



QE 3?

We are now two years from the bottom of the market in March 2009. The stock market has recovered nicely. People generally draw the inference that since the stock market is up; the underlying economy is doing great as well. We look at these underlying fundamentals for clues as to whether the recovery is self-sustaining and what this means for earnings and the stock market going forward.

A normal recovery is usually helped along by fiscal policy, monetary policy, or a combination of the two. In fiscal policy, the government runs a deficit and usually adds stimulus. In monetary policy, the Federal Reserve cuts interest rates, which lowers the effective cost of borrowing and buying durables like homes and autos. Both are currently being used.

Fiscal Policy

As for fiscal policy, the US Government has thrown quite a bit of stimulus at the Great Recession of 2008. Including the \$800 billion stimulus package (spread over three years) passed in 2009, the deficit in 2009 was \$1.4 trillion, in 2010 was \$1.6 trillion and in 2011 is projected to be almost \$1.3 trillion (Office of Management and Budget figures). By definition, deficit spending is stimulative. \$4.3 trillion can throw quite a party. In addition, the government has paid the several hundred billion (so far) in losses of Fannie Mae and Freddie Mac instead of exposing the bondholders to the losses.

In a more normal environment, these measures would lead to 10% GDP growth and probably 5-10% inflation. But obviously, these are not normal times.

Is the recovery now strong enough to be self-sustaining and no longer in need of such extreme stimulus? 2010 GDP is estimated to be \$14.6 trillion, so the 2010 deficit is expected to be about 11% of GDP. Clearly this is unsustainable. Just as clear, the recovery would not be self-sustaining if the budget were balanced tomorrow. However, even cutting the deficit down to a more sustainable 3-4% would knock 7% off of GDP. While Europe has begun to trim its deficits, it appears that the US will not voluntarily happen in the shorter-term unless we are forced to do so by rising interest rates and/or inflation increasing to some critical level. We believe that loose fiscal policy is at its limits and may contract which would hurt the chances of the recovery becoming self-sustaining.

Monetary Policy

During this recovery, the old tools have been used as well as some new ones. As for monetary policy, the Fed has held short-term interest rates near 0% since late 2008. This lowers the effective cost of borrowing and buying durables like homes and autos and should spur growth in all of the vendors who supply items into homes and autos like contractors, parts manufacturers, appliance manufacturers, etc. This in turn causes more hiring, which leads to more spending and after a few rounds of this (multiplier effect) we are in a self-sustaining recovery where temporary low interest rates and fiscal stimulus are no longer needed.

That has not happened this time, so the Fed has embarked on two rounds of quantitative easing (printing money). In QE 1, the Federal Reserve printed \$1.3 trillion to buy Fannie Mae and Freddie Mac paper and in QE 2 and is printing another \$0.6 trillion to buy US Treasury paper through the end of June.

Clearly the economy would be much worse without the stimulus. But we think that the larger question would be whether QE 2 is working and if so, is it enough?

Chairman Bernanke laid out how QE 2 was supposed to work in a speech in August and the Fed's annual conference in Jackson Hole, Wyoming. At the time Bernanke had said that buying treasuries would lower long-term interest rates which would boost credit, home prices and other asset prices and increase consumption and GDP. The day that he made that speech, 10-year USTs were yielding about 2.65%. Currently they are yielding about 3.40%. So from a long-term interest rate perspective, QE 2 has been a failure.

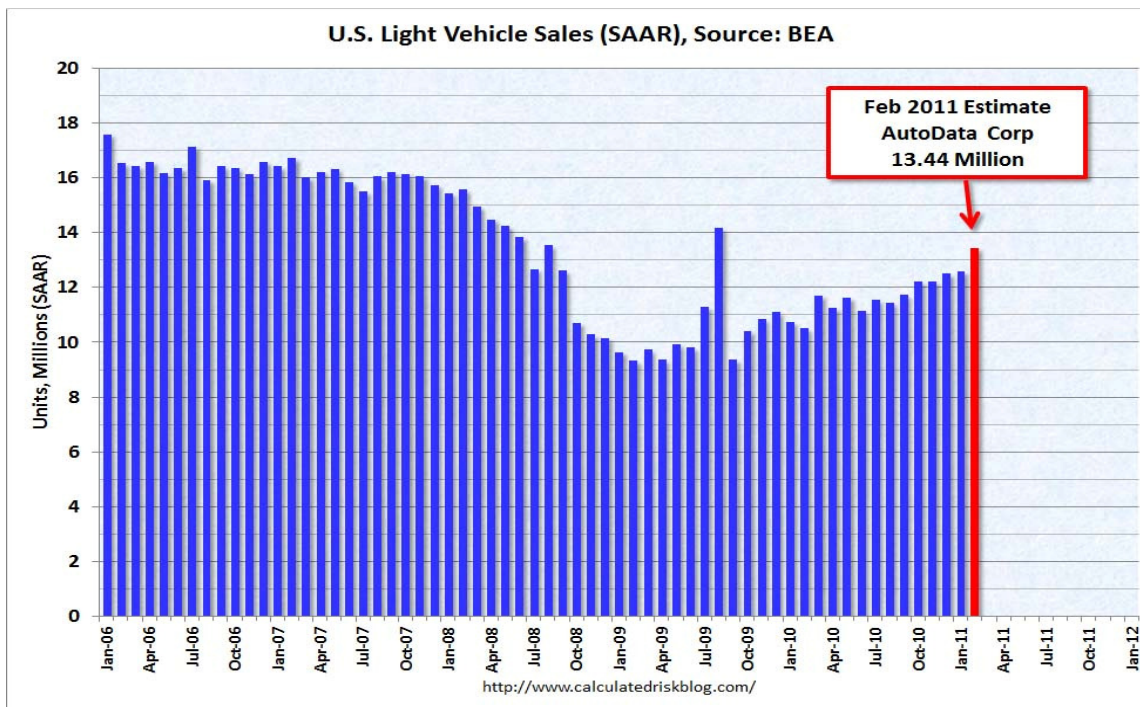
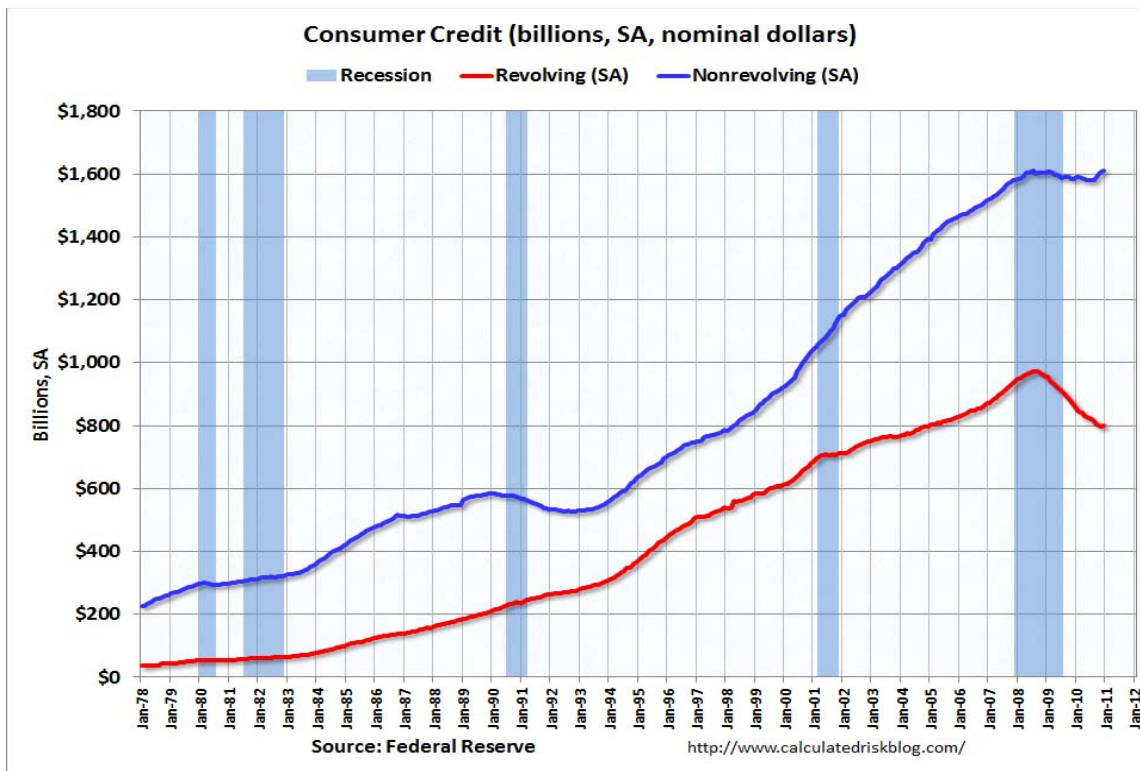
However, the end goal was to boost credit, asset prices and consumption. Certainly the stock market is up strongly since then and consumption has increased, but not for the reasons that Bernanke enumerated. So if QE 2 caused the stock market increase then one could say it was a success.

A third scenario would be that investors were front running the added liquidity that the Fed was injecting and momentum began momentum thus levitating asset prices. If this is the case, then one would expect asset prices to soften once QE 2 ends.

Which scenario fits reality is important because it leads to different conclusions about the health of the economy, earnings and the stock market.

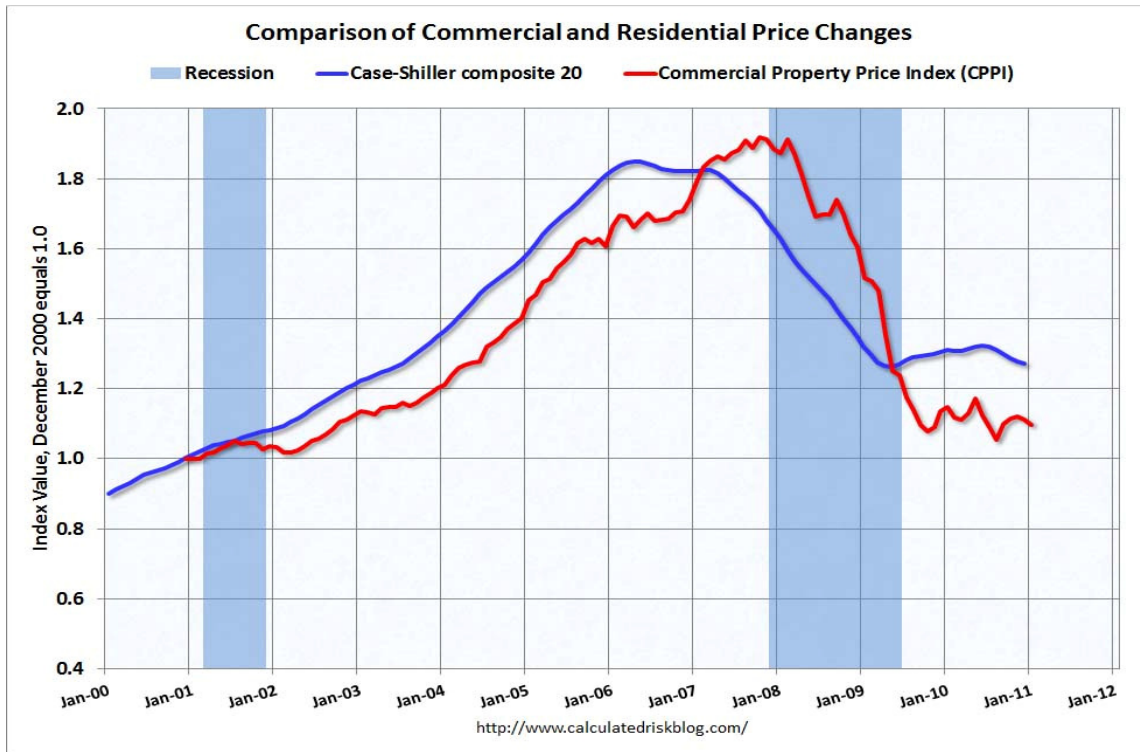
Indicators

Consumer credit growth will show if QE 2 has worked. As seen in the chart below, revolving credit is still contracting while non-revolving credit has seen a mild increase over the past couple quarters. The non-revolving increase is probably due to the purchase of autos which has picked up (see chart below), instead of housing. Honeywell has benefitted nicely from the auto growth. We have been underweight the financials in general and banks specifically as we look for signs of credit growth. You can see the solid credit growth from 1994-2007. This made financials a very attractive equity sector. QE 2 was supposed to jump start credit growth but the effect has been muted. Perhaps this is the start of another run by the financials, but we are concerned about credit quality given that home prices are rolling over again.



Home prices have begun to fall again. The Case Shiller Composite 20 has been dropping and is now within 1% of its lows in May, 2009. Home prices were temporarily supported by two home buyer subsidy programs in late 2009 and mid 2010. This had the effect of pulling sales forward into H1 2010. Now that those stimulus programs have expired, prices are again heading down. Since banks do not have to mark their real estate loans to market values, there may not be an immediate impact on their balance sheets and income statements.

However, with around 8 million home loans still in some form of default or foreclosure, home prices could still see significant pressure and banks could see larger losses when these foreclosures are sold. Commercial real estate prices also continue to be soft.

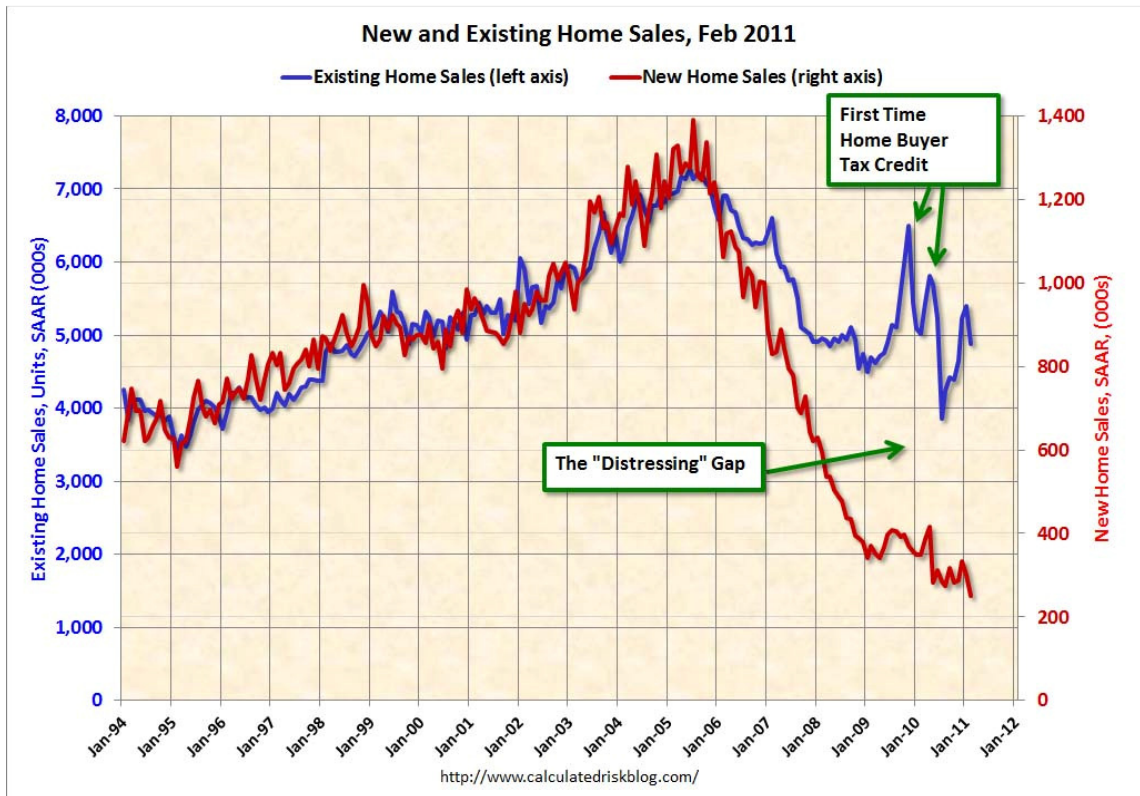


New home sales have been extremely soft. Last year this was due to an inventory overhang that had to be worked off. This year however it looks like new homes are struggling to compete with existing homes selling below replacement cost.

The impact from the home buyer tax credits can be seen below as sales spiked as these programs were expiring, only to resume there downward trajectory. We wonder if that might be a foreshadowing of what could happen if the stimulus is reduced.

Mortgage purchase applications have now fallen back to mid-1990s levels.

So although QE 2 was supposed to spur on real estate, it has not had that effect yet.



GDP growth has been running around 3% the past few quarters which is fairly solid. One would expect employment, wages and retail sales to be strong.

The unemployment rate has been coming down from a high of 10.1% back in October, 2009 to 8.9% in the February, 2011. However, the labor force participation rate has dropped from 65.1% to 64.2% over the same time period. This 0.9% of the population is not considered to be unemployed even though they have not found a job. So if you add them back in, unemployment has not improved much.

US real average weekly earnings are down in 4 of the past 6 months and are currently running at a -4% annual rate. Some of this is caused by increasing inflation which is deducted from the nominal number. But one would expect better wage growth given 3% GDP growth.

The Johnson Redbook reports that retail sales have been down the past three weeks in a row. This is following a strong 4 week period, but one would expect continued strength given solid GDP growth.

In summary, QE 2 has provided more liquidity to the market and that has helped the stock market. This created wealth for shareholders and in turn led to wealth effect spending which has helped consumption in Q4 of 2010 and the beginning of Q1 of 2011. Higher end retailers like Nordstrom and Tiffany have done well, while average American retailers like Sears and Kohls have lagged. We believe that consumption will need to broaden out in order for the recovery to be self-sustaining. So far, that is elusive. If consumption does not broaden we would expect either QE 3 or softer markets ahead.

A quick word about inflation. One risk of QE is that it fuels inflation. As the Fed prints money the US dollar becomes worth less and prices of commodities priced in USD go up. This feeds back into higher costs for companies which are passed along in the form of higher prices. For companies, it makes earnings guidance more difficult. If the price increases cause units sold to go down then net margins and net income could suffer. Nike recently reported soft margins and earnings due to increasing input costs. We will see if this is an isolated event or spread more widely.

The calculation for CPI has changed over the years. Some commentators have calculated that inflation would be around 8% if the 1980s method were used today.

The current core calculation methodology is comprised of 42% owners equivalent rent. With foreclosures and home prices going down, some people have concluded that it is better for them to rent than to buy. This is increasing demand for rentals and increasing the rents. We spoke to a large real estate investor who said that for 10 years, the rents on their class A properties stayed steady. Now, with the increase in demand and occupancy, they expect significant increases over the next 5 years. This would put upward pressure on 42% of the core CPI basket. The Fed has been trying to increase inflation. Be careful what you wish for.

Best regards,



Thomas H. Forester
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