



PLIMSOLL MARK CAPITAL

“May We Live In Interesting Times” – a derivation of the proverb that is commonly referred to as the first Chinese curse.

The second quarter of 2010 was indeed one of those interesting and chaotic times. Equity markets fell across the board, while government bond markets rose. Investors around the globe became increasingly concerned about the uncertainty of the developed world’s debt-ridden financial system and, consequently moved out of stocks and into less risky investments. The so called “risk-on” trade which has dominated the financial markets for the past fifteen months (since March 2009) reversed itself to become whatever is the opposite of “risk-on” – probably “risk-off” – leaving many disappointed investors wishing they could adjust their own portfolios to be in the right place at the right time as quickly as Wall Street comes up with clever neologisms (the creation of new words or phrases). Whatever the arbiters of neologisms might call it, US dollar oriented investors saw their equities decline in value by around 10%, while Treasuries have risen by 5%, bringing back some recent unpleasant memories.

Plimsoll Review: Trouble in Euroland

It’s always easy to look in the rear view mirror to explain what went wrong. The axis of the current crisis lies in Europe, but the repercussions affected everybody. The problems began in Greece, and despite the fact that the Greek economy is really rather small (the whole country’s GDP is only just over one third the size of New York’s), the ramifications have forced investors around the globe to confront some difficult truths.

The first of these is that the Euro has been revealed to be a political rather than an economic construct. Over time, this has caused a series of unsustainable booms (in peripheral Europe) which can only be corrected by severe deflationary policies. It is not a question of whether Greece defaults, but of when. The jury is still out on the second tier offenders, but without some serious weakness in the Euro, it is unknown whether balance can be achieved without policies which could be socially damaging. As some commentators have pointed out, cutting unemployment benefits when fifty percent of those under twenty-five years old are out of work (as is the case in Spain) is not for the faint hearted.

The second development is that the fashion for fiscal rigor has gained ground. Just three months ago, markets were drawing a distinction between countries which had to take immediate action, like Greece, and those (like the US) which had a little more time to wait for the fiscal stimulus to feed through into what was hoped to be a self-sustaining recovery. In the second quarter, in an attempt to comfort global bond markets, the political mood changed dramatically with the announcement of packages foreshadowing fiscal retrenchment in most major countries. The only exception has been in the US, where we see no signs of a political appetite for cuts in government spending or reductions in social programs. Although even here, fiscal policy is tightening automatically as the Bush tax cuts are reversing and State and local governments are under severe budgetary pressure.

So, markets are trying to digest two important new factors – (1) the risk that the Euro might unravel, and (2) the fact that fiscal conservatism is the order of the day. And as if that wasn’t enough, the economic numbers are beginning to weaken because the stimulus packages that put a prop under the global economy last year have now run their course, and the inventory cycle has completed a turn of its wheel.

Plimsoll Outlook – Slow Growth at Best in the Developed World

Equity market prognosticators remain hopeful, of course, and profit expectations for this year and next continue to rise. In our view, there is no chance that these forecasts will be met. We are already scaling back our earnings expectations because the macro-economic picture has worsened, and the profit rises in aggregate have been the result of what investment types rather inelegantly refer to as “sweating the assets” (meaning firing workers and making the ones who are left work harder, out of fear that they too will lose their jobs if they don’t). If demand picks up, companies will have to invest more and hire afresh, and if it doesn’t, sales will fall. Either way as we see it, margins will be under pressure compared to where they are now.

Another sign that the proponents of “we are in the early stages of an economic recovery” are currently ignoring is that government bond markets (at least those not in the Emergency Room like Greece) are doing just fine. Despite the fact that absolute yield levels are at historic lows, institutional and private investors (not the Central Banks) have been snapping-up large amounts of Sovereign Debt. The reason is that there is a whiff of deflation in the air. As a result of weakening global demand and with short term interest rates at zero, the risk of a double dip recession has clearly risen. Should this scenario unfold, the policy tools to deal with a weaker economic environment have become more limited. Fiscal policy is now a prisoner of the bond markets and monetary policy is constrained by the fact that interest rates can’t drop below zero.

The most likely response is that quantitative easing (a fancy term for printing money) will start up again, particularly here in the US, and in Europe there could be talk of further fiscal laxity – a luxury the Europeans have foresworn. The financial crisis which began in 2008 is about to enter its economic phase, and the prognosis is that growth is likely to be subdued at best across the developed world for an extended period – perhaps as much as five years.

Plimsoll Policy Response: [Go Where the Growth Is](#) and [Deflation Protection](#)

Looking around for signs of hope brings us to the emerging world. In a developed world dystopia, emerging markets are the one area where the five-year outlook looks reasonably rosy. Growth will be much higher than in the developed world, and something approaching a normal economic cycle is unfolding, with interest rates rising to dampen inflation expectations in many emerging market countries. This will slow growth somewhat, but there is enough momentum in domestic consumption to make this collection of markets attractive over the next few years.

In keeping with the theme go where the growth is, we will add to our direct participation in the emerging markets when we think the price is right. The two primary investment vehicles that the Plimsoll Global Investment Committee has carefully selected for emerging market investments (among a vast number of choices) are the Lazard Emerging Markets Fund and the Harding Loevner Emerging Market Fund. Both of these mutual funds are managed by experienced teams and have outperformed their benchmarks over the past 12 months.

At the core of the Plimsoll portfolios is a focused holding in what we call “global franchise” companies. These companies typically have a global footprint and diversified business model which will allow them to prosper in an economic environment where growth may be hard to come by. They also provide exposure to emerging markets while maintaining strong balance sheets and many pay a dividend providing the proper balance between desired return and risk.

To protect against deflation, our clients have significant holdings in bonds and cash. Our largest bond investment that we are currently recommending, the T. Rowe Price Strategic Income Fund (an opportunistic bond mutual

fund with a broad mandate) has done very well.

This review may seem rather gloomy, but it should not have you reaching for the self-destruct button. Markets are in the middle of discounting the unpleasant developments detailed here, and at the end of that process, we believe they will offer good value. In the meantime, there are many asset classes which should fare reasonably in the current climate. This isn't the environment of the Nineties or the "Naughties" (another Wall Street neologism) but with the benefit of hindsight; we can see that much of that optimism was paid for with borrowed money. While we are paying that back, it won't feel as buoyant as it did then, but the world still possesses many opportunities for those who know where to look.

Our very best,

The Plimsoll Mark Capital Team