



PLIMSOLL MARK CAPITAL

Still not a time to be brave

*When thinking about our current position on the financial markets, our colleague in London, Steve Bates, said it best – **it is still not a time to be brave**. In our last quarterly commentary, written during the first week of April, we talked about adding well-selected positions in emerging markets, commodities and global franchise companies that could benefit from worldwide trade opportunities. My oh my, how quickly things change.*

Since that writing, those three groups have risen in price to the point where future gains, in our opinion, seem unsustainable from current levels. And in fact all have retreated somewhat from the peaks in price that they achieved in June. While Plimsoll continues to favor the longer term profile of the developing markets and also believes that a position in commodities will be required to provide protection from the inflation that we inevitably see coming, it now seems like a time to be patient, to keep some powder dry and to wait for what we think will be better entry points at lower prices in the future.

In our last writing we also discussed, how the letters of “L”, “V” and “W” were being used to describe what the shape of the global economic recovery might look like. As believers in the “W”, we were in the minority at that time with most economists and market commentators advocating for a “V” shaped pattern. Well, it seems that over the last couple of weeks, we have a lot more company in the “W” camp and despite the fact that it is starting to get crowded under our tent we have not changed our view. If anything, we have become more firm in our position that, in the developed world especially, things are going to continue to deteriorate but at a less rapid rate. As optimists, it is really painful to think about what an elongated “W” shaped recovery means to the developed economies in the US and Europe as they go through a secular deleveraging process.

However as seasoned investors, we know that whenever there is significant dislocation in the economic system plenty of money making opportunities present themselves. We continue to favor long term positions in emerging markets and global franchise companies. We believe that inflation protection will ultimately be necessary and we have a full list of investments that should do well in an inflationary environment, but it is too early to heap them on in a big way. We don't see the inflation boogey man knocking at the door yet and, unlike many, we think his early arrival is highly over publicized. We also know that there will be lots of opportunities in distressed assets of all types that have not yet presented themselves because banks all over the world are still holding them tight in an attempt to delay the almost certain write-downs.

Economic Review

The second quarter of 2009 was when the market laid to rest the “demon of depression”. Thanks to a \$1.8 trillion U.S. budget deficit and a \$1.2 trillion twelve month increase in the Federal Reserve's balance sheet the U.S. financial system was stabilized and a potential deflationary decline in incomes was avoided. This stimulus was matched in various degrees around the world, most notably in China. At the same time, emerging world economies (with the exception of Russia) have begun to do better and have “decoupled” from the sharper economic declines of the developed world.

Global stock markets reflected this shift in psychology. At the market lows of March, stocks had begun to reflect the depression outcome. However, with that fear off the table, markets rebounded in the second quarter.

Investors now know that governments globally are not going to allow the financial system to fail. Historically unprecedented bucket loads of liquidity are being heaped into the economy, pretty much everywhere, and the banking system is recapitalizing by taking advantage of access to almost free financing. As a result, price earnings valuation have recovered to historical norms, based on current earnings expectations, and stocks no longer appear significantly undervalued. The equity outlook now depends primarily on the path of the corporate profits, and the path of corporate profits depends primarily on the vigor of the economic recovery.

Furthermore, economic “green shoots” began to sprout in the June quarter. In spite of a 9.5% unemployment rate, the highest in 26 years, and in spite of declining consumer confidence in the latest month, deterioration in the US economy’s service sector slowed markedly in June. This is good news since services account for nearly 70% of the country’s economic activity. These green shoots will still need the fertilizer of a fiscal stimulus and the ample water of a supportive Federal Reserve to more fully develop. Governments are unlikely to soon reverse aggressive fiscal and monetary policy trends, in spite of rising inflation concerns. The question then becomes what happens in 2010 and beyond?

2010 and Beyond*

In the developed world especially in the US, consumers rebuilding their savings rate and debt reduction will be the hallmark of this era. Although, the solution may be as painful as the problem since consumption, accounting for over 70% of GNP, will suffer accordingly. State and municipal governments must find new tax revenues while they cut back employment and

services. The federal government faces the combined fiscal burden of past deficit spending, the current economic crisis and the healthcare/social security dilemma. The fiscal hole is growing deeper and deeper. Taxes will have to go up and there is talk of a national value added tax such as in Europe. Disposable income will be under pressure as fast as the eye can see.

This time it is really, really different. While easy money, increased debt and lower taxes have led every economic recovery since the 1970’s, higher taxes and continued debt liquidation will rule the restructuring this time. Plimsoll Mark expects a real GDP growth rate in the developed world of only 1.5% over the next three to five years, even from this depressed economic base.

In the emerging world, on the other hand, things are better. We see increasing opportunity with the caution that we have to be selective and get the timing right. We are using a 4% “real” growth rate for these economies, over twice that of the developed world. The structural issues faced in the developed world are absent. The emerging markets will continue to be led by Brazil, China and India. The challenge is to redirect these economies away from export dependence and towards domestic consumption. Put simply, relying on US and EU consumers to determine economic growth does not look like such a good idea anymore. While this will take time, we believe the process is already well underway.

But before we become intoxicated by the elixir of the developing world, there are some potential flaws in the emerging market thesis. The primary problem is that these economies are now big, especially China. And you can’t turn them toward domestic consumption just by willing it to happen.

It will take time, good policy and most importantly cultural change. Remember, we are talking about China, a country whose poor receive no medical treatment and, thus whose motivation to accumulate wealth and save is not only moral but Darwinian.

OK, let’s review where that leaves us when we look at the items on the Plimsoll scorecard:

- Inflation/Deflation – deflation remains a much greater near term risk and inflation while inevitable is not yet evident.
- Green Shoots – really happening, but more the natural echo affect of the collapse than a genuine revival.
- Government Stimulus – starting to peak and future policy intervention will be constrained by the capital markets concern over public finances.
- Emerging Markets – the halo is in place but watch for a short term valuation trap as everyone rushes in.

Have a terrific summer and we look forward to reporting to you in the beginning of October with a clearer view of 2010.

Our very best,

The Plimsoll Mark Capital
Global Investment Committee:

- Bill Hall (Maine)
- Jim Awad (NY)
- Tom Barry (NY)
- Steve Bates (London)
- Steve Canter (NY)
- William Garrett (London)
- Don Kurtz (NY)
- Bruce Lueck (NY)

* The statements herein represent Plimsoll Mark Capital’s views on 2010 and beyond.
Actual results may vary.