

“The global financial crisis of the late 2000s, whether measured by the depth, breadth, and (potential) duration of the accompanying recession or by its profound effect on asset markets, stands as the most serious global financial crisis since the Great Depression. The crisis has been a transformative moment in global economic history whose ultimate resolution will likely reshape politics and economics for at least a generation.”

This Time Is Different: Eight Centuries of Financial Folly
Carmen M. Reinhart and Kenneth S. Rogoff, 2009

Dear Friends,

As discussed below, stock prices have been highly volatile in 2011. In patterns characterized as ‘risk-on’ and ‘risk-off’ the vast majority of stocks move up and down together, often in large increments, based strictly on the daily flow of news and economic data. This daily volatility, and the failure of investors to discriminate among individual stocks, is frustrating for serious long term investors.

Volatility, simply put, is a function of uncertainty – uncertainty about the economic recovery and uncertainty surrounding the political and economic consequences of excessive government debt in Europe and the United States.

This Time Is Different, by economists Carmen Reinhart and Kenneth Rogoff, is a landmark analysis of the origins and the aftermath of financial crises throughout history. Although the policies or events which trigger a crisis may vary, Reinhart and Rogoff demonstrate that every financial crisis is preceded by standard indicators: asset price inflation, rising financial leverage, a large and sustained trade deficit, and slowing economic growth. Reinhart and Rogoff also point out that every crisis has common outcomes; including slow and sluggish recoveries for production, employment and housing values. Most important, every crisis leads to a significant increase in public debt, due mostly to lower tax revenues on top of the costs of bailing out the financial system. Finally, professors Reinhart and Rogoff argue that all financial crises share a common origin in the “*this-time-is-different syndrome*.”

“The essence of the this-time-is-different syndrome is simple. It is rooted in the firmly held belief that financial crises are things that happen to other people in other countries at other times; crises do not happen to us, here and now. We are doing things better, we are smarter, we have learned from past mistakes. The old rules of valuation no longer apply. The current boom, unlike the many booms that preceded catastrophic collapses in the past (even in our country), is built on sound fundamentals, structural reforms, technological innovation, and good policy. Or so the story goes.”

More wealth has been lost, and more lives destroyed, by investors (as well as bankers, policy-makers and politicians) who convinced themselves that the laws of economics, or the lessons of history, are irrelevant in our time. Those who borrowed or lent on the assumption that home prices never decline are the most recent victims and perpetrators of the ego and arrogance which lies at the heart of the this-time-is-different syndrome. Obviously, Mrs. Reinhart and Mr. Rogoff hope that their work will help to reduce the risk of **future** crises. For policy-makers, politicians, corporate leaders and investors in the **current** environment, the ironic conclusion of Reinhart and Rogoff is this: “this time **IS** different.” Indeed, for those whose views of the business cycle have been shaped by the post-World War II American experience, the current recovery does not fit established patterns.

As we write this report in early July, leaders in Washington are negotiating an increase of the federal government debt ceiling. If they reach an agreement which also includes substantial and sensible cuts in spending, tax reform which promotes growth and investment, and changes to the major entitlement programs which balance compassion and affordability, if that political miracle occurs, then a great deal of uncertainty will evaporate and the stock market will celebrate – at least temporarily. Still, economic uncertainty will persist. Therefore, we thought it would be helpful to devote this entire report to a discussion of some long term economic trends which have lead to the current environment of slow growth and excessive debt. Our normal format, with reviews of individual companies, will return in September.

Some investment advisors use letters like this to advance their own views about fiscal and monetary policy. As stewards of other people’s money we believe it is best to put our own bias aside and deal with the world as it is – not as we might prefer it to be. Therefore, we will try, as always, to provide insight, understanding, a calm voice, and some measure of confidence that no matter how long economic and political uncertainty persists, we will invest successfully. ***Indeed, as regards our investment approach, this time is no different at all.***

The Equity Market

In the first quarter the S&P 500 Index increased nearly 7% before a sharp decline, triggered by a spike in oil prices and the tsunami in Japan, eliminated those gains. Share prices recovered in late March and posted a gain of 5.4% for the first quarter. A similar pattern occurred in the second quarter. At the end of April the S&P 500 was up more than 8%. Another correction in May and June, triggered by escalation of the European debt crisis, again eliminated the year-to-date gains. A strong rally at the end of June left the S&P 500 with a gain of 5% (excluding dividends) for the first half.

We look to the second half with modest expectations given the risks and uncertainties which we have emphasized in previous reports. These include: (1) the government debt crisis in Europe and its potential consequences for the global banking system, (2) a possible ‘hard-landing’ for economies in China, India and Brazil where policy-makers are working to control inflation, and (3) the failure, thus far, of America’s politicians to reduce excessive government deficits and unsustainable debt.

In our last report we reviewed the Equity Market Checklist – a framework for assessing the outlook for the stock market based on ten key factors. We emphasized that the most critical variables are (1) *monetary policy and liquidity conditions*, (2) *corporate profits* and (3) *the outlook for sustainable economic growth*. The recovery in stock prices since March 2009 has been due to a ‘V-shaped’ recovery in corporate profits and aggressive measures by the Federal Reserve to avoid deflation. The influence of these two variables now appears neutral.

The Federal Reserve completed its second program of quantitative easing (QE) on June 30. Barring a significant deterioration in the economic outlook, and a renewed threat of deflation, another round of QE is unlikely. Profit growth remains positive and near term results may continue to exceed Wall Street’s expectations. However, after rising 29% in 2010, corporate profits increased 18% in the fourth quarter and just 10% in the first quarter. ***Whether profit growth will continue to slow gradually or abruptly, and whether or not the Federal Reserve initiates a third round of quantitative easing, both depend largely on the outlook for sustainable economic growth.***

The Economy – A Short Term Perspective

Recent data confirm that the recovery remains sluggish. Gross domestic product increased just 1.9% in the first quarter -- a deceleration from the pace of late 2010. Increases in Personal Consumption and Real Final Sales (i.e. GDP excluding changes in business inventories) were similar to the trends prior to the Fed’s decision last Fall to implement QE2. The weak economic data of the first quarter have been followed by disappointing employment reports for May and June. The reluctance of companies to increase payrolls suggests that second quarter GDP reports will be similar to Q1.

	<u>2009</u>		<u>2010</u>				<u>2011</u>
	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Real GDP	1.6%	5.0%	3.7%	1.7%	2.6%	3.1%	1.9%
Personal Consumption	2.0	0.9	1.9	2.2	2.4	4.0	2.2
Real Final Sales	0.4	2.1	1.1	0.9	0.9	6.7	0.6

A case can be made for stronger growth going forward. The spike in oil prices has abated. Automobile production was sharply curtailed by temporary supply chain disruptions in Japan. Also, monetary policy always has a delayed impact on the economy and the benefit to consumption and investment from higher asset prices, courtesy of QE, may still be ahead. However, a comparison with past economic recoveries shows how the current cycle is different. Moreover, a review of longer term trends (see below) suggests that current trends are likely to persist. Shown below is a comparison of key components of GDP in the current recovery and those of the mid-70’s and early-80’s. For each variable we have calculated the average annual rate of growth over the first seven quarters of recovery.

	<u>Q2 1975- Q4 1976</u>	<u>Q1 1983- Q3 1984</u>	<u>Q3 2009- Q1 2011</u>
Real GDP	4.7%	7.1%	2.8%
Personal Consumption	5.5	5.5	2.2
Consumption of Durable Goods	11.7	14.3	10.4
Residential Fixed Investment (Housing)	24.8	31.9	(0.4)
Exports	3.5	7.2	11.4
Business Investment: Equipment & Software	5.7	18.4	13.7
Federal Government Spending:			
Defense	0.1	4.2	1.3
Nondefense	1.6	7.7	5.0

In the recovery of the mid-70's, the combination of home construction and spending for durable goods (e.g. automobiles, appliances, etc.) rose from 12% to 14.2% of GDP. In the recovery of '83-'84 these two components of GDP increased from 11.8% to 13.2%. At the peak of the housing bubble in early 2006, housing and consumer durables represented almost 15% of the economy. Three years later, at the bottom of the recession, they contributed only 9.6%. Today, these two traditional drivers of recovery are still less than 10% of total economic activity. Therein lies the critical distinction between the current recovery and past cycles; the limited ability of monetary policy (i.e. low interest rates) to stimulate demand for credit sensitive goods – particularly home construction and related expenditures.

Two strong contributors in the current recovery have been exports and business investment. However, imports are more than 20% larger than exports and have grown at essentially the same pace (11.5%) – more than offsetting the contribution of exports to GDP. Moreover, exports are dependent on the health of foreign economies – particularly emerging markets. Sharp slowdowns in China, India and Brazil would have adverse consequences for exports and the economy in general.

The strength in business investment is the flip side of high unemployment – low interest rates encourage a substitution of capital for labor. With strong profits and cash flow, as well as low debt, the non-financial corporate sector has the resources to continue this trend. Also, government policies which increase the cost of labor (e.g. health care mandates) are an additional incentive to substitute capital for labor. Finally, in the table above we have included data for federal government spending. The increase in nondefense spending in the current recovery reflects the stimulus program that was approved in early 2009. The relatively slow pace of defense spending may be a surprise to many readers.

The Economy – A Longer Term Perspective

The limitations of monetary policy in the current business cycle have their roots in an important transformation of the American economy over the last 40 years. In 1970 personal consumption accounted 62.4% of total economic activity. Today it accounts for more than 70%. Also, as shown below, the long and steady increase in consumer spending was accompanied by a shift from the consumption of goods to the purchase of services.

Personal Consumption as Percent of Gross Domestic Product

	<u>1970</u>	<u>1975</u>	<u>1980</u>	<u>1985</u>	<u>1990</u>	<u>1995</u>	<u>2000</u>	<u>2005</u>	<u>2010</u>	<u>2011 Q1</u>
Goods	30.7%	30.0%	28.7%	27.0%	25.7%	24.5%	24.7%	24.3%	23.4%	24.2%
Services	31.7	33.1	34.3	37.5	40.4	42.8	43.9	45.5	47.2	46.9
Total	62.4	63.1	63.0	64.5	66.1	67.3	68.6	69.8	70.6	71.1

At first glance, the overwhelming share of economic activity represented by consumer spending would seem to be a strong advantage for the American economy. Because a high proportion of GDP reflects consumption and production of everyday goods and services, the U.S. economy is more stable and resilient than most other countries. However, as shown below, the rising share of consumption over the last two generations was driven by lower savings and rising debt. The fact that higher debt burdens facilitated more immediate consumption (i.e. services) is also concerning. Some services are, in fact, a good investment (e.g. education) and some services are necessary (health care). However, others reflect the choices of a more comfortable or indulgent lifestyle (travel, leisure, recreation, etc.).

Shown below is the ratio of consumption to after-tax income as well as the savings rate. Forty years ago Americans spent only 88% of their income. By 2005 Americans were spending 95% of their income. Obviously, the increase in consumption was accompanied by a decline in savings. Although many studies have criticized the government's calculation of the savings rate, there is no dispute about the *trend* of savings over the last two generations. In 2005, at the peak of the consumption bubble, Americans were saving only 1.4% of their after-tax income.

Personal Consumption and Savings as Percent of Disposable Personal Income

	<u>1970</u>	<u>1975</u>	<u>1980</u>	<u>1985</u>	<u>1990</u>	<u>1995</u>	<u>2000</u>	<u>2005</u>	<u>2010</u>	<u>2011 Q1</u>
Consumption/Income	88.1%	87.1%	87.7%	88.3%	90.2%	91.4%	93.2%	95.1%	91.0%	91.7%
Savings/Income	9.4%	10.6%	9.8%	8.2%	6.5%	5.2%	2.9%	1.4%	5.7%	5.1%

Most studies of the credit bubble and financial crisis have focused on the housing and mortgage industries. Less attention has been given to the *non-mortgage* debt and interest that Americans incurred to support increased consumption. As shown below (page 4), 30-40 years ago Americans put 4-5 times as much into savings as they paid in non-mortgage interest. By 2005 the relationship was reversed and Americans saved only 60% as much as they paid in interest. Although this ratio has improved sharply in the recovery, the improvement is due mostly to rising personal defaults and lower interest rates. Indeed, the ratio of total household debt to income, which was only 60% forty years ago, remains near 115%.

Ratio of Personal Savings to Personal Interest Payments and Household Debt as Percent of Disposable Personal Income

	<u>1970</u>	<u>1975</u>	<u>1980</u>	<u>1985</u>	<u>1990</u>	<u>1995</u>	<u>2000</u>	<u>2005</u>	<u>2010</u>	<u>2011 Q1</u>
Savings/Interest	4.6x	5.3x	4.5x	2.8x	2.5x	2.2x	1.1x	0.6x	3.3x	3.2x
Debt/Income	60%	62%	70%	70%	85%	92%	100%	125%	115%	--

The Great Recession started in late 2007 and included an immediate increase in savings. From the third quarter of 2007 to the second quarter of 2009 (the end of the recession) personal savings rose from \$189.7 billion (1.8% of income) to \$793.5 billion (7.2% of income). This surge in savings triggered a void in aggregate demand that the federal government tried to fill (via the stimulus program) in order to support production and employment. In effect, the federal government moved to increase public debt in order to accommodate the decline in private debt. The combination of higher government spending, lower tax revenues (due to the recession), and the direct costs of bailing out the financial system, have driven a sharp increase in the federal budget deficit and pushed America's public debt to unsustainable levels – consistent with the post-financial crisis experience of many other countries as shown by Reinhart & Rogoff.

It is impossible to know how long the deleveraging process will last and how high the savings rate will go. Historical ratios suggest that there is room for much more debt reduction and much higher savings. Although balance sheet improvement is ultimately very healthy for the economy, the process implies a protracted period of slower than normal growth of personal consumption and the economy in general.

Investment Strategy – The Sustainable Growth Company Portfolio

Here, then, are the two critical assumptions which frame our view of the economy and the financial markets.

§ *The economy is recovering from a historic financial crisis and recession – the roots of which were embedded in excess debt and consumption over the last 40 years. The process of deleveraging will take years to complete and will serve as an anchor to a slow and fragile economic expansion.*

§ *Given this economic backdrop, financial markets are likely to remain highly volatile. Sharp corrections in stock prices are possible whenever economic events (e.g. a spike in oil prices) or policy decisions (or non-decisions) cause investors to question the sustainability of the expansion.*

Our proven long term investment approach – emphasizing companies which produce consistent and superior growth of profits and dividends over the long term – was designed for times like these.

Five years ago we introduced the *Sustainable Growth Company Portfolio* – a hypothetical portfolio comprised of one share for each of the companies we own which have demonstrated consistent profit and/or dividend growth over many years. Twelve of the companies in the portfolio five years ago (Automatic Data, General Electric, Hershey, Johnson & Johnson, Coca-Cola, Intel, 3M, Pepsico, Procter & Gamble, Stryker, Sysco, and Walgreen) remain among our largest holdings. Abbott Labs, Emerson, Exxon-Mobil and UPS have replaced Medtronic, Merck, Microsoft and Wrigley. Today the sustainable growth company stocks account for 84% of our clients' assets. The New York Times Company, a relatively new investment and 3.5% of our clients' assets, is excluded because of ongoing changes in the advertising/media markets and the company's business model (see our January 31, 2011 report). Cash reserves (9%) and several small miscellaneous holdings account for the remainder of our clients' assets.

Total earnings per share for the "one share of each company" portfolio were \$48.53 in 2007. In 2010 per share profits were \$53.91 -- a cumulative increase of 11% over three years of recession and recovery. Only three companies in the portfolio (Exxon, GE, and UPS) posted lower profits in 2010 than in 2007. Emerson's profits were essentially flat. The remaining 12 companies achieved an increase of 25%. In comparison, profits for U.S. companies in general, based on the tax returns of all U.S. companies (public and private) rose just 7.5% over the same three year period.

The dichotomy in terms of dividends is even greater. In 2007 the sustainable growth companies paid total dividends of \$18.46. Over the last three years 15 of the 16 companies increased their dividends – only GE cut its payout to shareholders. Total dividends for the sustainable growth portfolio in 2010 were \$24.50 – a cumulative **increase** of 33%. In contrast, total U.S. corporate dividends **declined** 4%.

In short, these companies achieved superior profit and dividend growth during the worst recession and weakest recovery in generations. Thus, we are confident that this collection of businesses, **as a group**, will also achieve superior financial results over the next several years despite the economic environment we have assumed. As you know, when profits and dividends increase, so too does the intrinsic value and, eventually, the share price of the companies we own.