

THE VIEW FROM PRINCETON

Market Commentary ♦ February 2011

MORE

**EXPECTATION
OF EXTENDED GROWTH
MUST UNDERLIE
INVESTMENT
STRATEGIES**

After two years of bold share price appreciation and eight consecutive quarters of rising earnings for most large industrial companies (and now early in the ninth consecutive quarter) what is to be expected hereafter? MORE: End of memo! Yet, not so fast; for is it not commonly regarded that fulfillment of readership value requires words, words, and more words? Even directionless soliloquies are too often fashioned as value rendered. Hence, the following memo that explains reasons for a continuation of highly supportive circumstances for equity investing provides pages of words (as customary in the trade). The paragraph headings in the margin allow a quick skip through.

Economists, as they describe the cyclical patterns of national production, largely agree that the American economy has emerged from the recovery phase from the 2008-09 abyss into a growth phase. These are typically the longer lasting phases; however, the growth phase entered recently will be slow (3% or less), burdened as it is by chronic unemployment in certain industries and certain locales. The important aspect is this: The improvement has become self-regenerative, and probably durable — in totality, generally supportive to equity investments.

And now, with help from a second cocktail, or extra strength Tylenol, expect herein a few mind benders and a return glimpse into the dangerous absurd, as an alert to the greatest of foreseeable hazards.

**EXTREMELY LOW RISK
IN SHARES
OF REDOUBTABLY
STRONG ENTITIES
DISCIPLINES
SELECTIONS
FROM LESSER
ENTERPRISES**

There are two quite opposite considerations for risk aversion. First, from the affirmative side of life, the most basic of considerations is presented by a question: Why should one assume incremental risks when the safest of equities promise, as now, a total investment return (dividends plus appreciation) well above the overall American experience of long-term investment in shares? These first and foremost of considerations are seen in the very evident undervaluations of major telecommunications providers, for which dividend yields range from 5% to 7% from clearly safe companies in America, Canada, Germany, Spain, and other nations. The fundamental assurance stems simply from the life-long evidence that message sending is ever increasing.

Additionally, shares of most electric utilities provide high dividend yields, as the depressed prices reflect anxieties over adverse regulatory decisions, the sponsored use of alternately sourced electric energy, and encouraged societal constraints upon energy use (the cheapest of energy is that saved by disciplined use). The share prices seem to show no intent to capitalize the prospects for the transition toward electrically powered automobiles (and other vehicles) that will be plugged in at night for battery regeneration — at night, when other use is sleeping and electric generation capacity in underused. This is one of the importantly large aspects of innovation and change. It could be money in the bank broadly throughout the electric utility industry, which, the facts would seem to indicate, will be augmented by prospective reductions in fuel prices (oil, gas and coal).

**WORRISOME
CONSIDERATIONS**

On the opposite (sobering) side, there are worrisome factors that dispose investors toward risk aversion. And, as the most horrendous of mind benders, there is a concerted effort most earnestly pursued by the financial industry to secure their formerly assumed privileges. If politicians and the agencies of government allow again such unbridled wantonness of large private funds and financial institutions, you can predict another financial collapse, delivered by the same friends who gave us this last one.

**WILL WE
LEARN FROM
LOOKING BACK
TO A FOREST
OF HORRORS**

If the thought of going back to the inherently disastrous model (with its conjured instruments, practices and permissiveness) doesn't tend to keep you sleepless, try reading the enclosed report from the New York Times (Saturday, January 1) regarding massive computerized trading organizations. Or, for deeper and morose thinking, try the just released Congressional Panel's report. This compilation of probing (and sometimes deceptive) comments was acquired for our staff as worthy keepsakes for historical perspective, and much more. If you would like a copy, call us and ask. If there be a return to the market's former model and mode, it would be just as easy to foretell the inevitability of a disastrous collapse as it was difficult to perceive the timing, or the vastness of the outer limits of the consequences of the 2007-8 experience. Put this aside for the time being; that is, on a wait list not to be forgotten.

Except for farmers and speculative traders, another negative influence that recently gained in scale is found in the rise in agricultural product prices, following the advances in oil and many material prices. Such agricultural price advances can have widespread implications, owing to the cost increases for processors, the distorting of trade balances between nations, the pressuring of currency valuations, and the preemptively compressing of household spending everywhere. Moreover, to the extent the price advances in materials and farm produce are driven by financial speculation, both financial assets and materials are diverted from flowing orderly through trade channels into more productive applications. Thus, this all becomes a deterrent to social growth at a time when growth is too slow.

**SUPPORTIVE
CARDINAL
CONSIDERATIONS**

The most protrusive of supportive factors and forces for investor consideration as perceived are these:

Large corporations in America (say the Fortune 500) and those elsewhere are driving the world's economic growth. Most observers give too little emphasis to this. American companies have never had so much money to spend. They have the sophistication, the presence and the incentives to spend for strategic expansion. Management can never leave cash idle for long.

Large private funds and certain financial institutions are driving prices of materials and produce upward to employ their abundant sums. Equity shares also sit in the pathways of their interests, which will claim more of their attention as material prices become less attractive.

The American stock market requires very little, or no, additional help from external circumstances to sustain a long general advance in prices. In contrast, long advances in stock prices usually have the benefits of inflowing money, a vigorous economy, and an optimistic populace.

Our stock market seems to be filled with self-sufficiency owing to (1) growth in corporate earnings, (2) their huge cash balance positions which will be deployed to buy their own shares or shares of others for enhancement of their growth, (3) the cheapness of so many shares (and excessive valuations of only a few) and (4) a relatively cheap dollar, which entices foreign capital into shares and into lowered priced real estate, and, further, aids American business in selling their products beyond our shores.

**BASIC
THESIS**

Our investment thesis reiteratively expressed throughout 2009 and 2010 (after the full interventions by governments had effectively buttressed against systemic collapse) can be distilled into the simple phrase, “physical factors will prevail over negative emotional factors to effectively elevate prices of equities of sound and thriving enterprises.” Events have validated that thesis. The thesis is still as valid as it has been from the bottom of the 2008 market; notwithstanding the portion of prospective gains already attained as share prices have risen.

Though it is never possible to know what will happen, it is always necessary to have a course of action in addressing the future: Act bullishly. It is not necessary to feel bullish, that is the beauty of this moment, as for months past. Act bullishly because there are still so many mispriced marketable securities still remaining, and such a redundancy of money within the marketplace dominated by professional investors. There are attractively priced equities aplenty. There are overvaluations of high quality credits because of extremely low rates of interest still encouraged necessitously by the Federal Reserve System. That will end during the ensuing months.

**STAY WITH
A POSITIVE
COURSE OF ACTION**

As interest rates rise for short-term items, high quality long-term credits will be in a downward pricing pattern. This is not expected to be very severe, because the total of demands on the capital markets from all sources is much reduced, irrespective of all that you read about the Federal deficits and the deficits of state and local governments. On a consolidated (net) basis, self-sufficient corporations supply funds into the market. This began several years ago. This is truly extraordinary, for in virtually every previous year since World War II American corporations had been net users of capital drawn from the capital market. Their contemporary huge cash balances, and generalized prosperity, now act to return capital to the marketplace through purchase of money market items, through purchasing of their own stock, through buying in of shares of others for mergers, acquisitions, or for investments. In all of these instances, they circulate money from their product sales toward the capital markets. Those who do not perceive this as a fundamental will doubt our expectations.

**REPAYMENT
OF HOUSEHOLD DEBT
IN EXTRAORDINARY
SCALE**

Household debt repayments have for months exceeded new extensions. For short-term installment debt there is nothing unusual about this for a recessionary period. This happens because of the short duration of debt, and scheduled repayments override reduced new extensions. But do make note of this: For the first time since the 1930's, residential mortgage repayments began to exceed creation of new mortgage obligations. The financing of residences has ever been the largest (by far, greatly) of net users of long-term credit.

**PLENTY
OF FINANCIAL CAPITAL
TO FINANCE
GOVERNMENTS**

Financing the deficits of the Federal government and of state and local governments poses no prospective stress upon the markets, nor an enduring effective lifting factor on interest rates. The reductions in total residential mortgages is the most extraordinary of changes — from an aberrantly large expansion of mortgage debt in the first decade of this century to a shrinkage in the use of mortgage debt owing to repayments, foreclosures, and in some instances, a tightening of lending terms. This has not happened before. So, do not worry about the markets ability to cope with the outpouring of debt from state and local governments, and from further Federal deficits. The rise in public debt, and reduction in scale of household debt, seems to be set in circumstances that will endure for months, possibly a few years.

It seems probable that the American dollar has entered the bottom ranges of its substantial decline. Further weakness would very likely bring more problems than benefits for investors.

The ferment of popular dissent through Mediterranean and more eastern states has the potential to rattle markets for stocks and currencies everywhere, which analysis and expectations cannot fathom. The equanimity in which the American stock markets have withstood such uncertainties seems to represent the extent to which investor attitudes had shifted toward optimism.