

Market Commentary December 2011

Recently, macroeconomic factors have dominated the news across all financial media outlets. Between the tough employment situation here in the United States and the debt crisis in Europe, many investors have shifted focus from company fundamentals to the macroeconomic environment and a more “top down” way of thinking. In their defense, the current situation in Europe cannot be ignored. Yields on bonds issued by several struggling European countries have risen dramatically over the last 10 months as investors continue to demand higher rates for holding high-risk European debt. The chart shown below, which uses Greece as a proxy for distressed nations, illustrates this dramatic increase in bond yields. Notice that the yield on German debt has remained steady, indicating a much stronger financial position than Greece.



Source: Bloomberg, Clifford Swan Investment Counsel

Many of our clients have asked why the U.S. equity markets have reacted so swiftly to what is happening in Europe. The short answer is that European defaults could lead to a serious contraction in European GDP, which would domino into a global, economic slowdown. Additionally, in the event that Greece, Italy, Spain, etc., default, U.S. financial institutions would be left holding worthless sovereign debt. The recent bankruptcy of MF

Global, a once reputable securities firm, is the first clear indication of the fallout potential for this concern.

All financial companies on Clifford Swan's approved list have been reviewed for their exposure to European debt, and we are confident that none of these companies will turn into the next MF Global. We are cognizant that some banks may have hedged their Eurozone debt exposure by essentially buying an insurance policy on this debt from a counterparty (another bank or entity). The stability of that counterparty, and its ability to make good on the insurance policy, does add another possible layer of risk. That said, especially with the mortgage meltdown counterparty fiascos so fresh in bank executives' minds, we believe that this "counterparty risk" is minimal.

The above analysis regarding the stability of financial companies is one illustration of a "bottom-up" approach to managing macroeconomic issues, such as the Eurozone crisis. In this case, our analysts' rigorous research into our financial companies' fundamentals, trends, and valuations provides the information we need to assess the risks each is exposed to in changing macroeconomic factors. We would never buy or sell a security based solely on the macroeconomic environment. In fact, we often find that macroeconomic turmoil presents opportunities for many of our quality companies, as is the case now.

As a result of both the current macroeconomic backdrop and a general aversion to equities, the U.S. stock market is poised for a period of strong growth. Valuations are attractive, fundamentals are solid, balance sheets are stronger than ever, and companies have cut costs to the point of maximum efficiency. The last 10 years were very unique in that we had two bubbles pop in a short period—internet companies in the early part of the decade, and the housing market in the latter part of the decade. It is doubtful that the next decade will see a similar trend. Rather, we anticipate a move back to normalcy (7%- 8% equity returns). Those who have reacted to the recent market volatility by shunning equities in favor of other asset classes could be in for a rude awakening. Let's explore this in more depth.

In relation to bonds—the second most liquid asset class—equities look attractive. The biggest indicator of this attractiveness is the difference in yield on the 10-year Treasury versus the earnings yield on the S&P 500 (inverse of Price/Earnings ratio¹). The current yield spread is 6.4% while it has averaged 0%- 2% over the last 50 years. The last time the spread was this wide was 1974. Subsequent to 1974, equities outperformed in the one, three, and five-year investment periods.

Recently, Colgate (a Clifford Swan company) completed a bond deal, setting the yield on its 10-year issuance at 2.45%. This is the lowest yield on record for a 10-year corporate bond issue (Bloomberg). Currently, the stock has a dividend yield of 2.6%. Given the low risk and stability of a company like Colgate, we would much prefer a little pickup in yield combined with the potential capital appreciation of the stock to the lower yield of the bond. In a nutshell, when Wall Street gravitates towards bonds in a herd mentality, we lean towards equities. Over the very long run, large cap stocks always outperform inflation and bonds, particularly Treasuries. See chart below:

Wealth Multiples for U.S. Asset Classes and Inflation

December 1802-December 2005

<u>Asset Class</u>	<u>Return</u>
Inflation	16 times
Treasury Bills	4.8 thousand times
Treasury Bonds	19.5 thousand times
Large-Capitalization Stocks	10.3 million times

Source: Pioneering Portfolio Management, Swensen 2009

Another way to think about the attractiveness of stocks relative to bonds is to look at 10-year Treasury yields in terms of nominal GDP, which is sometimes used by investors to approximate a “fair bond yield.” In our current environment, GDP and inflation are growing at a long-term average rate of approximately 2% and 2.5%, respectively, setting nominal GDP at about 4.5%. Currently, the 10-year Treasury yields approximately 2%, which means that bonds are not keeping up with inflation, let alone nominal GDP.

In reviewing real estate as an alternative to stock investment, we believe that stocks are likely to provide greater safety. The thought that real estate cannot lose value was disproved in the last few years, and property devaluation was dramatic in many cases. The housing market is still in disarray and distressed properties are the only inventory that has moved significantly (which, in some cases, could provide some interesting opportunities). It is important to note, however, that the real estate market is still in flux, and that it will take some time for it to stabilize before its next upswing.

Gold could be used for portfolio diversification in case of a catastrophic economic event (currency devaluation, hyperinflation, etc.). However, it is difficult to evaluate gold as a viable substitute for stocks. The very foundation of our investment process is our search for businesses that generate significant free cash flows with high returns on capital in industries with substantial barriers to entry. Gold cannot be qualified by any of these characteristics, thus we have a hard time with its valuation. As a pure investment, stocks do, and will continue to, outperform gold or any other precious metal over the very long run.

When we look more closely at the stock market itself, we find additional reasons to be optimistic. Using the S&P 500 index as a proxy for the entire stock market, the trailing Price/Earnings ratio (P/E) on this index is currently 12.5x, representing an earnings yield of 8%. The average bear-market bottom P/E is approximately the same at an earnings yield of 8%. This gives us some comfort that equity markets are close to, if not at, bottom, and may be nearing an inflection point signaling outperformance over a multi-year stretch. In addition, average interest rates at bear-market bottoms are close to 7%. Currently, with interest rates at 2%, it seems the earnings yield should be higher. Some would argue that using P/E as a valuation tool is flawed as earnings drastically decline when heading into a

recession. For those with that viewpoint, Price/Book might be a purer, more stable metric. Currently, Price/Book on the S&P 500 is 2.0x. Historically, Price/Book for the index has ranged from 1.5x-5.0x. So again, we are on the bottom end of that range signaling that stocks present a compelling value.

Stepping away from the index and focusing on Clifford Swan companies, we tend to invest in higher-quality companies than comprise the entire index. Thus, if we are wrong in our growth projections, and equities continue to lag, our companies should still outperform. With our focus on companies with stable business models, a strong history of paying and increasing dividends, conservative management teams, and attractive valuations, we expect our client portfolios to withstand another recession, just as they have in the past. Clifford Swan companies simply have less business risk than the average company comprising the market.

In conclusion, we believe that market psychology is far too negative right now. Investors have been burned as of late, and their recent memory is trumping any sort of rational behavior. Stocks look attractive both as a stand-alone entity and relative to other asset classes. If Warren Buffett is any indication, he put more money to work in investments last quarter than at any other time in the past 15 years. Much of that money was invested on August 8th, 2011, the first day of trading after U.S. debt was downgraded from AAA by Standard & Poors. It is during times like these when, instead of being shy, equity investors should be aggressive. As Mr. Buffett has said time and time again, "Be greedy when others are fearful."