TW Advisors

Newsletter
1st Quarter 2010

The Economy Has Responded

The stock market started the year off strongly with the S&P 500 advancing by over 5%. Although trading volumes and daily volatility were extremely low, there were some big moves within the quarter as stocks posted an early 9% correction before marching ahead 12% by the end of the quarter. Stock market activity has been dominated by professional trader-types, who currently favor riskier stocks like small caps, cyclicals, and financials, **while individual investors still shun equities and pour money into fixed income.** After the markets significant recovery rally we now believe it makes sense to maintain a marginally more conservative stance. For the first quarter our portfolios posted solid returns but lagged the indices due to our emphasis on high-quality, conservative stocks.

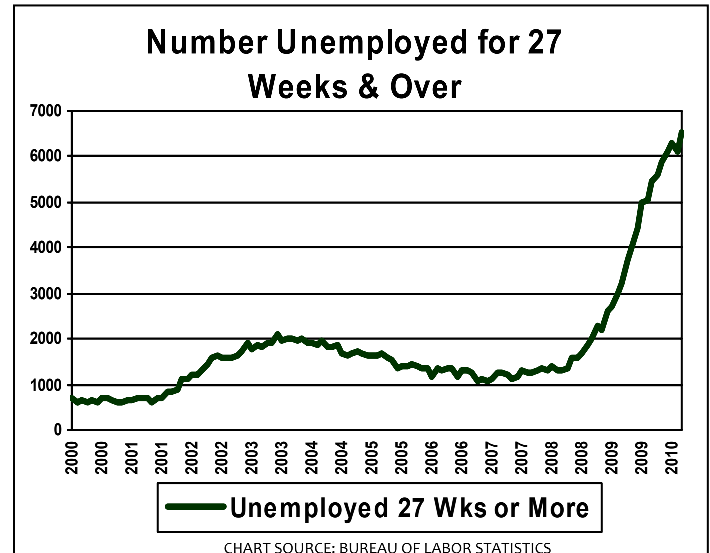
Almost everyone agrees that the financial crisis is over and the economy is on the mend from powerful cyclical forces. Rightfully so, our government attacked the severe downturn with massive bouts of fiscal and monetary stimulus. In addition, as a result of world trade virtually grinding to a halt during the height of the crisis, most economies are now enjoying a considerable inventory replenishment cycle. *Unfortunately, these positive cyclical influences have most likely peaked and leave the economy vulnerable to the structural headwind of deleveraging (def: Pay back all that debt), which is the critical issue for long-term investors.*

Although consumers are saving more, debt remains a huge issue. At the end of 2009, debt averaged about 122% of annual disposable income. Most analysts think a sustainable debt load is around 100% of disposable income, assuming a normal level of employment and access to credit, both of which are currently stressed. The only conclusion is that consumer balance sheets need to shrink much further.

McKinsey & Company analyzed 45 episodes of deleveraging, 32 of which followed financial crises. The average country spent six to seven post-crisis years deleveraging, over which time its total debt to gross domestic product ratio fell by 25%. Unfortunately, we have barely started this process. U.S. household debt did fall 1.7% in 2009, which is the first annual drop since the Fed's records began in 1945. However, a 22.7% rise in government debt more than offset the decline. In all, U.S. private and public debt rose 3.4% in 2009, to $34.7 trillion.

Weaning the economy off government support will be tricky. Withdraw support too soon and risk a double-dip recession, or continue to run high deficits and risk a public debt and currency crisis. Japan has tried several times since their asset bubble burst in the early 1990s to reduce the government's support. Each time the economy stumbled badly resulting in 20 years of economic stagnation. After the stock market crash of 1929, our economy responded to major stimulus and galloped ahead by 17% in 1934, 11.1% in 1935, and 14.3% in 1936. Over this period unemployment fell by 30%. In response to this strong growth spending was cut back and monetary policy was tightened to improve the fiscal condition of the Federal government. The economy promptly stumbled into another downturn in 1937. *These experiences show that unwinding from asset bubbles is a long-term process and suggests the potential for the current recovery to become self-sustaining in the near-term is in doubt.*

In the near term the cyclical tailwinds mentioned above are supporting strong profit growth from corporate America . For small businesses that rely on bank lending it is a much different story. In a credit survey in February from the National Federation of Independent Businesses, only 34% of small businesses reported normal and adequate access to credit. The struggles of small businesses do not bode well for employment growth.



Echoing our comments from last quarter's letter the challenge for investors is that the range of possible outcomes for the economy and stock market is wide. Our biggest concerns revolve around the debt issues described above; however, this condition could persist for quite a long time before the financial markets revolt. We believe that current strong corporate profits will prove unsustainable and transitory, especially for cyclical businesses. **Overall, we are maintaining our strategy of emphasizing steady-growth businesses, with strong balance sheets, healthy dividends and exposure to emerging economies. Our hope is that companies with these characteristics, and other special situations stocks, will move higher despite the headwind of deleveraging.** In fact, we made several changes during the quarter that we feel significantly improved the risk/return profile in the portfolios. Our belief is that our portfolio will do quite well over the long-term, while preserving capital relative to the indexes during corrections, especially since we hold some cash and high-quality fixed income that can be reinvested during any pullbacks.

If you have any questions, please feel free to contact us. As always, thank you for trusting portfolios to our care.

Steve Wenstrup, Jim Tillar, CFA

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