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Choices
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Each recovery period following a recession presents investors with unique challenges that seem insurmountable. Otherwise, markets would easily and quickly discount a full recovery, with normalized earnings, modest inflation and prosperity for all. Instead, little weight is given to unanticipated, positive shocks, and valuations often presume the worst - as they assume the best when times are good. This is natural, post traumatic conservatism, easily justified by a general lack of visibility regarding regulation, tax policy, and consumer retrenchment. Of course, visibility was clearly excellent in 2007, when the S&P 500 traded at 17.5 times earnings**, and equity volatility and bond default rates (corporate and consumer) were at 40 year lows.*

As investors crawl from the wreckage of the Great Recession, there are still a number of problems that threaten to overwhelm:

- Foundering ships of state in Europe, their debt held by wounded banks
- Staggering current account imbalances among trading partners
- Undeclared currency wars
- Persistently deflating collateral (i.e. Real Estate) on developed country bank balance sheets
- Alarming amounts of liquidity pumped into the global economy by the Federal Reserve (QE2)

If there is a darker, mirror image of Greenspan's "virtuous cycle," this is it.

And yet, one of the silver linings to be found in a recession is the dramatic reallocation of capital to more productive investments, once fear starts to dissipate. We have been asking ourselves whether ten year US Government debt should be trading at a price to earnings ratio of 35:1, with a current deficit of $1.3 trillion, and 50 times that in entitlement liabilities.* We compare the aggregate balance sheet of Corporate America, the S&P 500, with $1.7 trillion in cash, a comparable dividend of 1.9% and abundant profits, trading at just 13 times earnings.* In our view, this is a fairly dramatic misallocation of capital that will continue to adjust, with or without QE2.

This outlook is admittedly constructive for equities, and we believe rising stock prices should eventually help improve overall sentiment. Loan volume, consumer demand, merger activity, and a desire to embrace risk have all gone missing, but perceptions can change very quickly, with significant positive impact on the economy. For the past two years, banks and consumers have been locked in a deleveraging mode, and we still seem an impossibly long way from any tipping point towards accelerating, positive growth. What will it take? We offer a few possibilities: 1) greater policy clarity, 2) fiscal reform, including the tax code, 3) credit creation, however nominal, and finally 4) creativity with regard to the first three. Amid the gloom, we do have a generational opportunity to challenge the status quo and create new, sounder footings for the global economy. We believe our politicians will have to act accordingly, and the debt markets, if not the voters, will continue to hold them accountable. A strong balance sheet provides a range of choices, and, while the sovereign state with the world's reserve currency has more flexibility than most, the number of options is clearly diminished.

We remain positive on the outlook for our portfolio companies. The strength of their global footprints, balance sheets and focus on smart capital allocation should allow them to prosper, even with below average GDP growth. In fact, we can make the argument that the current subdued growth environment is beneficial to the best managed companies, as competition for attractive internal or strategic investment opportunities is less intense. If our companies cannot find appealing opportunities, they will eventually return the capital to shareholders by raising dividends or stock buybacks, a form of self-liquidation that often raises valuations.

** **Source: Bloomberg***
*** **On a trailing basis***