dividend tax rates has made it difficult for companies to make investments, which in turn delays job creation. Instead of spending, companies have been hoarding cash and now sit on a record amount of cash relative to assets. The excess cash should be a catalyst for higher prices if companies repurchase shares, increase dividends, or make acquisitions. The problem is that corporate management believes the cash belongs to them and not the shareholders.

Regulation

The managers' discussion on whether the US needs more or less financial regulation is an extension of the debate on public policy. Our visits took place on the heels of the announcement of new bank requirements under Basel 3. (Basel is an international banking committee that formulates broad supervisory standards and guidelines for the banking industry.) Basel 3 increases the amount of reserves that banks must set aside as a percentage of capital; the new rules dictate that banks must set aside reserves equal to 7% of assets, up from 2% currently. The increase in reserves is expected to provide a cushion when times get tough, ensuring that banks have adequate capital to remain solvent. The new capital rules won't begin to phase in until 2013 and many of the details related to implementation and enforcement are still yet to be ironed out.

We also attended a conference with keynote speaker Jamie Dimon, CEO of JP Morgan. He said that the passage of Basel 3 was "good" and "removes a major overhang from the market." In his opinion, US banks will adjust to the new capital demands and move forward but he cautioned that European banks would have a much more difficult time implementing Basel 3. In Europe, roughly two-thirds of credit is derived from banks versus only one-third in the United States.

As a result of Basel 3 and the Frank-Dodd Financial Reform Bill, banks will be subject to tighter regulations in the future. According to Mr. Dimon, an indirect consequence of tighter bank regulation will be an increase in costs that will be passed on to all consumers. As an example, Mr. Dimon referenced a small passage in the Financial Reform Bill that allows the US government to implement a price control on fees that banks charge retailers that accept debit cards. He commented that banks will simply adjust pricing elsewhere to recoup those fees and the detriment is that ultimately everyone pays. He used an example to illustrate the point: if the government said that a restaurant can't charge for the food it serves, the restaurant would ultimately charge for the use of the table. He fears that regulators are underestimating the transfer of costs.

By and large, investment managers are supportive of the new regulation but believe it is not going to have the intended impact until the SEC increases its level of sophistication. Jim Simons, who founded Renaissance Technologies in 1978, told a story of an SEC regulator that examined his fund's books in 1993 and didn't know what it meant to short a stock position. He asked, "how in the world is an SEC regulator going to understand my business?" The 27 PhDs on Jim's staff have developed extremely complex quantitative models that scan the globe for investment opportunities. He did admit that the SEC was making an effort to hire auditors that have prior hedge fund experience but added they would be playing catch-up for a long time.

Asset Classes

Ask an equity manager about 2010 and you are likely to hear that it has been a challenging year. The difficulty in managing assets and selecting stocks has increased due to the market's high correlation and the role of the macro environment in influencing equity returns, two conditions that have persisted longer than expected. Portfolio managers must not only concern themselves with stock fundamentals, but also focus on a sluggish US economy, the outlook for inflation or deflation, and whether Europe's peripheral countries can maintain solvency. Most everyone that we spoke with agreed that inflation is an inevitable outcome of the Fed's current monetary policy; however, the timing and magnitude of its presence over the next three to five years is unknown. The right amount of inflation serves as a catalyst for higher stock prices. If inflation, however, moves significantly higher, or worse, moves lower (deflation), then equity prices will fall – illustrating the delicate balance between inflation and stock performance.

Most managers are reluctant to handicap equity returns for 2010 but believe investors should lower their return expectations to mid to high single digits for the next several years. Many managers recommended high quality, dividend paying stocks. This consensus advice resonates with our Research Team which has been advocating high quality, dividend equities since 2008. The ability to add 3 to 4% in incremental return to an equity portfolio makes a lot of sense when investors are facing a low return environment. As one fund manager stated, "cheap equity is a great asset class." A robust M&A environment was also cited as being a catalyst for higher stock prices should the economy remain on steady footing.

Most of the managers we spoke with continue to be long-term bullish on the US stock market. They believe, however, there are enough headwinds in the near term to make it difficult to present a compelling argument for a sustainable rise in equity prices. The most commonly cited impediment to higher stock prices is debt, both on the government and consumer's balance sheet. Total debt as a percentage of GDP is currently above 300%, a level unseen since the 1930's. As one manager said, the United States has been levering its economy for 30 years and the bill is now due. Much of the economic growth experienced over that timeframe was driven by the expansion of consumer credit. (Consumption represents roughly 70% of GDP growth.) It is difficult to make the case that consumers are capable of driving the economy in the near term given current unemployment levels, levered consumer balance sheets, and weak home prices.

Because the US has been in a low-growth phase with no signs of inflation, many of the fund managers have been bullish on fixed-income securities. Confidence in these investments has been bolstered by the belief that the Fed will leave interest rates unchanged for an extended period. Their optimism is waning, however, as yields for many fixed-income securities have compressed significantly. One only has to look at the current yield on the 10 year Treasury to realize that it hasn't been at these levels since the March 2009 lows, and prior to that the Great Depression. A few managers who were long US Treasuries are now considering reversing the trade due to the likelihood that rates will move higher from current levels. For investors that require exposure to fixed income, many fund managers have been willing to purchase longer dated maturities for higher yields. This trade has worked in 2010 but we know that the level of interest rates can change quickly and long-duration investors could find themselves with too much interest rate exposure when rates increase.

Conclusion

Our recent conversations and visits with the global community of investment leaders have enabled us to compare and contrast our views on financial markets. Much of what we heard confirmed our recent research. The US economy is on a slippery slope and it appears that future growth will not be as strong as anticipated only six months ago. Unfortunately, the government is still confronted with the task of keeping the economy in growth mode until private demand rebounds, even at the risk of larger deficits. We believe markets are reflecting this new reality and we contend that risks are equally balanced to the upside and downside. Short of a great innovative breakthrough that will spark growth, the solution to fixing the economy is a long de-levering process. This path, however, doesn't preclude financial assets from generating positive returns. Corporate balance sheets are strong, companies are lean, and equity valuations are very attractive. Congress can certainly stoke the fire by resolving the current tax impasse. Over the past three years market volatility has been hard to stomach and returns have been even harder to generate. Our conversations with the investment managers has reinforced our conviction that a globally focused firm that is flexible and active in its approach will be in the best position to help individual and institutional investors realize their goals.

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