



PLIMSOLL MARK CAPITAL

“Wall Street people learn nothing and forget everything.” Ben Graham.

The first quarter of 2010 has seen investors wobble slightly, then find their bearings and allow the tidal wave of liquidity to carry them forward. On balance markets have been benign, reflecting reasonably positive economic and corporate news, with an apparent recovery under way. There have been, however, one or two uncomfortable moments: the first was when the US, in the shape of former Fed Chairman Volcker, announced plans to regulate banks more vigorously than those much maligned banks would like; the second was when Greece was revealed to be the Achilles heel of the Eurozone; and now we have a glimpse under the tarpaulin which was thrown over the toxic debt mess, and it's not pretty.

These wobbles might well have been enough to cause the wheels to fall off a less robust wagon, but wagons don't come any more robust than when underwritten by the people who have the capacity to print the money. At any sign of trouble the Fed reminds investors that interest rates are going to stay low for the foreseeable future, and that governments around the globe stand ready to anaesthetise the patient at any sign of pain. On an encouraging note, there are some signs that economic activity is improving: purchasing manager surveys point to growth; capital spending seems to be picking up; and, even the beleaguered consumer is spending a bit more than the pessimists expected.

Plimsoll Outlook: Uncertain Times

There is good and bad news but for now the continued stimulus of the global economy—that is, the printing of money—is keeping problems at bay and the good news is likely to trump the bad. Unfortunately, this is not likely to go on forever.

It's important to remember that this is not a normal recovery. A “normal” recovery is led by strong consumer spending. Given the degree of government stimulus injected into the patient, if this was like every other post war recovery we would be well into a robust economic advance by now. *Something else* must be happening. That *something else* is called deleveraging, or paying off debt. Over the course of the last five decades debt has risen sharply in the developed world and has reached levels never seen before. There have been academic studies which try to define how much debt can rise in relation to overall economic activity, but nobody really knows the answer. Even now they don't know, but we do know that once confidence is undermined, in this case by an unholy mix of subprime mortgages and financial market implosion, it's enough to start the process of deleveraging.

There is another phrase which the financial wordsmiths have coined to express all this – “the debt supercycle”. The theory is that debt builds up gradually over a very long period, underpinned by financial market innovation and the absence of economic shocks. Something bad happens to reverse this process, and it unwinds back towards the mean. The memory of the damage caused by leverage prevents the accumulation of new liabilities until the next generation is in the financial saddle.

In our view this is a plausible explanation for what is currently happening. Consumers and businesses have begun to reduce debt, but overall financial liabilities are not falling because governments have stepped into the breach. At some point, however, markets will begin to worry about funding of government debt and solvency, as they have in the case of Greece. Indeed in many countries, government bond yields have already begun to rise.

On the other hand, there is a possibility that capital spending by corporations may spur a more self-sustaining recovery, ultimately leading to significant job creation and better consumption growth. Today capital spending is growing, due largely to government provided incentives and demand from the emerging world. Our worry about this trend is that interest rates are already rising in emerging markets on signs of economic overheating and a lot of idle manufacturing capacity remains on the sidelines. Moreover, more rapid growth today in the developed world has minimal impact on the expansion of government debt. In our view, the risks are tilted toward the likelihood of a prolonged period of sluggish growth in the world's developed economies.

There are a lot of elephant traps out there, ranging from the unravelling of the Euro, to overheating in China, to nascent trade wars and to the prospect of toxic debt as yet unaddressed. All of these appear containable as long as the scale of the stimulus remains as large as it is now. But unless a much more normal economic recovery takes hold in the next few quarters, an outcome we think unlikely, the stock market will likely begin to anticipate the reduction of stimulus resulting from a change in Fed policies or some mix of spending cuts and tax increases.

Plimsoll Policy Response:

Over the past three decades, we have experienced an overall decline in interest rates from the mid-teens to virtually zero today. This decline in interest rates and the resulting increase in debt levels provided a significant tail wind for financial assets, and the economy as a whole. Looking forward, it would seem that we are entering a period where the inverse will be the norm. A rising interest rate environment will represent a secular head wind, benign or not, that will cause a fundamental change for investors.

The last time there was an extended period of rising interest rates - 1962 to 1982 - stocks increased slightly in nominal terms but decreased slightly in real terms. This condition resulted in periodic liquidity crises, thereby affording great opportunities to buy stocks, but not conducive to a "buy and hold" strategy. This all supports the need for the Plimsoll's inflation/deflation approach to asset allocation and the consideration of alternative asset management classes.

At Plimsoll, we are focused on the targeted rates of return required to achieve your investment objectives, employing a mix of vehicles intended to provide diversification and dampen potential volatility. The key here is selectivity – selectivity in the asset categories in which you invest and selectivity in the managers to whom you entrust your precious investment capital.

Thematically, we are looking abroad to find the long-term drivers of growth and capital appreciation in our portfolios. Specifically, we are seeking the proper balance between US domiciled companies that have a strong global distribution platform and direct investment in the emerging market based companies. The Plimsoll investment committee added to the emerging market exposure in our baseline portfolio during the first quarter. This adjustment was based on our belief that selected emerging markets will enjoy a widening growth advantage over developed economies in the environment ahead. For US company exposure, we are focusing on strong balance sheets (those without a lot of debt) and secure dividends.

We also believe that resource based investments in certain carefully selected commodity funds present potentially interesting opportunities when purchased at the appropriate price. And finally, we think that there may be opportunities in a broad range of distressed assets if money is placed with talented fund managers having the analytical resources to discern the gems from the gravel. In summary, our investment strategy involves moderating risk, maintaining a fair level of exposure to global markets and opportunistically deploying capital when the environment is right for a particular asset category (like distressed assets and commodities).

Proceed with Caution

It often takes a considerable amount of time for the economic impact of politically driven policy decisions to play out in the financial markets—today’s environment reflects the distinctive policy decisions made over the past eighteen months. For the most part, the influence of those policies is still in force and will likely continue to support the markets until a shift to less stimulative policy is anticipated. The emergence of a strong self-sustaining recovery could mitigate this outcome, but we believe this is less likely.

At Plimsoll, we treat your capital as if it were our own and in doing so we use our considerable experience attempting to stay above the day-to-day commotion in the markets, taking a more strategic stance. There’s an old Wall Street adage that “bull markets climb walls of worry”, and that would be a fair description of what has happened since the current rally began. For now, though, we believe that the stock and bond markets reflect much of the good news out there - and that going forward it will pay to be selective and proceed with caution.

Our very best,

The Plimsoll Mark Capital Team