Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

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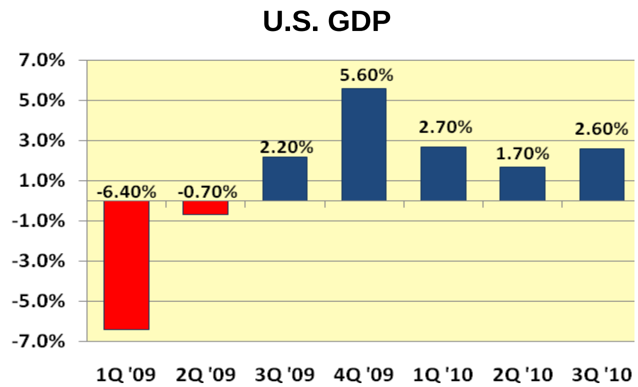
U.S. Economy: A Story of Good News and Bad News

> It seems that Secretary Leonid Brezhnev, surrounded by underlings, was at Lenin's Tomb watching the May Day Parade. The Soviet Union's full military might was on display. First come battalions of elite troops, marching in absolute lockstep. Then come phalanxes of modern tanks and artillery. Then come the missiles. All in all, an awesome show of strength! But after the missiles come a bunch of civilians – unkempt, shabbily dressed, utterly out of place. An aide rushes up to Brezhnev and begs forgiveness. "Comrade Secretary, my apologies, I do not know who these people are or why they are in the parade."
>
> "Do not worry, Comrade," replies Brezhnev, "I am responsible for them. They are our economists, and you have no idea how much damage they can do."
>
> President Ronald Reagan to Alan Greenspan, *The Age of Turbulence*, 2007

Economists have always been a favorite butt of jokes. The jokes that President Reagan loved to tell about Marxist economists in the Soviet Union turned out to be an accurate reflection of life there, as the world learned after the fall of the Berlin Wall in 1989. Economists are also the butt of jokes in the U.S., and often with good reason. The U.S. economy is expanding, but investors would not know this if they only listened to the economists in the media. Academics and intellectuals generally have little hands-on business experience, and thus many routinely underestimate the strength and resilience of the U.S. market economy. Rather than counseling politicians that the self-correcting mechanisms of the market economy be allowed to work to create robust economic growth, many recommended massive government fiscal intervention and increased regulation to right the economic ship. However, from the experience of the last two years, it appears that huge government borrowing to provide massive fiscal stimulus as well as expanding regulatory initiatives retards economic recovery rather than aids it. The U.S. economy bounced back strongly during the second half of 2009, but GDP growth began to wilt during the first seven or eight months of 2010, as the flood of government intervention in many key economic sectors and the threat of higher taxes created uncertainty in the minds of business leaders and owners. This resulted in fears of a "double dip recession," and the economy slowed significantly during the first three quarters of 2010. This pattern of GDP growth is shown below:



Source: U.S. Dept. of Commerce

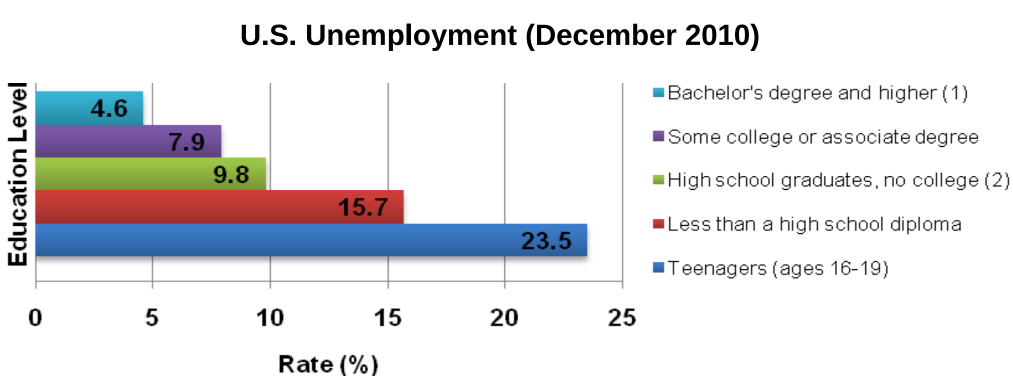
The Aftermath of Severe Financial Crises

As traumatic as the Great Recession has been, there have been numerous similar crises in the U.S. as well as globally. The U.S. experienced a higher unemployment rate (10.6%) in the early 1980s than during this downturn, and the peak-to-trough decline in GDP of 4.1% was scarcely greater than the economic contractions in 1957-1958 and 1973-1975. Yet there is no doubt that in the Panic of 2008, the U.S. suffered its worst financial crisis since 1929-1933. The credit markets froze, the banks were on the ropes, and there were runs on money market funds. Carmen and Vincent Reinhart have done extensive research into the intermediate and longer-term effects of severe economic dislocations. In their research, they examined 15 severe post-World War II financial crises in advanced and emerging economies and three synchronous global contractions – the 1929 stock market crash, the 1973 oil shock and the 2007 U.S. subprime collapse. If the U.S. follows the historic pattern, it is likely that the deleveraging process and the weak housing market will moderate GDP growth and employment gains for years to come. The main results of the Reinharts' research can be summarized as follows:

- Median post-financial crisis GDP growth is lowered by about 1% in advanced economies for periods of up to a decade.
- Median housing prices are 15-20% lower in the decade following the crisis, and a protracted slump in construction activity accompanies depressed housing prices.
- In the decade prior to the crisis, domestic credit/GDP climbs about 38% and external debt soars. After the crisis, credit/GDP declines by approximately 38%. Deleveraging often is a lengthy process lasting about 7 years (2015).
- In the 10-year window following severe financial crises, median unemployment rates are substantially higher (5%) than in the decade that preceded the crises.

Main Factor in U.S. Unemployment is Educational Achievement

One of the greatest challenges facing the U.S. in the aftermath of the Great Recession is unemployment and so-called underemployment – those who want to work more than they currently are. Educational achievement in the U.S. is not only the main factor in causing inequity in income and wealth but also the key determinant in unemployment rates. The most recent report indicated that the U.S. unemployment rate was 9.6%. The table below illustrates the value of education in the workforce:



Source: U.S. Bureau of Labor

(1) Includes persons with bachelor's, master's, professional, and doctoral degrees
(2) Includes persons with a high school diploma or equivalent

Lower Consumer Debt Replaced by Skyrocketing Federal and State Debt

Perhaps the major challenge facing the U.S. is that we are a country living beyond our means. The U.S. budget deficit for the fiscal year 2010-2011 is projected to exceed $1 trillion. This will be the third successive year with budget deficits exceeding $1 trillion. The federal debt/GDP ratio is at its highest level since the Korean War and is forecast to keep climbing. The Federal debt ceiling (gross debt) at the moment is $14.3 trillion – about the same level as GDP. And the deficit problem is not confined to Washington D.C. Many states have yawning fiscal deficits; the aggregate fiscal deficit for the 50 states for the 2011-2012 fiscal year is in excess of $100 billion. How do we balance the budget? The "right way" to balance the budget and reduce the debt/GDP ratio, according to Messrs. Biggs, Hassett and Jensen at the American Enterprise Institute, is not to raise taxes and cut spending; it is to cut spending. They cite recent research by professors Alberto Alesina and Silvia Ardagna of Harvard University who analyzed fiscal consolidations in 21 countries over 37 years. In most cases in which a combination of higher taxes and lower spending was used, the fiscal consolidation was unsuccessful. Successful efforts to balance the budget – such as those executed by the U.K. and Finland in the 1990s – relied overwhelmingly on reduced government expenditures. The lion's share of the steps to balance the budget was made by means of expenditure cuts (social transfer payments) and reduction in government salaries (through cutting personnel and salaries). Reducing entitlements and government pay was found to be vital because it spurs people to work and save more.

Will Some States and Municipalities Default on their Debt?

Another challenge facing the U.S. economy is the $2.8 trillion tax-exempt bond market. Over the past 70 or more years, few municipalities (and no states) have defaulted on bonds that they have issued to investors. Thus, many investors assume that there is very little risk in buying "muni" bonds. This has, however, not always been the case. In the 1840s, Michigan, Mississippi, Arkansas, Louisiana and Florida defaulted on their debt and later repudiated the bonds. It happened again in the late 1870s and 1880s. Eight Southern states repudiated the bonds that were issued by the Radical Republican state governments during Reconstruction. While there were cries for Washington to bail out the states, the Federal government in both periods refused to intervene. Could this happen again? Recently there has been much discussion about the declining creditworthiness of a number of states such as Illinois and California whose finances are in shambles. The market's focus and media's emphasis on these problems appears to be causing some states to take steps to close the gaping holes in their budgets. This is important because both Federal Reserve President Ben Bernanke and GOP leaders in the House of Representatives have publicly stated that Washington will not aid the states in fiscal trouble. It is perhaps more likely that some towns and municipalities will default on their debt or need to restructure their obligations.

Why Investors Became Bullish in September, 2010

With the abovementioned major macroeconomic obstacles weighing down the stock market, what happened to cause the explosive 20%+ rally since September 1st? Three key events happened to change investor psychology. The first was a growing intuition that the November mid-term elections would bring a dramatic reduction in political uncertainty for businesses and investors. Specifically, a landslide in the House of Representatives by the GOP would mean no potentially crippling tax hikes, less regulation and a more business-friendly administration. Secondly, following the mid-term elections, investors have sensed that President Obama is moving towards the center. Evidence of this is his support of the December tax bill, discussions underway to overhaul corporate taxes, and his appointment of a pro-business chief of staff. Thirdly, Fed Chairman Bernanke's announcement of QE2 – further monetary stimulus through the Fed's purchase of $600 billion in government bonds – assured investors that interest rates would remain low and liquidity high. These three events persuaded investors to focus on the microeconomic picture of rapidly growing corporate earnings combined with rock bottom interest rates: a powerful combination.

Will the Bull Market Continue in 2011?

There is contradictory evidence (as there usually is) about the direction of the economy and the stock market this year. The table below outlines some key positive and negative aspects which need to be weighed in formulating an investment strategy for 2011:

Pros	Cons
U.S. corporations are in sound shape	U.S. consumer still deleveraging
Corporate earnings should exceed 2007 level	Weak housing market
Strong GDP growth in China, Brazil, India, etc.	Foreclosure mess here until 2013
U.S. GDP growth accelerating to 3.5-4%	Unemployment to remain over 9%
Inflation and interest rates remain low	Interest rates may rise later in year
Less political uncertainty from Washington	Federal spending out of control
Modest S&P 500 valuation – 14 P/E on 2011	Shaky tax-exempt bond market
Federal taxes remain low	Troubles in Euroland
Banks beginning to lend more	Potential conflicts in Iran and Korea
Increasing funds flow from bonds to stocks	QE2 may cause higher gas and food prices

Summary

The table above delineates many reasons why the bull market may continue in 2011. An accelerating U.S. economy with GDP growth of 3.5% or more, higher corporate earnings, ample liquidity and low interest rates, and reasonable market valuations usually mean good news for investors. However, the table also points to a number of serious fiscal imbalances in the U.S. and macroeconomic problems. Some of these issues are so serious that they could derail an improving economy and the bull market if progress is not made in solving them. For example, a strong economy combined with continued monetary easing could cause increased interest rates and higher gas and food prices. This would not only hurt the consumer (and GDP growth) but also cause the stock market's P/E ratio to contract. In brief, we at Bradley, Foster & Sargent, Inc. remain cautious on bonds and positive on stocks in 2011, but we do not expect it to be a smooth ride. It is likely that volatility will spike up again this year from time to time, producing a roller coaster stock market similar to that of 2010. To protect against the possibility of higher inflation, investors should own well-managed companies with hard assets (energy and minerals). Above all, we continue to emphasize the importance of owning quality stocks with strong balance sheets, robust cash flow and well-known brands in order to weather periods when investors' confidence is shaken by macroeconomic events.