Slocum, Gordon & Co. LLP
Investment Management and Counsel

Viewpoints

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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.

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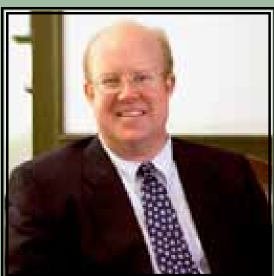
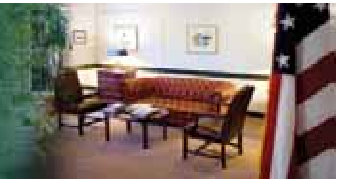


Kenneth M. P. Lindh

To say that the world has changed since the onset of the financial crisis in 2008 would be an understatement of some magnitude. In fact, our view is that it really changed after the collapse of the dot-com bubble and the events of 9/11 at the start of the new millennium, and investors have good reason to feel exhausted by the tremendous market volatility that has occurred over these last dozen years or so.

The recent environment for long term investment portfolios has been difficult indeed. There is some logic to staying the course by remaining invested in the traditional assets within our particular universe of securities, and furthermore, no one can time the markets. For example, in 2009 the S&P was up 23.45%. However, 69% of that gain was in ten trading days from March 9th to March 23rd. If an investor missed those ten days sitting in cash, the return for the year would have been a mere 7.25%.

For the most part, our stock universe has been large capitalization, multi-national, US companies that have a long history of paying <u>and</u> increasing dividends. If there is an undervalued area in the market, these large, household name companies may be it. In fact,



these stocks have generally underperformed the wider market for decades, and their more seasoned, conservative profile may bring them back into focus for investors who are starved for income and just want to preserve capital.

The economy right now is just ok, not good, but not cratering either. Our current estimate for growth is 2-2.5% over the next four quarters with earnings growing about 5% along with rising dividends as well. Over the last 50 years, the S&P multiple has averaged about 15 times earnings, and the ten year US government bond rate has averaged about 6.5% Right now, the market multiple is a little over 12 times, but the 10 year Treasury is 1.6% with short rates virtually at zero. The S&P 500 dividend yield has now overtaken the 10 year Treasury yield, a condition that has not existed for over 50 years.

This clearly reflects a flight to quality and safety, so to speak. Over the last five years, the public has been a significant liquidator of equities and a significant buyer of bonds. To our way of looking at it, this is where the risk lies right now, not in equities. The math goes like this. Historically, the 10 year US government bond in normal times (which we will get to over the next 2-3 years) has yielded in line with nominal GDP. So, looking ahead, if real growth is

2-3% and inflation is, say, 2-3%, that means that nominal GDP over the next two or three years would be growing 4-6%. This should push yields on the 10 year government bond to 4 or 5 or 6%, and that will create a significant capital loss on those bonds that were bought today at these historically low interest rates simply as part of the fear trade.

As investors, we have to make certain assumptions in an incredibly difficulty geo-political environment. These would include that the US does not go into another recession, that China has a soft landing where their growth decelerates to 7, maybe 8%, and ultimately the ECB with the IMF, along with Germany and France and the US and China and Japan, they will deal with the problems in Europe. Greece may well exit the Euro, but with a strong ring fence around it to protect the system. Equities in general appear cheap compared to bonds, and with high dividend rates, an investor is paid to wait. It is difficult to imagine a more negative sentiment toward equities, and as a contrarian, that has traditionally been a good time to invest. So those are our fundamental judgments, and if they are wrong, then we all have to rewrite our scripts.

There is no shortage of risk out there, but the main one that we have been talking about for some years now is deflation. So far, the US has avoided it and disinflation has been the main driver.

A global slowdown, however, would risk tipping into deflationary territory, and that would not be a good thing. Bernanke knows that, and further quantitative easing...printing money...could clearly be another bludgeon in the Fed's tool box. As they say, historically central banks write the market script for Wall Street, and with expectations so low right now, it seems to us that when the Fed chairman says he wants more growth and inflation, we should be paying attention.

There will be years when our style will not be in sync with the risk appetite of the market, but to us, it boils down to making money when everyone else is, but not losing as much when everyone else is, and that has everything to do with mitigating risk wherever possible. Risk and return are inextricably linked, but the best of all worlds is to maximize the return with the minimum of risk. That remains our central goal, but as we have said many times since the 2008 financial turmoil, it will take time and patience for investors to see returns commensurate with historical experience.

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