THE VIEW FROM PRINCETON

Market Commentary ♦ August 18, 2011

DISENGAGED MUSING IN THE SHADE, WITH NO TELEVISION NEARBY

(you might wish to refill, or fortify, your lemonade before reading, or begin at Page 3)

First, an acknowledgement: My hope for the benefits of surcease from raucous political vying and from the machinations of overgrown hyperkinetic financial markets during slower-paced August is corroded by the recurrent incursions of morose ruminations. Yes, a river swollen and sullen runs through it. Sadly, Americans spend so much of their energies in hurting themselves. A reminder was delivered in the form of the rating agency shaving the top rating on the credit of the United States of America. Such a high profile pronouncement is not something Americans can dismiss, or find acceptable. This is painful, notwithstanding the implications that the decision to downgrade, in the context of all things considered, seems to be a much greater negative comment upon Standard & Poor's than upon America.

Our clients must have noticed that we provided very little commentary regarding the matter of the debt ceiling, for how such a fracas would end (for the umpteenth time) seemed inevitable. There was no need to make so much of it. As the leader of the Republican House opined, there was a victory in this in that they had shifted the focus of discussion in Washington toward excessive government. Yes, but unwittingly also changed the focus toward voter disappointment (some say disgust) insofar as those elected to serve as their representatives were expected to make decisions in the public good, not as they did in the placing of political vying over the evident needs of our Republic. This was putatively a redux of the Republican Gingrich-led House in 1992 that went *ad hominem* against the incumbent President, Mr. Clinton, to the point of stalling Federal operations. The "law of unintended consequences" thereafter acted effectively to assist the reelection of the President for the second term.

The lowering by Standard & Poor's of the United States' credit rating provides a wake-up call, and it also calls attention to one of the most dismaying aspects of the financial scene. For one who had the good fortune of spending the 1950's at Moody's Investors Service (at the center of institutional investing and debt financings), it seems that rating agencies have "sold their birthrights for a mess of potage" (read mess of prosperity). Debt ratings by the agencies have become little more than shallow labels, vacant of careful analysis in their perceptions of possible prospective events, as well as in contemporary interrelationships among bonds by categories. After Moody's was sold to Dun and Bradstreet (1962) and began to sell their credit ratings for fees (S&P soon following), ratings were placed on the skids toward venal shoddiness at best, and were meaningful to few other than traders who could trade the labels for a quick turn. At Moody's, in earlier years, there was experience-guided careful scrutiny, and simulations were considered for the consequences of whatever might happen during the tenure of a bond. The integrity of the ratings was sacrosanct. These became embedded in societies, much as the metric system is. It was not a question of whether the triple-A rating was too stringent in the necessary qualifications, or that it was too liberal; it was a question of keeping ratings constant. This changing of the credit rating of the United States is a vitiation of that dear concept.

The credit of the United States is now, and for the foreseeable future, unsurpassed. The top AAA classification along with the creditworthiness of the United States will probably be shared henceforth with a few other sovereign states as the rightful benchmark from which all other credits are measured. This downgrade is a bit like saying the twelve-inch foot should not be twelve inches, it should be eleven and three-quarter inches. Or, we should take several millimeters off the meter. Or, with a stretch, this is a bit like moving the marker that sets the Greenwich Meridian. This downgrade in the credit of the United States cannot be taken lightly; the effects on capital markets everywhere are rippling through in ever widening (but thankfully attenuating) force. It is general and not severe. Such nonsense often evaporates and is forgotten.

In the traditionalist mind, this recent-year neglect of virtuous analysis for ratings has become a matter in its own right deserving social attention. Some, as I, would be willing to say criminal negligence substituted for the former integrity underlying the ratings. The laxities were made abundantly apparent in the lack of analysis or foresight regarding mortgage-backed fiascos in 2007-2009, or for the disastrous Enron and Worldcom debacles. This recent downgrade of the United States' credit smacks of a lack of social awareness, as well as a disregard for a job that society has expected of the rating agencies. It raises the question of what else might be expected from these three agencies that bear the public trust, and have accepted their incumbent duties so cavalierly.

Can any human doubt America's credit is stronger than it was in 2007 before the financial disaster struck? Can anyone doubt America has grown in strength every year since 2008? The rating agencies in recent decades respond after the fact, while ratings (if they have inherent worth) are considered to be quotients of risk for events in years ahead that might not validate one's expectations.

Clients might also have noted that this Firm has not made much of the credit crisis regarding the smaller Mediterranean nations, including Ireland and Iceland. These do not all fit into the same category other than a bad apple in the barrel puts approximate others at risk of contamination. We regard this largely as a matter of relative scale, and another passing piece of half-spurious excitement presented by the financial world, which prospers on exaggerating instances (if the trader is writing the script, or is close to those who do). For instance, look at the GNPs of these nations: Portugal's GNP – $247 billion, Ireland's GNP – $172 billion, Greece's GNP – $318 billion. The three largest oil companies (Exxon, Royal Dutch and BP) are each larger than Greece. Altogether, the three nations are less than one-third the size of Germany.

The financial world certainly made a lot of noise regarding the crisis, causing politicians and financial leaders to pose for many pictures, including multiple handshakes between France's President Sarkozy and Germany's Chancellor Merkel. But, if you see the relative proportions of Germany's GNP, one can quickly come to the conclusion that one way of handling all this would be for Germany to just buy Greece and maybe several of the others. The point meant to convey in these allusions is that the crises, as experienced, are in the financial markets and among political bodies. These are not spewing from the commercial spheres. The appropriate time for concern regarding sovereign debt comes when debt expands rapidly, not years later when credit default swaps dramatize the vulnerabilities. The interactive coincidence of Europe's financial malaise with another American financial epileptic spell reverberates worldwide and augments the baneful extent of potential harm. Even so, bet on commerce to win, as history guides. The real crisis is not in the scale, but in a lack of unity and a sense of purpose.

The "forgotten" basic use of Federal debt — or the unnoticed "elephant in the living room" — is the military and related expenditures. For America, protected east and west by extensive areas of ocean waters and unthreatened north and south by much smaller and friendly nations, it scarcely seems necessary that we have fought four wars of our choosing since World War II, and that we maintained an outsized military budget that we refused to pay for on a current basis. None of these wars were very popular with American people, and thus taxing to meet expenditures currently for unpopular causes was not politically expedient.

Waste and graft in large government involvements or contracts are as inevitable as the sunshine, but cuts should follow contemplative analysis where cuts are not simply a reduction. These should also bring benefits in the form of relief from graft, increased self respect, and good feelings broadly. It is not a question of turning away from the needs of the poor or the helpless; it is a question of seeing ourselves in terms of wastes, and of a new array of opportunities. Hopefully, this might be brought into being by a new form of "social environmentalists" who would first clean the streams of contentiousness.

So what are serious minded investors to do? We advise paying attention to how prosperous and vigorous most of America's major corporations are, like never before. For nine consecutive quarters revenues have grown by uncommonly large increments. And so it is similar for counterpart large companies in Europe, Russia, Japan, China and India. And for the present growth period, America is not leading (as the engine pulling the rest of the train) for the first time. The United States is one, interrelating with other nations, both large and small, whose growth rates approximate or exceed America's. This is to be expected to continue for immediate years.

Our commentaries have reiteratively cited that these major industries have persistently grown since 2008: energy, agriculture, healthcare, communications, electronics, and entertainment (very broadly defined). The scale and vitality of these extend slowly to others, and compensate in part for the impaction of the financial industries excesses upon the residential housing industry and the stringencies experienced by state and local governments (that formerly were bulwarks of strength in other recessions). The disappointing slowness of economic growth is not cause to discourage ownership of equities of thriving companies; rather, the slowness is supportive by way of extending extraordinarily low interest rates. Our viewpoint, apparently in the minority, has served clients well. Stay invested with unusually high proportions in strong company shares. Stay the course.

Especially, it is pleasing to find mutually shared views with persons who are demonstrably blessed with outstanding acumen, experience, and alertness. A qualifying small group in New York City would stand near the top of anyone's list for excellence and experience-guided judgment. This is Craig Drill Capital, created by Craig Drill toward the end of the 1980's after a distinguished career in a leading Wall Street firm. In their July commentary, "Stock Market Observations", they end with this brief itemization that follows a recitation of the negatives that seem to stymie so many other persons.

> *"While the US economy struggles, growth in corporate profits and free cash flow is robust. Almost half of the sales of the companies in the S&P 500 are coming from outside the U.S. In addition, unit labor costs (about two-thirds of total business costs) remain stable, while revenues rise. The cost of capital also remains low."*

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> *The U.S. stock market is selling at a P/E near 13X bottom-up consensus EPS of $98 for 2011 and at 2.2X current book value. This valuation is compelling taking into account prevailing interest rates and inflation, dividend yields, strategic and private market value, and preferential tax treatment for long-term capital gains and qualified dividends.*
>
> *Moreover, cash-rich corporations are returning money to shareholders through share buy-backs and dividend increases. Shareholder value is further benefiting from mergers and acquisitions, as well as debt reduction and restructuring.*
>
> *Interest rates will also remain low for an "extended period," and that extended period will keep getting extended. The monetary punchbowl remains on the table, and it is "Happy Hour" for the pricing of drinks…for those who want to drink."*

When persons of such caliber so closely concur with the judgments here, yes, there is comfort in having another in the same minority.

All things considered, the American recovery is proceeding with remarkable persistence, notwithstanding the dismaying slowness that is still constrained by 1) the depth of the damage done by the financial collapse, 2) the overbuilt stock of residential dwellings, 3) the suppressing impact upon state and local government budgets, and 4) most importantly, the lack of coherence and comity in national perceptions and dialogue. Notwithstanding the foregoing, this bad-taste-in-our-mouths recovery is writing extraordinary longevity daily into the record books. There must be vigor and strength somewhere that minds, set by denial, do not comprehend.

DOGGEREL FOR OUR TIME
(or the unreality of contemporary reality)

Hey diddle-diddle (*read trading funds*)

The cat and the fiddle (*read the Congress*)

The cow (*read Goldman Sachs*) jumped over the moon.

The little dog (*read SEC*) laughed to see such a sport,

And, the dish (*read lawyers*) ran off with the spoon.

So what else is new?

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