ECONOMIC OUTLOOK

bounty management
unique investment insight

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BORROWING FROM PETER TO PAY PETER

Since 2008, the U.S. government has spent $2.6 trillion or 18% of GDP in taxpayer funded stimulus, including the Trouble Asset Relief Program (TARP) of $800 billion, to save large financial institutions and their creditors as well as cushion the overall economy. In addition to the stimulus, governments have been transferring money from one pocket to the other or borrowing from Peter to pay Peter. Here are a few recent examples:

- NY State has urged cities and towns to take $6 billion in loans from the state pension fund. The proceeds from the loans are used to make the state's annual payment to the same pension fund!

- In the recent $130 billion bailout of Greece, shared by EU members, Greece must pay $2.5 billion essentially to itself. Spain and Portugal are eventually likely to be in the same position.

- With unemployment still at a severe high, a majority of states (33 at last count) have drained their jobless benefit funds, forcing them to borrow billions from the federal government to finance unemployment compensation payments. State obligations are now federal obligations.

When governments resort to the above tactics, they are desperate for funds. Although the U.S. economy in the 1st quarter grew just above our target level at a 2.7% annual rate, real demand and service spending growth were both weak. A number of factors contributed to growth, including the tail end of the federal stimulus, higher inventory levels, and spending on incentive-laden cars, appliances, and homes. Spending was further boosted by a lower savings rate. By the end of the 2nd quarter, many leading indicators of economic activity were pointing to high odds of another recession, but, in our view, the original recession never ended. Three areas remain a concern: consumer spending, real estate, and state finances.

Consumer Spending

Debt, employment prospects, and the real estate market trouble the consumer. On the job front, 2nd quarter private employment barely inched up, hours worked were flat, and income growth year/year was only 1.7%. For the unemployed, 46% have been unemployed for 6 months or more. Forty million people are on food stamps or almost 15% of the population. U6, a broad measure of unemployment and underemployment, is 16.5%. Consumer confidence barely budged in the 2nd quarter from recession levels. Consumer intent to buy homes and autos is the weakest in decades. With household debt 9 times the level in 1980 and 2 times disposable income, consumers have been cutting installment debt by over 4% annually or $35 billion since February by either paying back loans or defaulting. If the savings rate ticks up above 4% from the current 2-3%, consumer spending, two thirds of the economy, will be flat.

Real Estate

Housing/real estate is offering no support to the consumer. After the homebuyer's credit expired in April, pending sales were off 30% in May and new sales were down 33%. At existing sales rates, inventory was over 8 months with a large shadow inventory (inventory held by banks or homeowners not yet in the market). Prices fell from the 4th quarter to the 1st quarter by 3.2% and more in the 2nd quarter. Prices could decline another 10-20% before inventory starts to clear. Commercial real estate, down 42% from the high, is in equally tough shape as most properties are not re-financeable now.

State Finances

States have been deprived of new revenue for so long that they now need to cut drastically. As expenses climb and revenue slows, 22 states have resorted to unpaid furloughs. With unfunded pension gaps of $1.5 to $3 trillion, a projected 2011 deficit of $112 billion and a 2012 deficit of $130 billion, states will be forced to cut programs and employees. As state jobs represent 14% of the economy's employment, a 10% employment cut translates into 200,000 lost jobs. The worst states, with budget deficits of 35%, are New York, New Jersey, Arizona, and Illinois. Texas and California face 20% deficits. This level is so bad that we feel that the next federal stimulus may be in the range of $500 billion to support state employment and guarantee state debt.

Domestic GDP

Going forward, weakness in the above mentioned areas - consumer spending, real estate, and state finances - will have a negative effect on domestic GDP. We now think that 2nd quarter GDP will be 0 to1%, far below consensus. There is the possibility of negative 4th quarter GDP and 2010 GDP will be no more than +1.5% versus 2009. Further policy moves will occur in the 2nd half of 2010 to obtain this result: either more stimulus or quantitative easing by the Federal Reserve (for example, purchases of financial assets such as government bonds).

A couple of sectors have done relatively well year-to-date. The industrial/export/capital expenditure part of the economy has benefited from some capital spending and especially from the worldwide inventory rebound. Durable goods orders and industrial production are well above year ago levels. However, May and June evidence gives us pause. Utilization is still 6% below the 1971-2009 average at 74%. GE's 1st quarter order book is still 10% below last year. World trade is still down 13% versus the peak. Freight rates have dropped over 50% from April levels. So even in the industrial area, the recovery remains subdued.

During 2008-2010, economic activity excluding inventory changes grew by $200 billion (1.5%), but income from business activity dropped $500 billion. This is a poor return on taxpayer investment. Normally, four quarters after an economic low, economic activity increases by an average of 4.4%.

World Economies

Japan: Japan's domestic economy continues to be distinctly subdued as the jobless rate remains high. Consumer wages have fallen 21 months in a row on a year over year basis and consumption continues to fall. Capital expenditures, despite great exports to China and the rest of Asia, have been lower than expected. The government launched a new program with $2 trillion in monetary stimulus and promptly suffered in the subsequent election. May exports were +32% versus a weak 2009, but down from 1st quarter 2010 levels. Chinese orders may have peaked. 2010 GDP will be in the range of +0.5% to 1.0%.

Europe: Europe has been the poster child for the problems of the 1st half of 2010. Southern and Eastern Europe represented by Greece, the Baltics and Balkins, and Spain/Portugal, have had a whole series of problems. Housing bubbles have collapsed, the population and the banking system are over indebted, and large budget deficits are prevalent. This leads to funding problems for both the governments and the banking system for new debt and restructured debt. A debt crisis has blown up even in strong countries like Germany, France and the Netherlands since their banking systems are highly involved in these problem areas. No one is willing to lend on an interbank or corporate level. Bank loans in May fell and funding costs shot up. There was a $130 billion bailout of Greece in March-April, but the market extrapolated the problems of Greece to Spain, Portugal, Ireland, and even Italy. In May, the EU and European Central Bank were forced to support European bonds and banks with $1 trillion, and yet the crisis still continues due to the overleveraging of the broad banking system. As for the overall European economy, it seems hostage to the weak members who are in recession. Unemployment is 10.1% and consumption is very sluggish. With the biggest northern states growing somewhat, GDP for 2010 will still likely be no more than 1% in Europe.

Emerging Markets: The 20% of the world GDP that is the emerging markets economy is supplying 1/2 of the world growth and it all revolves around Brazil, Russia, India and China, the BRIC nations. These countries trade with and supply each other and have growing consuming and banking sectors without the overleverage of developed nations. Many have huge foreign exchange reserves that they can use for investment. They all have strong enough situations to enable them to raise interest rates in the first half of 2010. China's growth was 11.9% in the first quarter and even if the rate tapers to the 9.5% range by year end, the prospects of the emerging group would not change too much although some fallout could possibly be seen in commodity prices for a short time. The emerging markets have momentum on their side: momentum of domestic demand, infrastructure building, capital spending, and funding inflows from foreign equity that is not just hot money, but investing for the long-term. The growth rates are fabulous: Russia 5.5%, India 8%, Brazil 6.5%, South Korea 5.9%, Malaysia and Singapore 5.0%. Even Canada, Australia, New Zealand are growing at 2% to 4%. The IMF has recently said that they expect 4.6% world GDP growth this year, but they far overestimate U.S. and Japanese growth. We believe that emerging market growth will remain strong and lead the way, but since emerging markets constitute only 20% of world GDP, world growth will likely remain in the 2.5% to 2.75% range.

Investment Expectations

We have two opposing forces: emerging markets will try to retain their GDP growth rates at all costs while large economies will try to overcome their major structural problems and reignite growth at all costs. What is the best way to deal with this investment climate? We continue to emphasize hard, tangible assets. Metals, energy, capital goods, fertilizers, and chemicals are what the emerging economies need to grow. At the same time, heavy fiscal and monetary stimulus in developed economies make these goods and the fixed assets of producers more valuable. In energy, China, India, and Saudi Arabia will add 3 million barrels per day or about 3.5% to demand by 2012. As China's oil use per capita has moved from 0.8 barrels to 1.4 barrels, demand has been consistently growing 10-12% per year. China is now 51% dependent on imports for energy. India has moved up to the world's third largest crude importer and even Saudi Arabia is using more of its own oil and gas to run its economy. Even though the present demand is sluggish in the developed world, we feel there are many reasons now for price spikes in oil prices within the next 18 months.

Manufacturing stocks are attractive because as governments flood the market with more and more liquidity and stimulus, the replacement cost of fixed assets, and the cash flows produced by the assets, rise over time. The stocks of these companies will reflect the increased value. Gold is attractive as money that cannot be devalued by the government. Gold is likely to be a cornerstone of any reformation of the world's presently unworkable paper currency system. We also like blue chip defensives in the major countries due to the yields and stability (e.g., drugs and telecom).

We avoid consumer issues, as the consumer continues to be overleveraged. We do not like cash since it has no yield and is subject to timing risk. Bonds are perhaps the most overvalued asset class right now. Bond yields are very low and they have little in the way of purchasing power protection going forward as the government continues to stimulate the economy. Though stocks may be somewhat overvalued, and roll around like a marble on a table top, bonds are much more overvalued for most politically plausible environments. The government has been borrowing from Peter to pay Peter, protecting creditors everywhere, so far, to the detriment of savers and taxpayers. This situation will have to change relatively soon as sovereign debt mounts and political distaste grows. Though risk and volatility are high, our present composition seems, to us, the only logical one to avoid timing risk of moving in and out of markets and to preserve purchasing power of the assets over time. In short, investing is the only sound alternative in real terms. We remain vigilant and persevering.

June 30, 2010
DJIA: 9,774.02
S&P 500: 1,030.71

About Bounty Management

Bounty is an investment firm based in Boston that provides personalized, professional management of investment portfolios. For nearly 40 years, we have successfully managed investment, trust and retirement portfolios for clients including individuals, families, non-profits, and endowments. Our primary goals are to preserve purchasing power and to produce long-term appreciation of capital.

We believe that:

- Global macroeconomic analysis of world-wide trends is valuable
- Security and sector selection is an important source of return
- Unique business models and good management teams generate better returns
- A valuation discipline can help avoid mistakes

If you would like to learn more about our investment management services, performance, and how we can help you, please give Ray Bligh a call at (617) 357-8285 or access our web site at http://www.bountymanagement.com.

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