



# INVESTMENT STRATEGY UPDATE

June 10, 2010

*In light of current stock market volatility and an elevated level of client inquiries, we have chosen to accelerate publication of BTR's second quarter Investment Strategy Update.*

## **CORRECTION, OR SOMETHING WORSE?**

May was a terrible month for stocks. And thus far, June has been no better. Considering that U.S. shares had risen almost 70% from the March 2009 bottom to the April 2010 high, some sort of setback was certainly due. But the flow of news has been quite disturbing and investor sentiment has rapidly grown more negative. One can't help but wonder whether we are witnessing a correction within an ongoing bull market, or the start of something worse.

Every stock market downturn is scary. This one seems particularly so, given current events and investors' too-recent memories of the 2008-09 bear market. What started out with the Greek sovereign debt crisis has now spread to include the U.K., Ireland, Hungary, and most of southern Europe. And in Asia, China's authorities have instituted restrictive economic policies in order to slow their overheating economy and stem an increasingly speculative real estate market. These events, along with the huge environmental disaster off the U.S. Gulf Coast, will surely serve to slow the U.S. and global economies. And as if that weren't enough, there are also the military situations in North Korea, Iraq, Iran, and Afghanistan to worry about.

What happens next? Will China be able to pull off an economic soft landing? Can the European Union survive this crisis in its present form? Will current events serve to push the nascent U.S. and global economic recoveries back into recession? And are we, indeed, witnessing the start of another global banking crisis? We think not. While risks have undoubtedly grown, our expectations are that the U.S. economic expansion will continue, albeit at a slower rate, and that the current stock market decline is, in fact, a correction within an ongoing, cyclical bull market.

### **This Is Not "Lehman" Revisited**

The U.S. economic and financial environment today is quite different from that which preceded the collapse of Lehman Brothers. Back then, our economy had moved into recession. World trade was contracting, U.S. residential real estate was crashing, and banking system leverage was wildly out of bounds. In addition, oil prices and interest rates were quite a bit higher.

Today, our economy is in the first year of a new expansion and there are encouraging signs that the process of transitioning from recovery to sustainable growth is proceeding normally. Consumers are spending, U.S. corporations are flush with cash, and a capital spending cycle has barely just begun. Credit, while not necessarily abundant, is no longer frozen, and corporate profits have been in a dynamic rising trend. Moreover, the global economy is expanding, world trade has been growing, and U. S. manufacturing seems poised to experience a meaningful revival as our costs of manufacturing have become much more competitive internationally in recent years. In addition, while last Friday's employment report was certainly disappointing, the very high current level of corporate productivity should soon lead to significantly improved job creation. Evidence of increasing hours worked and rising wage levels imply that businesses are still squeezing what they can out of their current work force, and need only a shot of confidence to start hiring again. Furthermore, while the financial deleveraging process undoubtedly has further to go, U.S. banks seem to have a handle on where their problems are and are taking advantage of the extremely low Fed funds rate to generate profits and rebuild their capital bases, which makes them far more sound than they were before Lehman failed.

Could events in China and Europe derail our economic recovery? We don't think so. First, we believe that China is doing the right thing by tapping on the brakes. Its policymakers are attacking their real-estate speculation problem early enough, while it is still concentrated in a relatively few coastal cities, and not yet a broad-based bubble. China's centrally directed economy has been well managed. Just as the government was successful in stimulating the economy during the global credit freeze of 2008-09, we believe it will now be successful in engineering a soft landing, thereby slowing China's growth to a more sustainable 8-9% rate.

Regarding Europe, containment of the sovereign debt crisis is very important, even though the direct effect on the U.S. economy is relatively small. Greece's economy is roughly equivalent in size to that of the San Francisco Bay Area. In fact, Europe as a whole currently accounts for only 3% of global economic growth and 9% of U.S. corporate profits (14% of S&P 500 company profits). Even if the euro/dollar exchange rate were to decline 30% from top to bottom, S&P 500 earnings would be shaved by only about 4%. Of course, the economic and financial risks will grow if the debt crisis in Greece spreads to include other countries.

### **Can the European Union Survive?**

When we first wrote about the European Union ("EU") in July 1998, we had our doubts about its longevity. While a common currency was going to be used by most EU members, with a centralized monetary authority in control, it was impossible to unify and centralize fiscal responsibility. Our opinion was that the individual nations' productivity levels and cultural attitudes were just too different from each other and, in the past, their populations had shown little willingness to compromise. Time has proven this view to be accurate. Despite rules intended to control fiscal overindulgence, individual EU member states have consistently failed to keep deficit spending and debt levels under control. Greece was one of the more egregious violators, which inevitably led to the current situation.

Historically, sovereign debt problems have been resolved by a combination of currency devaluation and the partial write-down or repudiation of the affected nation's debt. In the case of Greece, or any EU nation that also uses the euro, unilateral currency devaluation is not an option. Without a separate currency to debase, thereby stimulating exports and other economic activity, we doubt that Greece will be able to get its financial situation in order, even if its politicians and populace have the will to do so. As such, we expect that Greece will eventually leave the Eurozone and the EU, voluntarily or otherwise. Regarding other European nations, there is no quick fix, but we are hopeful that they will get the message and work to reduce their debt and spending levels. If they cannot, the EU may have to abandon the euro and eventually consolidate into a smaller, sounder group of nations, or perhaps even disband altogether.

### **Some Expected and Unexpected Positives**

Strange as it may seem, there are some long-term positives that will be derived from the current sovereign debt crisis, just as there were from the bursting of the U.S. real estate bubble. What's happening in Europe is fundamentally deflationary. That fact, along with the related dampening effects on U.S. economic growth, will serve to keep Federal Reserve Board policy on hold for longer than we had been expecting, thereby maintaining a highly stimulative low-interest rate environment. Thus, mortgage rates and other borrowing costs will remain at very affordable levels. It is fortuitous that China is simultaneously acting to slow its economic growth rate. By doing so, it may help to maintain the global economic advance at a lower, but ultimately more sustainable rate with, we hope, less volatility.

More importantly, the crisis in Greece may serve as a shot across the bow to much of the rest of the developed world where, in many cases, debt-to-GDP levels have become unsustainable. Undeniably, those countries were, and may still be, headed towards their own debt crises. The European social welfare experiment had grown out of control and was destined to come to a difficult end. We hope the Greek debt crisis will be sufficiently revelatory to spur other nations into undertaking corrective action. Ireland is already doing so. Spain and Portugal have recently announced severe fiscal cutbacks, and the governments of France, Germany, and the U.K. have stated their intentions of doing the same.

So, what about the United States? While this country may be "the best looking horse in the glue factory," there can be no doubt that we are headed down the same path. We wonder whether the events in Europe can also serve to foster the beginnings of fiscal responsibility on our own shores. It is difficult to be optimistic, in light of overall spending trends at the federal, state, and local levels. But the aftermath of the real estate and financial bubbles proved a few things. First, when faced with overwhelming evidence of the need to act decisively and effectively, American politicians can do so. Second, in the face of what they perceive to be ineffective government, American voters can also act decisively. The question is whether or not we have gained a sufficient collective understanding of the fact that whether you are an individual, a family, or a nation, you cannot continually spend more than you bring in. Furthermore, beyond a certain level, raising taxes will not maximize a nation's revenues. Fiscal restraint and a vibrant, healthy economy, driven by the private sector, will be absolute necessities if we want to ensure this nation's future prosperity.

## **Conclusion**

The U.S. economy is transitioning from the faster growth of recession recovery to a slower, steadier, and more sustainable rate of expansion. In the past, such transitions were often accompanied by stock market corrections, but once growth expectations were readjusted, the stock market advance usually resumed. We expect much the same in this environment. Growth will be slowed by current events, but our economy is basically in good health and the U.S. is well positioned to participate in what we expect will be a continuing global economic expansion.

Nonetheless, there is little doubt that risk has increased, and we recognize that now is not the time to be inflexible. We are well aware of the danger of financial contagion associated with this particular pullback, and we are carefully monitoring events as they evolve. We may choose to lighten exposure to equities somewhat on the next advance, but we continue to believe that there will be a next advance.

How will this correction end? We consider it unlikely that the stock market will just turn around and go right back up. Alternatively, it is possible that news events and crowd psychology will become sufficiently negative to bring about a selling climax – short, sharp, and then over. However, we think it most likely that the markets will undergo a bottoming process that will take a couple of months or more to evolve, probably with some scary moments along the way.

What to do now depends on one's time horizon. While many stocks have fallen to what we consider to be highly attractive levels of valuation, it is always difficult to know how the next few months will evolve. Yet we are confident that, from these levels, our current portfolio holdings will be quite rewarding to clients over the next two to three years.

*Previous Investment Strategy Updates are available online – [www.btrcap.com](http://www.btrcap.com)*

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