



PLIMSOLL MARK CAPITAL

Market and Economic Overview – A look in the rear-view mirror

Economists have a word for what's going on at the moment. It's 'hysteresis', which comes from the world of physics. It describes a state where the effects of a policy have many different possible outcomes, regardless of the inputs. This is in contrast to a deterministic system, where you can predict the outcome for a given input. In other words, it's a fancy way for economists to tell you they don't know what's going to happen.

When we look at the behavior of markets in the first quarter of this year, we can see this in action. For the first couple of months, markets worried about what the Obama stimulus package would look like; they worried about the parlous state of the world economy; they watched in horror as corporate profits vaporized; and as a result, they went down and, not only did they go down, they went down dramatically. From the beginning of the year until the trough in early March markets recorded declines of 24% (World Index), 25% (S&P 500), 21% (FTSE 100). Even after the sobering experience of last year, this was hard to take.

Just at the darkest moment, though, things turned on a sixpence. The cusp was, arguably, the release of the details of the latest bailout package in the US – TALF or Term Asset Backed Securities Loan Facility. There are too many details in the package for a letter like this, except to say that the ambition of the program is vast and the money slightly less so.

On the heels of this, we had quantitative easing (or the printing of money) in the US, UK and Japan, and then the G20 meeting wasn't a disaster, even if it didn't achieve much beyond proving that the Eurozone is run by people who like form over substance. Bolt on a slackening of the pace of decline in the global economy, and presto; you have the ingredients of a spectacular global equity rally. From that trough to the time of this writing, the World Index has risen 24%, the S&P 500 23% and the FTSE 100 14%, although they are all still down year to date.

Going Forward what does it all mean for the Global Economy?

Turning first to the global economy, it is possible to draw a basic distinction between those parts of the world which have structural problems and those that don't. Despite the precipitous decline in exports, developing countries, particularly in Asia, are suffering more from cyclical problems than secular ones. Banking sectors are generally in good shape, government and personal sector finances are fairly robust, and there are attempts underway to shift the balance of the economy (most obviously in China) away from exports and towards domestic consumption.

This suggests that once things stabilize, the developing markets may be among the strongest candidates for recovery. Whatever happens, however, the hope that there will be strength enough to bail the rest of us out is an arithmetic fantasy because there isn't enough capacity in their systems just yet. The only part of the world able to replace the broken US consumer engine is the European consumer, and there is little hope there. As is now clear, the developed world has structural problems which will take an extended period of time to resolve. This brings us to the problem of letters.

The letters causing this problem are 'V', 'L', and 'W'. These describe the possible shapes to be drawn by the global economy over the next couple of years. The 'V' school expects the downturn to be followed by

a sharp bounce, and for everything to return to normal quite quickly. The 'L' school thinks the economy will fall and then go sideways for a long time as the excesses of the noughties are excised. This would be a bit like what happened in Japan during the '90's. The 'W' school expects a bounce after an initial decline, but then another leg down as policy tightens to squeeze out the spectre of inflation and to correct for the fiscal profligacy which underpins the bounce.

A "W" means a looooong Wait

At Plimsoll Mark, we think the balance of odds favours the W's. The monetary easing we have already seen, coupled with a variety of fiscal stimuli, should combine with attempts to smooth the furred plumbing of the banking sector and provide the conditions for an economic recovery. Given the amount of liquidity pumped into the system, this will have the capacity to be highly inflationary once the global velocity of money starts to pick up.

Up to now, velocity (or the rate at which money flows around the economy) has been declining because it is correlated with overall economic activity which fell off a cliff in the last quarter of 2008. Add to that the damage in the banking system and monetary velocity has been slowed to a mere trickle causing all sorts of concerns about deflation and a global depression. However, once a recovery starts, the creation of so much liquidity by the world's central banks will quickly feed inflation. The investment environment at that point will depend on how the central banks react to this dramatic reversal in the primary threat from deflation to inflation.

In sum, there isn't an easy fix because either we are set for an extended period of weak (i.e. below potential) economic growth or for inflation and future price bubbles. How bad is it? As a rule of

thumb, the echo effect of a decline in aggregate net worth usually results in a corresponding loss of approximately 30% in real annual economic output as measure by GDP - meaning that for every \$1 decline in net worth, \$.30 of GDP is blown away. This relationship between GDP and net worth is a function of a concept called the wealth effect. The wealth effect simply tells us something we intuitively already know and that is that the wealthier a consumer feels the more likely they are to spend money and the poorer they feel the tighter they hold their money and the less likely they are to spend it.

In the US, the wealth effect is particularly pronounced because consumer spending drives almost two thirds of the US economy. In the US, the aggregate loss in wealth as a result of the collapse primarily in the housing and financial markets was equivalent to almost all of annual GDP. Let's repeat that, the aggregate decline in US net worth as a result of the recent collapse in the financial and housing markets measured in terms of dollars was equal to almost one year of US GDP causing the consumer to feel significantly less wealthy.

Using the ratio introduced previously where for every \$1 of net worth lost results in \$.30 of economy activity going away, this negative wealth effect suggests that real economic activity in the US will only stop going down and start rising again after the process of creative destruction has stripped 30% of the output from the US economy. Think about that for a minute, if this ratio holds true then 30% of the US economy has to go away or be transitioned to more productive areas before, it can start rising again.

With the destruction of the financial and auto industries leading the way and almost complete, it appears that by year end the US will have experienced

about half of the expected decline in the economy with the other half still left to go. New government programs already in place suggest that the remaining 15% loss in US economic output will probably occur gently and over an extended period of time resulting in a prolonged period of sub-par growth rather than swift and violent down-draft that we just experienced which translates into a protracted period of just bumping along until it can get going again.

We leave it to the politicians to decide which has a more favourable impact on a society - that is, bite the bullet and cause great economic dislocation or cushion the fall and suffer the consequences of a stagnant economy over time. Letting the air out of debt bubbles is truly painful. And in Europe where reality has not yet hit home, the situation is just as bad or worse because of the aging demographic profile of their population and their hard tilt toward regulated economies.

It seems like things are getting better but....

While the proximate causes of the recent stock market bounce have already been enumerated above (i.e. massive injections of capital from new governmental programs, a decrease in the rate at which the real global economies are declining and the inspirational boost from a meeting of worlds economic leaders), most investment managers have begun to feel that they understand what is going on. Most would probably even agree with the idea that economic growth in the developed world will be anemic for a long time, and that the banking system still hides a lot of risk. It is legitimate to ask why, then, are they feeling more optimistic?

The answer probably lies in the rate of change. Things are not getting worse more quickly. They are still getting

worse, but more slowly. The first part of any downturn always has the greatest momentum because it is when businesses run their inventories down to adjust for a new level of final demand. That process looks as if it has run its course, and lies behind some of the data around at the moment indicating that the economy is getting better. We, on the other hand, see harder times still ahead for most of the developed world's economies.

Don't swing at the first pitch - Be Patient and Be Selective

This doesn't mean that there are not money making opportunities to be found. We believe we are truly at an inflection point where the growth in the developed economies is going to be muted and the action is going to be in the developing world as they dramatically increase their economic output, standard of living and demand for their share of the world's resources. It will take some time before we can feel and see the tangible results but we do believe we have reached the tipping point.

In equity markets, as the tide goes out, the scavengers trawl through the mud to see what can be saved and what can't – some assets are cheap, even if, in aggregate, public equities appear to us to be fairly valued. Although earnings forecasts are still falling, unemployment is still rising and corporate financing remains precarious, the system itself no longer looks as if it will collapse altogether. The government has made it known that the banks will be nationalized if TALF fails.

Further, many investors were forced to sell into falling prices because of pressure from redemptions. A new language has grown to describe how investors have had their liquidity curtailed – 'gates' designed to open rarely and only allow small redemptions;

'side-pockets' where fund managers stick assets they can't sell. The hedge fund industry which sold this illiquidity under the wrong labels (e.g. risk arbitrage, market neutral, portfolio insurance, etc.) will shrink or disappear, but we believe the majority of that forced selling is behind us.

To be a successful investor in this environment requires discipline and patience. To use a US baseball analogy, be selective and don't swing at the first pitch because there are lots of opportunities out there and we are still in just the first inning of a brand new game.

In your portfolio, think Global, High Quality and watch out for Inflation. Equity investment also looks more sensible today in a world where the lower the risk, the more expensive is the asset class. 'Low risk' assets like Treasuries offer no protection against the inflationary monetary and fiscal policies that the Administration, the Fed and their fellow central bankers are explicitly executing. Cash has no yield and that makes it expensive to hold. And investors who bought equities at most points over the past 25 years have not earned any premium (over 10 year bonds) for the extra risk taken.

This suggests that either capitalism is fundamentally broken, or the next 25 years will be different. It is always better to buy risky assets after they have fallen and after they have fared worse than non-risky assets and not the other way around. This is not to call the bottom of the market, but it does argue that it is time for long term investors to start adding risk to their portfolios. Economists may be suffering the effects of hysteresis; it is vital that investors don't take this as an excuse for paralysis.

At Plimsoll Mark Capital, we have thoughtfully considered the fundamental changes in the global economic environment and the pricing of financial assets across markets. This

has led us to begin the process of gradually adjusting our tactical asset management models away from an ultra defensive approach with an extreme focus on capital preservation and deflation protection. As a result, we have started to add to very carefully selected growth opportunities in commodities and emerging markets. In addition, we are focusing our core high quality equity investments in those capabilities that emphasize global trade opportunities as part of their stock picking discipline. In client portfolios, we want US and European domiciled companies that can benefit from global trade as well as direct investments in emerging markets and commodities.

In much the same way that the ancient Greek philosopher Diogenes carried his lantern throughout Athens during the daylight seeking the "truth", Plimsoll Mark Capital travels the globe constantly in search of those very rare and high quality investments capabilities to add to our client portfolios at the appropriate times.

Sincerely,

The PMC Global
Investment Committee

Bill Hall (Maine)

Tom Barry (NY)

Bruce Lueck (NY)

William Garrett (London)

Jim Awad (NY)

Steve Bates (London)

Steve Canter (NY)

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