



PLIMSOLL MARK CAPITAL

Jousting with Shadows?

This time last year the global investment community was on the verge of a collective nervous breakdown. Few commentators could come up with a positive prognosis for markets in the year ahead—and we were no exception. Since then, however, many investors have gone on a buying binge, pushing aside concerns about the damage inflicted by the financial crisis. The problems are still there, but they have been shoved out of sight—a pile of old rags in a closet.

*A year ago, we titled our Review and Outlook “Early is the New Wrong”, and used this space to make the case for continued caution. **When we wrote that, were we merely jousting with shadows?***

At first glance, it looks as if we were. Stock markets have rallied powerfully nearly everywhere in the world. Bond markets have remained benign, with very good results in corporate bonds and respectable numbers in the government sector. Inflation has stayed low. Economic indicators have started to point upward. Emerging economies like China have recovered vigorously, anchoring a sharp rally in commodity prices. For most investors, the crisis is a fading memory.

Even so, we remain skeptical of claims that the economy’s and the markets’ problems are really over. This isn’t just some Puritan itch. We think our view reflects a more realistic interpretation of events than the current market consensus.

Fourth Quarter Market Summary

Here’s how we read the story of 2009: Governments around the world headed off a self-feeding financial catastrophe by injecting huge amounts of liquidity into the system. This required them to maintain very low interest rates and print lots of money (a practice that sounds less reckless when central banks label it “quantitative easing”). Many countries also implemented huge fiscal stimulus programs (think “cash for clunkers”).

These policies worked. The banking system stabilized, confidence returned and economies everywhere started to recover, with the customary lag of about a year. Economists generally agree that the original contraction is now coming to an end. Markets anticipated the economic recovery, as they always do.

So, you might ask, *what’s the problem?* For once, governments got something right!

The problem is this: The rescue saddled taxpayers with massive debt. The source of the money that is temporarily pulling the global economy out of its rut is not consumers (still struggling to pay down their own enormous liabilities) or businesses (banks remain unwilling to lend as the banks try to rebuild their own balance sheets) but from the public sector. This situation is unsustainable. Eventually, someone will impose order on government finances. If governments don’t do it themselves, the bond markets (who must finance all this largesse) will do it for them. The result will be significantly higher interest rates.

But wait, you say. Japan’s public borrowing is far higher than public borrowing in the U.S. and other developed countries - yet interest rates remain low in the land of the rising sun. Alas, two factors make the Japanese example less than reassuring. First, it is a distinctive feature of Japanese culture to save at very high rates, so the

government can finance deficits without recourse to foreign lenders. This is now changing as the population ages and is forced to draw on its savings. Second, Japan's real interest rates turn out to be higher than ours once you take into account the deflation in that country.

By contrast, U.S. consumers are loaded up to the hilt with debt, and many are beginning to stare down the barrel of uncomfortable (and likely delayed) retirements. As Americans increase their savings rate and pay down their debt, consumer spending and economic growth will decline. To counteract the fall in consumer spending, the Fed is counting on selling debt to finance the government's large stimulus programs. The buyers of the debt are largely foreign central banks, particularly China, and their continued cooperation is required for this scheme to work. Ireland and Greece recently discovered the limits of this approach when foreign investors dumped their bonds, leaving both economies in a ditch.

The New Normal

All this means that the recovery from the recent recession will not be a normal one. Economic numbers are likely to be reasonable for most of 2010, but public spending cuts and reductions in liquidity are likely to put economies on a meager diet in 2011. It's time to prepare for what venerable bond investor Bill Gross has called "the New Normal". Its components include slow economic growth; weak corporate profits; significant government regulation and control of the economy; and a consumer who stops buying and starts saving. It's too soon to say whether the economy will slide into the much discussed "double-dip recession", but we think that at the very least growth will be slower than usual—and markets will discount slower growth well in advance.

As long as central banks in developed countries keep interest rates near zero and continue to pump liquidity into the financial system (Don Coxe of Coxe Advisors has termed such liquidity "financial heroin") corporate profits, especially in the financial sector, will tend to surprise on the upside, and the market bubble will probably expand. (It's ironic: Most observers expected central bankers to *de*-leverage the system after the 2008 financial crash; instead, they are actually *re*-leveraging it.) Sooner or later, however, governments will have to deprive the economy of its fix, and the result will be a painful withdrawal. Unfortunately, trying to predict when this will happen is a fool's errand.

Furthermore, the theory of "decoupling"—the view that emerging markets have so much domestic momentum that they can continue to grow without any help from the rest of us—has once again become common currency. This explains emerging markets' surge, and also helps explain some of the gains posted by equity markets in the developed world. Stocks that benefit from emerging markets' secular growth story have performed best (particularly mining and resource stocks), while shares of companies with defensive characteristics and strong balance sheets have lagged.

The decoupling theory has been wrong before, and we suspect it is this time too. Emerging markets have navigated the crisis well, but they have used many of the same policy tools used in the developed world and are likely to experience similar problems. Take China: That country's government has intervened and supported its economy with enormous fiscal stimulus, which will have to be withdrawn to avoid creating structural problems. Once the fiscal stimulus fades, it will become evident that China's economy still relies primarily on exports to deliver growth, and that its re-invention as a domestic consumption-driven economy will take some more time.

Looking Forward From Here

Our prognosis clearly is not as optimistic as "the Crisis? What crisis?" mindset that has bolstered equity markets since March. Nor is our view as pessimistic as that of the "We're going to hell in a hand-basket" crowd. As we enter the New Normal, the economies of developed countries will generate some degree of growth, however

sputtering. That said, we believe the crisis and its aftermath have fundamentally undercut the developed world's capacity to expand—and the financial markets do not yet reflect this fact.

Against this back drop, where does opportunity lie? It's not easy to say. Global equity markets in general are either fairly valued or expensive, and we believe the cycle will turn increasingly hostile during 2010. While the long-term argument for investing in Asia and other emerging regions holds true, in the near-term markets in these areas face the considerable risks described above.

Corporate debt did very well in 2009, but the low-hanging fruit has been picked. Returns are likely to be leaner going forward, though still positive. Government debt will be in over-supply, and that will push investors who are concerned about inflation (like us) to the short end of the market. The performance of commodities in such an environment is difficult to forecast, but we suspect it will be less rosy in the near term than many investors hope.

If the overall investing climate does become hostile, correlations between so-called risk assets are likely to tighten up, as they did during the crisis. Generally speaking, now is not the time to be filling up your boots with risk.

Be Realistic, Not Afraid

Our advice to investors is to consider assets that can generate returns in the slow grind of the New Normal. We believe this environment calls for emphasizing current income and yield. Stocks and bonds of global companies with strong balance sheets and generous dividend yields currently form the foundation of Plimsoll's portfolios. We believe, the positions we hold in emerging markets and commodities provide balance to our accounts; we expect only moderate but acceptable returns from these assets given their current price levels.

While we are inherently optimists, we attempt to view the investment landscape as it is - not as we'd like it to be or others fear it could be. We encourage investors to do the same: to concentrate on the reality of their own circumstances and the changing world around them, and to ignore both seductive illusions and frightening apparitions.

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)*