

# Market Outlook March 2011

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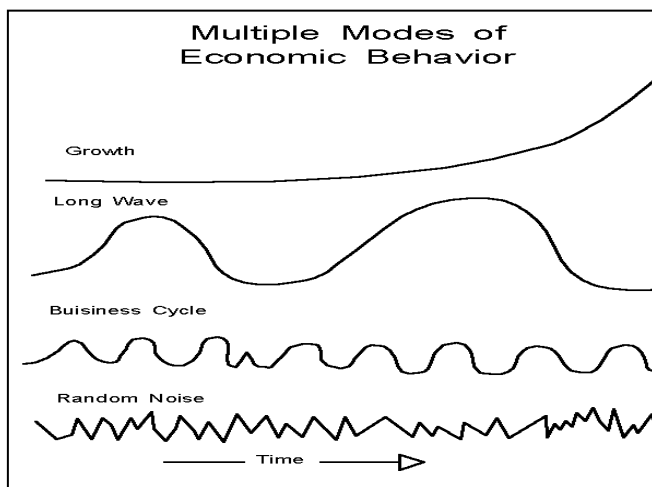
## Social Values and Political

### Fragmentation: Right on Schedule

Lost in the daily cacophony of 24-hour news, instantly politicized media scrutiny, and fashion models posing as financial analysts is the truly long-term view of how our society has gotten to where it is today. This isn't referring to the typical 3-year "long-term" of Wall Street, but a very long-term view that encompasses the balance that must occur to survive.

If you think about it, any political or economic system that survives over the long-term must have ebbs and flows because they rebalance the system. No economic sector can indefinitely grow much faster than the economy at large. No asset can consistently have higher returns than its underlying variables. No political system can move forever to the left or right. The ebb and flow is rebalancing, but painful, as we see today.

Karl Marx was a bright man who missed the rebalancing nature of economic systems. He looked at the political and economic



scene of his time (mid-1800s Europe) and saw only one side of the cycle. When he looked at capitalism, he saw a mechanism by which the rich got richer. When he looked at the social democracies of his time, he saw moves to the right, then stability, then further moves to the right. He assumed that if this trend continued, eventually the system would implode. It didn't, because wealth concentration was invariably followed by wealth dissipation. Social modes are neither progressive nor regressive; they are cyclical. Through rebalancing, the system (i.e. capitalism) has prospered in the long term.

In this Market Outlook we track historical ebbs and flows in economics (we have about 150 years of good data) and social mood (through political platforms and elections). This brief history of the Social Value Cycle is based on work done by John Serman of MIT, Zvi Namenwirth of the University of Connecticut, and Henry Galliot, former chief economist of the Federated mutual fund family.

The foundation of the Social Value Cycle rests not upon traditional business cycle analysis, but on the concept of the "Long Wave" business cycle. This is a concept new to most investors, since the primary focus of economists and academia is on business cycles. Yet for long-term investors, it is the Long Wave which is the most important cycle, and least understood. Like a glacier, its procession is imperceptible to the eye, yet it can change the landscape dramatically over many years. Investors can spend their entire lifetimes in one half of the cycle, not recognizing the changing environment until it is too late.

The chart at left idealizes the main modes of economic behavior. "Growth" is the relatively steady expansion of society's wealth due to population growth, technological progress, and the accumulation of human capital (knowledge). For the U.S., the annualized 150-year growth trend of real GDP has been about 3.4%. The Long Wave appears as a slow-moving curve with long-lasting periods of rise and decline. While subject to great variability, it is estimated that peak-to-peak cycles of the Long Wave have lasted 45 to 60 years in the U.S. since the 1800s. The "business cycle" appears more rapid and shallow by comparison; typically a few percentage points of growth from peak to trough. Historically, the business cycle has been three to six years in length. Finally, "random noise" is the weekly and monthly data that Wall Street worries so much about.

The genesis of the Long Wave is the long-term ebb and flow of capital creation. The most recent trough in this cycle was right after WW II, as the U.S. underwent extensive post-war rebuilding. Before we could produce the consumer goods we wanted, the machine tools and factories that produced these goods had to be built. Factories required ways to get raw materials to them, requiring development of transportation systems, which in turn required production of equipment for the transportation industry, etc. The demand for capital stimulated further demand for capital. There was a very powerful self-reinforcing process that continued for many years and pushed the standard of living well above average.

### Real GDP Growth Rates (% annualized)

1894-1923	3.82%
1924-1938	1.01%
1939-1973	4.22%
1974-1982	2.02%
1983-2000	3.67%
2001-2010	1.68%

As capacity catches up with demand, the expansion phase peters out, with the result that the capital goods sector is larger than required for the long run. Capacity caught up with demand in this country in the early 1970s. Excess capacity first appeared in heavy industries such as autos and steel, then spread to durable goods industries, services (e.g. airlines), and ultimately to real estate and the government sector. This created a self-reinforcing

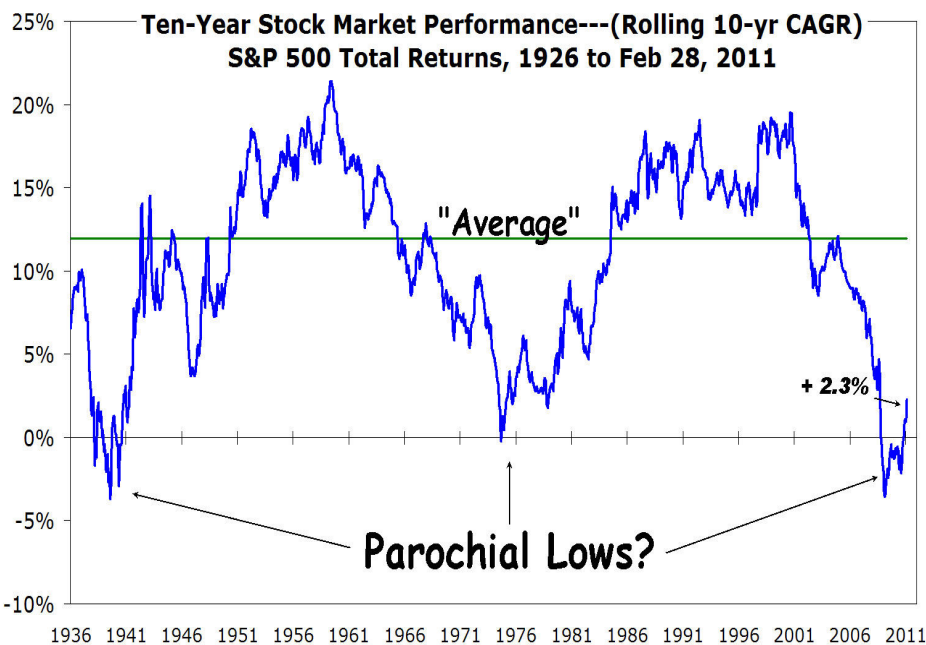
cycle that cut into demand well into the 1980s, as the same process that powered the upswing worked in reverse to drag the economy below its growth trend rate for over a decade. The accompanying chart shows the marked differences in growth rates during these broad expansions and declines.

The most recent economic recession was brought about by an excess of financial capital, rather than physical capital such as factories and inventory. The long decline of interest rates from 1981 to today has provided ample opportunity for the financial sector to encourage borrowing and refinancing until the capacity to fund the debt merry-go-round was exhausted. Like historical Long Wave troughs, the collapse of the credit bubble has created the current self-reinforcing cycle that is cutting into demand, causing huge dislocations in the financial and housing markets, and exposing major defects in government budgets that have been years in the making. The “creative destruction” of the 1970s took place as factories were shuttered, production increasingly moved to Asia, and talent, capital, and labor was freed up for the age of high technology brought on by the invention and application of the computer semiconductor. Creative destruction today can be seen in the wide swath of bank and corporate bankruptcies, the real estate foreclosure quagmire, and widespread stress among over-leveraged federal, state, and municipal governments.

**Ebb and Flow in Finance**

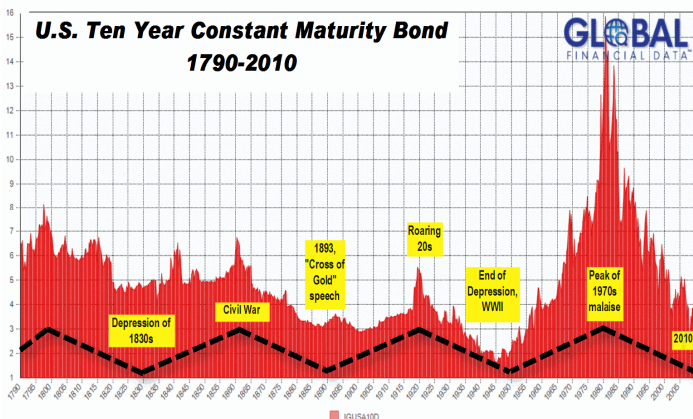
Although there are long-term averages that can be calculated for any economic statistic, when viewed through the Long Wave lens one realizes that hardly anyone experiences the “average.” In reality, there are long periods of above normal returns, followed by long periods below normal.

This effect can also be seen in the returns among financial investments. Stock returns, measured as a 10-year compound



annual growth rate (CAGR), show large troughs in the late 1930s in the late stages of the Great Depression, and the mid-1970s as America shifted from an industrial to a service/technology economy and struggled with OPEC’s supply shock. Today, we are at another trough, witnessing the end of the “financial era” of the last 30 years, due to heavy borrowing and a collapse in real estate prices. Clearly, hardly anyone over the past 80 years has gotten the “average” return (about 11.5%). They got way above average, as in the late 1990s, or way below, as you can see from the most recent readings (+2%). These extremely low ten-year returns are consistent with Long Wave troughs in the past.

Bonds, too, have been subject to the influence of a Long Wave, as interest rates have risen and fallen in alternating cycles of about 30 years from trough to peak. As capital creation got underway in earnest, creating rising GDP and incomes, inflation



had also taken root and pushed interest rates up. Note how the long-term trend on bond yields has superseded the much smaller effects of the business cycle. While rates fluctuate with the business cycle, those swings are quite shallow compared to the broad secular rises and falls shown in the chart below. Though interest rate trends (above) don’t match the presumed parochial S&P 500 lows, *turning points* in interest rate cycles seem to roughly match parochial eras.

**Social Mood and the Long Wave**

The Long Wave cycle is so powerful that the pressures it creates spill into our social and political institutions. An analysis of social mood by Namenwirth and others was conducted by studying political party platforms, state of the union addresses, key speeches, and major social legislation and is dubbed the Social Value Cycle. It is based on the theory that political parties exist to be elected and re-elected, and therefore, perhaps more than any other institution, have an interest in capturing the mood of the electorate. A social mood is not a theory for them, it is the reason they win or lose elections.

Under this model, the social mood of a country cycles around four phases:

- The progressive phase—when liberalization occurs with government becoming actively involved in social policy with justice and equity becoming dominant cultural issues.
- The cosmopolitan phase—in which a wealthy, confident nation is outwardly focused, has little hesitation in telling others what to do, and is fairly imperialistic.
- The conservative phase—in which stresses appear, economic issues come to the fore, and the focus turns inward.
- The parochial phase—by far the least attractive phase, and often driven by economics, it is characterized by

<b>Political Value Shifts During the Long Wave</b>	
<b>Long Wave Phase</b>	<b>Social Value Cycle Phase</b>
Expansion	Progressive
Peak	Cosmopolitan
Decline	Conservative
Trough	Parochial

high social stress as divisive issues dominate, often with moral overtones. It is a very difficult time for political parties.

While these phases are far from exact, and the timing of the cycles occurs with great variability, it is interesting how history follows this model in a broad sense. A brief stroll through U.S. history illustrates the cycles.

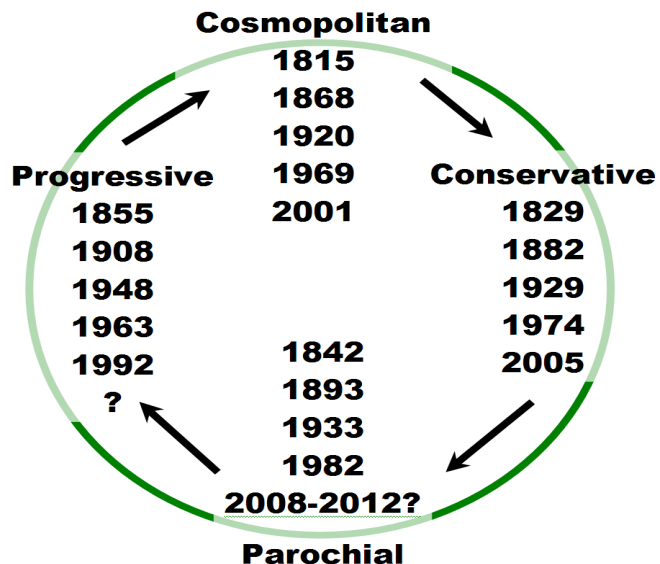
During Long Wave expansions, political values tend to become more liberal, as rising incomes and economic security seem to provide a basis for more cultural “risk-taking” in a society. This is the “progressive” phase of the Social Value Cycle. Public mood is focused on civil rights, social equity and justice. Examples include the abolitionist movement (circa 1855), Child Labor Act and women’s suffrage (circa 1907), and the Civil Rights movement (circa 1959). Two of today’s most intractable financial commitments, Medicare and Medicaid, were born in this period as Lyndon Johnson’s Great Society vision was implemented. But business is good, and there is confidence about jobs and spending.

At the peak of Long Wave expansion social mood moves into the cosmopolitan phase. There is an outward-looking, almost imperialistic attitude in society. Wealth creation is in high gear during these periods, and the population is very confident about itself with little hesitation in telling other countries what they should be doing. Cosmopolitan periods have occurred around the time of the Napoleonic Wars (1816), the Civil War (1860s), World War I (1918) and the Vietnam War (1967), and each represented a bid for dominance of their respective continents. In 1969, the ultimate exploration quest was achieved--Neil

Armstrong walked on the moon. Fast forward about 30 years to 2001 and 2003, and we find ourselves initiating invasions of Iraq and Afghanistan in the wake of the 9/11 attacks. That period also coincided with the peak in S&P 500 returns (+20%/yr for ten years!)

As the Long Wave declines, the conservative era emerges. Conservative eras have been marked by major economic slowdowns, and rising fears of job security. 1829 marked the beginning of major depression of the 1830s-40s. Late 19th century depressions began in 1881. 1929 saw the infamous stock market peak and subsequent Great Depression. In 1985 we saw a peak of a conservative phase, with the popularity of Reagan and Thatcher and conservatism in economics. A deep recession in the early 1980s was followed by major dislocations in farming, S&Ls, and real estate. Pro-business and anti-government sentiment during these phases has often led to massive tax reductions. In the 1870s, Civil War taxes were reduced to the point where the income tax disappeared by 1880. In the 1920s the highest tax rate was reduced from 73% to 25%, and in the early 1980s rates dropped from 70% to 28%. Many thought Ronald Reagan unique in this regard, but in a sense he arrived right on schedule.

Finally, the parochial phase represents the trough of the Long Wave, and is the nastiest phase of the Social Value Cycle. It is marked by weak business cycles, rather extended recessions, and an increase in government regulation. Also characteristic is a debt “hangover” as the exuberant lending of previous days is replaced with bankruptcy and falling asset prices. Moreover, the social focus shifts inward. Individuals are out for themselves; the only way of bettering one’s lot in life is at the expense of some other group. Examples would include the rise of fascism in



1920s-30s Europe, America’s isolationism in the 1930s, the malaise of the late 1970s, and the heightened religious tensions directed against Muslims in America today. When we look at the divisiveness today through this model, it’s easy to consider that

we may be at the low end of the cycle, that is, somewhere in the parochial phase.

One of the key similarities among parochial periods is the great difficulty the political parties face. For example, between 1836 and 1860 no president was ever reelected. There were nine presidents in 24 years. The period saw the rise of the Know-Nothing party, an anti-Catholic, anti-immigrant, anti-Semitic group that was a kind of secret society.

The next Long Wave downturn was in the 1870s to 1890s. Two parties evolved, the Democrats and Republicans. They became indistinguishable, however, as neither wanted to deal the thorny issues of rising monopoly power (Rockefeller, etc.) and the not so pretty side of capitalism, increasingly violent labor-management struggles, and the decline of the agrarian economy due to rapid and unchecked industrialization. In the five presidential elections after 1876, the average margin of victory was only 1 ½% of the popular vote, and in three elections it was ½%. During this period the economy was going through weak business cycles and deep depressions punctuated by financial panics. Naturally, these came to haunt the party in power, and they would lose their ability to carry on or get re-elected. Parochial periods are a fertile time for new political parties to sprout, and this period was no exception. The Populist Party rose to prominence and their power culminated in the 1896 “Cross of Gold” speech given by their failed presidential candidate, William Jennings Bryan.

Unlike the 1800s when European problems came to America, in the 1930s our problems went to them. In previous parochial periods, parties had a very difficult time getting re-elected. Roosevelt’s presidency was unusual in the opposite way—he was elected four times! Though the economic stresses were painful, World War II made it a politically stable time.

In the 1970s, we had three presidents in ten years as Nixon’s resignation put Ford in office, who then lost to Carter. Economic issues dominated the headlines this decade, as industrial America gave way to a nation dominated by services and the microchip. This generational dislocation generated racial agitation against Vietnamese immigrants and an increasing number of illegal Latin Americans as the early 1980s dawned.

Listening to the quality of political debate today makes it easy to envision we are many of the signs that are consistent with parochial periods of the past. The rise of the Tea Party, the back and forth changes in the control of congress and the unwillingness of its members to deal with our *really* big problems, the backlash against public sector employees, and the xenophobic tone of almost any discussion of Muslims in America all have precedent in American history. It also says the gains either political party may enjoy will be short-lived as voters seek quick answers to the problems that dog us, which narrowly-focused politicians fail to deliver. This lesson hasn’t been lost on Republican presidential candidates, who are just now hesitatingly

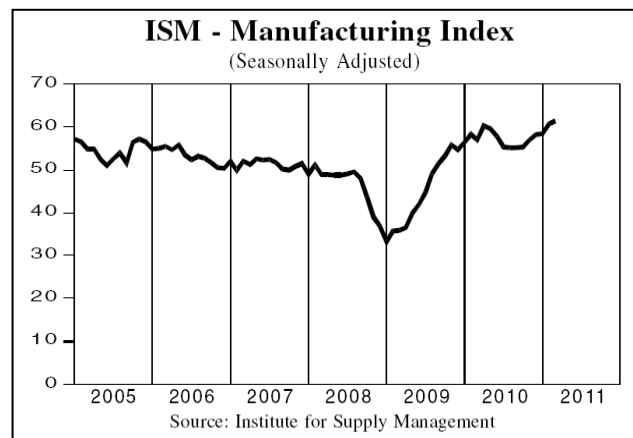
throwing their hats in the ring. Becoming president today is quite hazardous, to say the least.

Based on the economic, political, and cultural environment today, we seem to be moving through the parochial phase of the Social Value Cycle. The bad news is that we can’t tell how far along this phase is, nor how long it will last. The good news is that if the Social Value phases repeat, at least in a very broad sense there may be a more optimistic period following our current malaise.

Can we look forward to a “progressive” phase some time in the next 30 years? It sounds farfetched, but capitalism’s “invisible hand” has proven its adaptability over time, managing to hold together despite lurching from boom to bust and back again. Can our society find the backbone to deal with the daunting challenges of debt, slow growth, reluctant politicians, and threats from abroad? Probably, because we have solved intractable problems before. Is there reason to believe our will to carry on is less now than it was in times past? I don’t think so, but the process of owning up to our self-made problems (precarious debt levels), and then working on solutions for them is a messy, tense, and fractious affair. Political power will vacillate back and forth until the right leaders are found, who will either lead an effort of “shared sacrifice,” or have it thrust upon them. So political fragmentation will continue, along with the negative campaigning, surreal promises, and spineless short-term thinking that goes with it. It’s likely to be frustrating for the left and right alike, but as mere Band-Aid solutions run out, the collective wisdom of voters will grind toward a resolution. And from that a progressive period may emerge. If the Social Value Cycle has any validity at all during these dark days, we can take comfort from Winston Churchill’s comment about America, “You can always count on Americans to do the right thing - after they’ve tried everything else.”

### The Markets Today

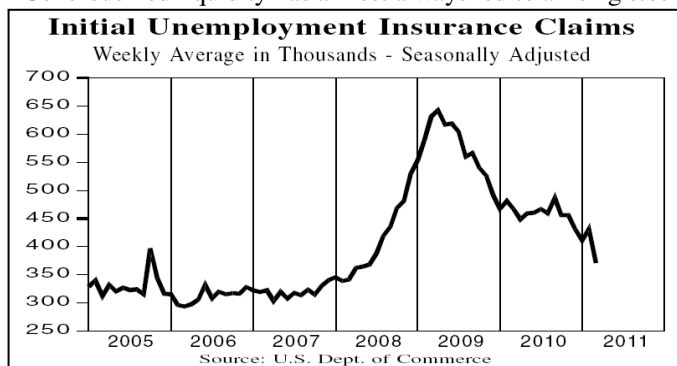
Stock markets had been enjoying a long rally from summer 2010 when they were jolted by the twin crises of rapid Arab revolution and the disastrous earthquake in Japan. The economic landscape thus changed mightily in the first quarter of 2011, and probably not for the better. Tunisia’s fall is the earliest of these events, but



happened only in January of this year, therefore it is too early to

be certain what effects these upheavals will have. They would seem to argue for higher energy prices as Libya burns and the Japanese make up for lost nuclear power with higher oil imports. We would also expect continued pressure on business and consumer confidence as factories are idled while the Japanese supply chain is rebuilt. Coupled with the struggle to rein in municipal, state, and sovereign spending, growth is likely to be anemic, consistent with a parochial low.

Up until now, the Federal Reserve's efforts to pump up the economy via "quantitative easing" (QE) were bearing fruit, as industrial production and stock prices were up, and initial unemployment claims were down. In normal times, this extreme of an increase in the money supply by the Fed would have caused a boom brought on by loose money and borrowing. Today, even though liquidity is extremely "loose," that money is finding its way only grudgingly into the "real" economy (via loans), but quite easily into the "paper" economy of the stock market. Generous Fed liquidity has almost always led to a rising stock



market, and that's been the case over the last six months. But the opposite is true also. With the QE program scheduled to end in June of 2011, we will have to be watchful for the effects of *liquidity* on the stock market, in addition to the effects from oil prices and Japan.

The market correction of March was on its way to rapid repair as of this writing, as investors seemed to shrug off the twin shocks above. While it is hard to believe the economic outlook has brightened over the past month, it is possible to believe that Bernanke's QE can move prices higher for a while. But the correction came from a level of overbought stocks, overly bullish sentiment, and heavy insider selling, all indicators of elevated risk. As such, client accounts have had significant cash to cushion that risk, and also to take advantage of price declines. Nonetheless, our focus this quarter has been on preserving gains, rather than heavy buying. With many measures having gotten to short-term "oversold" levels, securities are slowly becoming more attractive, but only selectively. It will be important for stock prices to reverse recent key sell signals (advance/decline line, etc.) before we can expect broad uptrends to resume in a sustainable way.