SLOCUM, GORDON & CO. LLP
INVESTMENT MANAGEMENT AND COUNSEL

VIEWPOINTS

JULY 1, 2013 • NEWPORT, RI

This Economic Commentary is designed to present the Firm's current views on timely topics that we feel may be of interest to our clients. Viewpoints is also available electronically on our website: slocumgordon.com.

JOHN J. SLOCUM JR.

JEFFREY L. GORDON

BARCLAY DOUGLAS, JR.

KENNETH M. P. LINDH

We are frequently asked these days where we are at this moment on the economic timeline since the Great Recession began in 2008? So much has occurred that it is difficult to say because most of the current economic picture has never been experienced before. Clearly, the Fed dominates the landscape and has created an environment that is increasingly dependent on its actions. The Fed's dogged determination to stimulate the economy by injecting enormous amounts of liquidity into the system is a bit reminiscent of Churchill's famous comment after he had bought a farm, and new to the world of farming, he prophetically declared to Dame Margaret Lloyd George that "he was going to make this farm pay no matter what it costs."

The Fed, as the only game in town, has the same stubborn determination and has supported the economy without any help from fiscal policy by buying Treasury securities in such volume that it has effectively kept short term interest rates at zero for about 5 years now. Totally unprecedented, but now other central banks around the world are following suit. Have there been positive results yet? Certainly the one asset that has inflated because of the Fed largess has been the stock market, and only grudgingly is there evidence elsewhere in the wider economy.

The Fed's objective for the increase in stock prices is to improve consumer sentiment and encourage more capital investment on the part of corporations hoarding vast amounts of cash in reserve on their balance sheets. Though there is small evidence that this is beginning to occur, we are a long ways off from a conventional post war recovery. High global unemployment is chronic and will probably remain high for some time to come. Companies remain fearful about the future: taxes, healthcare costs, regulations, and general business conditions that there is a real reluctance to hire and invest at this point in time.

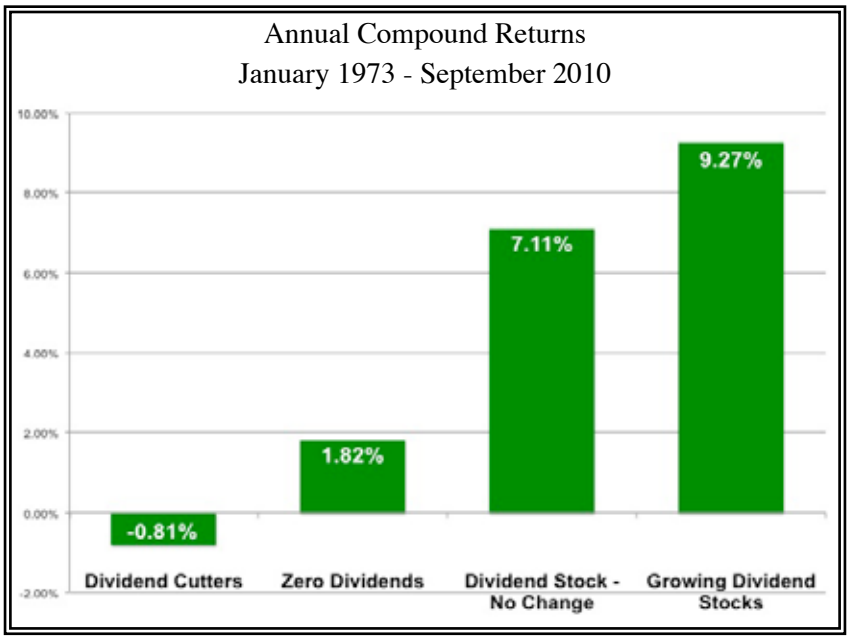
As we have pointed out for some time, the larger issue the Fed and other central banks are concerned about is deflation along the lines that Japan has experienced for nearly two decades. The commodity boom during the early part of the new millennium was basically the consequence of the enormous appetite in China and other emerging countries for all things related to their huge growth spurt as cheap exporters to consumers worldwide.

Events have since conspired to suggest that this insatiable demand for commodities from these emerging countries is slowing, which should continue to put downward pressure on natural resources and other industries dependent on China's previously aggressive growth rate. China is feeling the pinch from dampened consumer spending in the US and Europe, and it may take some years to absorb the huge new capacity that China and other emerging countries

built to accommodate what had appeared to be endless demand. This overbuilt manufacturing capacity adds to the tendency towards deflation globally.

However, there is a bright spot, and it is the US. Keeping in mind that the US is essentially a commodity user rather than exporter, lower commodity input costs in US manufacturing should translate into lower costs for consumers here at home. Coupled with another theme that we have suggested for some time, energy independence and therefore lower energy prices, these lower costs translate into the equivalent of a tax cut for US consumers. Furthermore, with a burgeoning new cohort of consumers, the baby boom of the baby boomers' children, increased household formation will be an important economic engine for this country for some number of years to come.

Without the benefit of clarity of foresight, we are hedging our bets by taking a barbell approach to our equity portfolios with defensive stocks on one side and more cyclical, economically sensitive stocks on the other, while maintaining a focus on dividend paying securities.



As to dividends, regardless of where we are in the economic cycle (growth or value, defensive or cyclical) we have been consistent believers that dividends matter. The accompanying chart illustrates that over the last 40 years companies that not only pay but increase their dividends have clearly outperformed companies that paid no dividends and relied only on growth to attract investors. We would rather our clients be paid to wait for the potential of higher stock prices with a good income flow.

It should be no surprise to hear that even experts have been confused by the unfolding economic events lately. There is simply no blueprint for what we all have recently experienced in the global economy. We have managed to steer around most of the shoals for our clients' capital over the last few years, and we will stay the course and keep one eye on return and the other eye on risk. Everyone sleeps better that way.