



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

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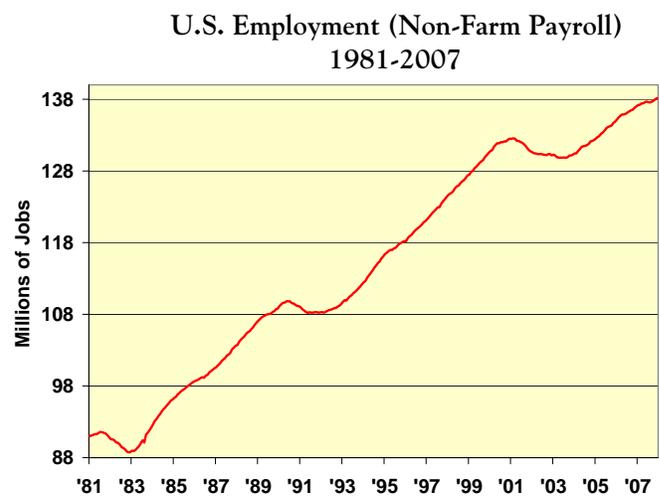
Seeing Through a Glass, Darkly

What an extraordinary episode in the economic progress of man that age was which came to an end in August 1914! The greater part of the population, it is true, worked hard and lived at a low standard of comfort, yet were to all appearances, reasonably contented with this lot. But escape was possible, for any man of capacity or character at all exceeding the average, into the middle and upper classes, for whom life offered, at a low cost and with the least trouble, conveniences, comforts and amenities beyond the compass of the richest and most powerful monarchs of other ages... But, most important of all, he regarded this state of affairs as normal, certain, and permanent, except in the direction of further improvement.

J.M. Keynes, *The Economic Consequences of the Peace*, 1919

During this season of Passover and Easter, it does not seem inappropriate to use St. Paul's famous phrase from 1st Corinthians, "For now, we see through a glass, darkly" as the title for this investment commentary. Rarely has the state of economic affairs seemed more confused and muddled with seemingly contradictory events occurring daily. Reports about nationalization of the banks, failing industries, and protectionism invoke the fear of another Depression. To prevent economic collapse, governments have been forced to provide huge levels of fiscal and monetary stimulus, to inject capital in the banks to stabilize the global financial system, and to prop up key private firms. Are we living through the end of an age, as Keynes wrote about in his famous work following the Peace Treaty of Versailles at the end of World War I? The aim of this quarterly outlook is to help investors think through what is before us in the near and medium term and to provide some historical context for our challenges.

In this country, there is a sense that the events of last year have transformed everything. You hear the expression constantly: the world has changed. Many observers now see the past 27 years as a golden era of economic growth and prosperity, which may never return. In fact, the period between 1981 and 2007 in the U.S. was characterized by robust, sustained economic growth and a remarkable increase in the standard of living in the U.S. and globally. The charts below tell this story of strong GDP growth during this 27-year period and the concomitant growth in the number of jobs in this country:



Source: StockVal

Source: StockVal

The Age of Prosperity

During this 27-year period, U.S. GDP grew almost fivefold to more than \$14 trillion. Nominal GDP grew at an average annual rate of 6% (3% real growth). During the same period, the U.S. economy produced almost 47 million new jobs – an increase of more than 50%. And this only includes the number of jobs that were reported, as immigrants flocked to the U.S. to participate in this job bonanza. Job growth in France, Germany and Italy during this period was less than half of that in the U.S. Investors in the U.S. stock market prospered mightily too, as the Dow Jones Industrial Average increased more than fifteen-fold (not including dividends), reflecting the strong corporate earnings growth.

During the early stages of this period, the economic growth and prosperity were the result of the political and economic steps taken in the U.S. (and later copied abroad). Taking office after more than a decade of stagflation, President Reagan sought to execute his political philosophy which embraced smaller government, less regulation, lower taxes, and a strong defense. One of his first priorities was to break the back of inflation (running at over 10% when he took office). With Reagan's encouragement, Fed Chairman Paul Volcker strangled the money supply, causing short-term interest rates to rise to nearly 20%. This induced a painful recession in 1981-1982 during which unemployment reached 10.8%. By 1983, inflation had dropped below 4%. President Reagan was a strong proponent of supply-side economics which holds that broad economic prosperity is best achieved by growing the economic pie through incentives such as lower marginal taxation, thereby encouraging more investment, jobs and production. Accordingly, Reagan dramatically lowered the top marginal income tax rates from 70% to 28%. Many industries were deregulated – including the U.S. oil and gas industry, which helped to banish the lines of cars waiting to fill up at U.S. gas stations. During the same period, Margaret Thatcher was executing much of the same political philosophy in the U.K., and these reforms were later imitated by many countries in Europe (including the newly liberated Eastern European countries) and Asia. The results were generally so positive that the opposition political parties in Europe and the U.S. maintained most of these policies long after Reagan and Thatcher had departed the scene.

Too Much of a Good Thing

As the economic good times snowballed, Americans began to change their behavior. With their securities portfolios growing nicely, consumers saved less and less. The personal savings rate in the U.S. dropped from 10% in the early 1980s to less than 2% in 1999. The housing boom got into full swing in the following decade, and by 2005, U.S. consumers abandoned saving altogether. With housing prices continuing their inexorable rise, homeowners started to use their homes as a piggy bank, drawing down their home equity lines of credit at a rapid rate. Credit card loans skyrocketed. Not to be outdone, the U.S. government brought pressure to bear on Fannie Mae and Freddie Mac to buy sub-prime and Alt-A loans, which, in most cases, were home mortgages made to borrowers without the financial wherewithal to put 20% down on a home or the income to service the loan. This orgy of debt enabled U.S. consumers to live beyond their means for most of the past decade. U.S. consumers were the global engine of growth, importing ever larger amounts of goods from abroad. This caused an enormous U.S. trade imbalance with countries such as China, Japan and Brazil who amassed huge foreign exchange reserves (mostly U.S. Treasury securities). Another key piece in the puzzle leading to last year's financial collapse was the excessive leverage of the banking and financial community, much of which was not transparent due to the use of derivative and off-balance sheet instruments.

The New Economic Order

In certain ways, the world has changed – at least for the foreseeable future. The changes are both a reaction to the excesses of the previous decade as well as the political agenda of President Obama and the Democratic Congressional majority. The following table contrasts the different political philosophies and possible economic consequences of the New Order with those of the previous several decades:

Old Order (1981-2007)

The era of big government is over
 Prosperity comes from growing the pie
 Lower taxes cause greater growth
 Less regulation causes greater output

 No need to save in a prosperous world
 Banks take increasingly risky bets
 Energy costs low
 Maintain private health care system

 Strong economic growth
 Higher job growth
 Higher return on equity and P/E ratios

New Order (2009-?)

Government is the solution to the mess
 The pie must be divided more fairly
 Higher taxes on the wealthy are appropriate
 More regulation will curb excesses

 Savings are vital for the economy
 Banks return to basic lending
 Energy costs (carbon tax) increasing
 Universal health care system needed

 Slower economic growth
 Lower job growth
 Lower return on equity and P/E ratios

What Does It Mean for Investors?

While it is unclear how the above trends will play out over the next decade, there are other factors which will determine when the economy will recover and the trajectory of the stock market in the immediate future. One of the key questions is whether the current deflationary cycle will be halted or not. The shock of 2008's global financial collapse caused consumers to stop spending and businesses to halt investing, resulting in a dramatic collapse in demand. Governments here and abroad have stepped in to boost demand. For example, the U.S. budget deficit for the year ending September, 2009 is projected at \$1.75 trillion – 12.3% of GDP. This is double the previous postwar record of 6% of GDP in 1983, when unemployment was over 10%. At Bradley, Foster & Sargent, Inc., we believe that this massive fiscal stimulus, along with the unprecedented monetary stimulus which the Treasury and Fed are executing, will reignite the private sector demand needed to defeat deflation. Evidence is also accumulating that the economies of emerging nations like China and Brazil are improving. While 1st quarter 2009 GDP in the U.S. probably declined 5-7% due to inventory de-stocking, we believe that the chances are good that the economy will return to positive growth by year-end. The bigger problem may well be much higher inflation not too far down the road.

We believe that investors need two positive signs before they are fully ready to move their cash from the sidelines back into the stock market. The first is a clear indication that housing prices are bottoming out. This could well happen by the end of 2009, as the chart below shows:

S&P/Case-Shiller 10-City Composite Home Price Index



Source: S&P/Case-Shiller Composite

Investors also need reassurance that the U.S. banking system will survive without the need for additional government assistance. Former Fed Chairman Greenspan wrote recently in the *Financial Times* that the potential losses to the consolidated U.S. banking system are estimated at \$1 trillion, of which \$500 billion has already been written off. It is likely, we believe, that the remaining \$500 billion will be written off by the end of 2010 against the enormous earnings power of the banking system (with the cost of money now being close to zero). Some banks will need more capital, but it is becoming clear that the banking system will not only survive but re-emerge in a profitable, reformed state.

In recent days, investors seem to be moving from a depression mentality to a recession mindset. A sign of this is the VIX (CBOE volatility indicator), which dropped from a high of 89 to 36 – its lowest level since September 2008 when the Panic started. There are still many challenges which the economy and the market must overcome, not the least of which are the dismal 1st quarter corporate earnings and GDP numbers soon to be reported. Investors also fear the potential damage Washington can do to the economy and the stock market. On balance, however, the low valuations of quality stocks still discount a Depression scenario. The chart below shows the relationship between the earnings power of stocks compared to that of bonds over the past decade and demonstrates the current attractiveness of stocks compared with the 10-year U.S. Treasury note (the earnings yield of the S&P 500 Index is the reciprocal of the P/E ratio – recently at 12.5):

U.S. Treasury 10-year Note Yield
vs. S&P 500 Earnings Yield



With the earnings yield on stocks 5.5% greater than bonds, money at the margin should flow out of risk-free bonds and money market funds into stocks. Thus at BFS, we are becoming more constructive about the stock market, believing that there is a good probability that stocks will trade higher a year from now. However, the stock market rarely moves in a straight line, and it is possible that before this occurs, the market will re-test the March bottom. Over the longer term, we are still peering through a glass darkly to fathom how the new administration's ambitious agenda will impact the economy and the stock market as well as what new investment opportunities will present themselves for the benefit of our client portfolios.