WASHINGTON CROSSING ADVISORS

Market Commentary

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Past Commentaries

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Tactical Asset Allocation Observations, Q3 2009

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Signs of Improvement

March 13, 2009
A Big Hit to Wealth and What to Do Now

March 5, 2009
A Questionable Plan and a Free Market Silver Lining

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Credit: Don't Want It... Can't Get It...

September 24, 2008
Downgrading Outlook Based on Credit Freeze

Trough Earnings and the Path Forward

How Earnings Recovery May Be Different This Time

- We believe that S&P 500 earnings have reached a trough and that recovery in earnings, led by cost reductions, is real and underway.

- Our most likely scenario calls for earnings to return to $65 by 2011 from the $40-45 in trailing-12 month earnings that are likely to be posted by the S&P 500 companies this quarter. ***We are marking this quarter as the trough point in that data series***.

- We have some concerns, however, about the forecasted growth rates in earnings implied by bottom-up analyst forecasts which call for a doubling of earnings by 2011. We view this "V"-shaped set of expectations as too optimistic.

- The driver for earnings will likely be limited to aggressive cost cutting, synergy-driven business combinations, and investment in productivity-enhancing information technology. Past cycles relied on a number of factors to drive rapid earnings recovery including robust top-line growth, tax and interest rate reductions, and increased leverage which are not likely to materialize this cycle.

- Tactical asset allocations have been returned to "neutral" positions in response to improvements in our various indicators on credit, the domestic economy, and trade.

Normal Prosperity and The Road to Complete Recovery

Going into the financial crisis, very few understood the magnitude of what was about to unfold. It is not clear what comes next. The Federal Reserve has done its job to interrupt the negative feedback loop of falling asset prices and deflation. Massive amounts of government loans, guarantees, equity infusions, and direct asset purchases have stopped the distressed asset sales and debt liquidation that are part of a debt-deflation spiral like the one that occurred during the Great Depression. On a separate front, the Federal Government is rapidly growing and replacing private and state spending with its own spending to tilt the consumption-savings scales back away from savings and toward higher aggregate consumption.

However, stability is ultimately restored through capital accumulation and savings. The economy has not delevered and, therefore, defaults and delinquencies remain stubbornly high. Mortgage markets are not yet settled. Both government sponsored (now government controlled) entities that account for the vast majority of the mortgage market continue to lose money. The automotive industry is still in need of a workout. The Federal Reserve's balance sheet holds nearly a trillion in refugee assets from the banks. Interest rates are at 0% with no chance of them going lower, and state budgets are deeply in the red. There is significant likelihood that higher taxes are part of the solution to the fiscal budgetary crisis which has the potential to further retard growth and recovery. These reasons alone are enough to suggest that this time is very different than last cycles. Nonetheless, there are those who look to the robust recoveries of past cycles as a guide to what might be expected now. We find these analyses and comparisons to past cycles to be overlooking some very large and obvious differences between today's difficult times and those of the past.

This is not to say that there is no chance for recovery. We, too, believe that markets will eventually clear, and normal prosperity will return. However, there is a strong chance that there will be unintended consequences of extreme levels of government involvement in private markets which will slow those markets from returning to normal. Selectively lending money to shaky businesses or calling on banks to make non-economic loans may prevent the disorderly liquidation of assets and hold back the tide of deflation, but creates longer-term distortions in private markets. Similarly, efforts to counteract falling prices with inflationary policies can delay the market's adjustment process that would otherwise improve the affordability of items to consumers and raise the real rate of interest earned by investors and savers. Like distortions caused by any form of price control, malinvestments will be likely created and will end up having to be liquidated at some point down the road.

Hence, the dynamic between the government and private sector creates a set of tradeoffs. The tradeoff involves greater stability in the short-run for potentially less stability in the long-run. Thus, we want to spend some time talking about the road forward. Thus far, we have shown through our various economic and credit indices (see Quarterly Review for more) that the economy has moved from outright contraction to a more "neutral" condition. Looking ahead, we see three possibilities: the traditional "V" shaped recovery; the double-dip "W" shaped recession; and below-average growth recovery.

Three Scenarios

Scenario 1: "V"-Shaped (Consensus)
S&P 500 Earnings: ($50A-2008; $60E-'09; $75E-'10; $91E-'11)
WCA Probability: 25%

The "V"-shaped recovery thesis is the current consensus view. Based on analyst consensus earnings, S&P 500 earnings are expected to grow from $50 in 2008 to $91 in 2011 ($50A-2008; $60E-'09; $75E-'10; $91E-'11), according to Thomson/Reuters. We believe that these expectations are largely formed by looking at past economic cycles. In past cycles, the economy and the earnings of S&P 500 companies did grow rapidly following recessions. In the five years following the last two recessions, for example, S&P 500 earnings grew at roughly double the long-term average growth rate. This happened because businesses emerged from recession with leaner cost structures; with lower financing costs; with lower tax burdens; and inventory levels were typically very low. Notice that much of the recent positive earnings surprises have been due to cost and inventory management rather than revenue growth. In fact, revenue for the S&P 500 was *down 25%* in the second quarter of 2009 versus the year-ago period. The rolling-12 month revenue trend was also negative as revenues measured that way were off 13% year-over-year.

The only way for profitability to emerge "V"-shaped from recession, is that top line growth accelerates faster than costs so that $1 dollar of revenue growth produces more than $1 dollar of profit growth. Improved operating leverage, in other words, requires rising sales. We note that Thomson/Reuters recently reported that analyst expectations for S&P 500 earnings in 2011 are for $91 – a 84% improvement from '08. This large "V"-shaped bounce is a tall order even under normal circumstances. In both the 1992-1995 and 2002-2005 post-recession earnings recoveries, earnings posted 80% improvements over three years and the same is expected this time despite greater challenges.

Scenario 2: Below Average Growth
S&P 500 Earnings: ($50A-'08; $52E-'09; $54E-'10; $65-'11)
WCA Probability: 50%

We believe the most likely scenario is that of below average growth for post-recession earnings growth. We laid out our forecast in our June 6th commentary and that forecast is for sluggish earnings growth in 2009-2010, with a delayed pickup in growth beginning in 2011. Our mid-case scenario calls for S&P 500 earnings to reach $52 in 2009; $54 in 2010; and $65 in 2011.

There are four primary reasons that we expect a more modest initial growth rate in earnings post-recession. First, there is a much higher degree of debt and leverage than before. Second, the largest segment of the population are exiting their peak spending years and the echo boomers are some years away from entering their peak spending years. Third, there has been negligible change in the cost of money as the result of rate cuts to stimulate spending. And lastly, we are seeing aggregate income and debt levels in the private sector falling for the first time since World War II, indicating that this cycle is different from the past post-war recession periods. Thus, comparisons to the "average" post war cycle should be viewed with some skepticism.

The private sector represents the largest segment of the U.S. economy at 70% of GDP and that sector has begun a process of increasing savings while also working to reduce indebtedness. In past recoveries, the economy was helped because households had the capacity to expand debt and leverage. Today, the household debt to income ratio is 40%

higher than the last consumer-led recession in 1990-1991, and the debt to equity ratio for households is also 40% higher. We conclude from this that the shift in aggregate spending, savings, and attitudes about debt are likely a longer-term, secular shift and not easily reversed. Hence, the effectiveness of monetary easing is more limited in encouraging top-line consumption growth and will be a depressant on earnings growth across our forecast horizon.

Another major difference this time around is that the 76 million "baby boomers" have moved beyond their peak spending years after a 30 year ascent in spending and accumulation. In the early 1990s recession, the average baby boomer (those born 1946-1964) was just turning 30, and had entered into the process of family and household formation. Today, those same boomers are often looking to downsize. In 1990, roughly a third of the group owned a house (versus 70% today), and the average mortgage was more than 3 times annual income (versus 1.7 times today). In addition, only 13% were free-and-clear of mortgage debt in 1990, while 50% today do not carry a mortgage at all. The largest segment of the population is clearly looking to spend and owe less than in the past. This dynamic will likely accelerate from here as retirement age grows nearer, and the "echo-boomers" are not yet in a position to take up the spending slack.

Monetary stimulus doesn't pack the same punch as it used to, either. Back in the early 1990s recession, 30-year mortgage rates fell to 7% from 11% which helped stoke a new round of consumption and refinancing. It had been almost 30 years since Americans saw 7% mortgage rates after all. Thus the perception was that the cost of money was very low, and this enticed borrowers to borrow and spend. By comparison, today's 30-year mortgage rates of 5-6% are not materially different from the rates seen in recent years. Hence, there is little new excitement or refinancing activity driving incremental purchases of large-ticket items such as housing, appliances, and automobiles. Again, if top line consumption growth is anemic, the full effect of improved corporate operating leverage will not be felt and the earnings recovery will be less than "V"-shaped resulting in earnings disappointment.

Lastly, we continue to see a lack of demand for credit by households. This creates downward pressure on prices as bank credit contracts (at worst) or expands very slowly (at best). Since our monetary structure is built on debt, the extinguishment of debt, will tend to put downward pressure on the money supply which, in turn shows up as falling prices. This phenomenon goes a long way to explaining stimulative and quantitative easing efforts by the Fed and Treasury which effectively put the government in the position of "borrower of last resort" to compliment the Fed's role as "lender of last resort". The netting together of the government's rising indebtedness against the private sector contraction has helped to provide some support under prices. Without the government and central bank asset purchases of the past year, the downward pressure on prices today would likely be far more dramatic. Since dollars do not distinguish between consumable and investable items, we believe that inflationary or deflationary pressures will show up in both categories. This has been clearly evident in the past year. Not only have asset markets (stocks & housing, notably) been under pressure, but the both the consumer price index and producer price indexes are down -2.1% and -6.8% year-over-year.

Price pressure has been seen both in and outside the consumer price index. It has also been seen in the commodity markets and other asset classes which experienced a very sharp downward adjustment in 2008, before inflationary policies were fully implemented.

Wages have not escaped this process either as evidenced by falling aggregate income levels (-0.5% in 12 months). While this does not look like a large decline, keep in mind that it is the first time in post-war history where there has been any decline in this figure. Not surprisingly, the price pressure also accompanies the first post-war decline in household debt levels as well. These deflationary pressures pose unique challenges to recovery; have not exhibited any sign of ending yet; and will be a headwind to restoring normal consumption patterns.

"W"-Shaped:
S&P 500 Earnings: ($50A-'08; $38-''09; $43-'10; $53-'11)
WCA Probability: 25%

This scenario envisions a double-dip recession where, following the end of aggressive government stimulative actions, the economy does not recover on its own and a second wave of job cuts emerges. We come to our earnings figures by applying the bad case set of expectations in our model. In this scenario real GDP would turn positive for the third and fourth quarter of this year, but slip back into negative territory next year and the unemployment rate rises above 11%. According to the Philadelphia Federal Reserve's *Survey of Professional Forecasters,* there are fewer than 5% of economists that expect this outcome at present.

Deflation remains a key concern of ours. Relatively low breakeven inflation yields in the inflation-protected Treasury market, continued deterioration in the core services and producer price inflation (which is now at a record low), ample global capacity, and sluggish credit growth forces us to weight this scenario equally to the "V"-shaped recovery scenario. The concern here would be that, if deflationary pressures fail to respond to monetary easing, that deflationary expectations could become embedded in public perception which could prompt a further de-leveraging by households and prompt renewed downward pressure for asset prices. This is exactly what Irving Fisher described as the vicious cycle of debt deflation that he saw as the root problem affecting economies that are over-indebted. Arguably, it was this same process that made the Great Depression in the United States, and Japan's "lost decade" track so differently from typical recessions.

For now, we are willing to take a broader view across a wider variety of data as seen though our credit, economic, and foreign indices that suggest that the economy will be able to recover despite currently weak prices. However, we remain respectful of the significant dislocations that can be caused by deflation, and remain watchful for signs of distress caused by chronic, severe deflation.

We would expect S&P 500 earnings under this scenario to be far below current expectations.

Breaking Down Earnings

Profitability must be driven by a combination of top-line growth, margin expansion, lowered tax and interest costs, or increased leverage. When we think through these component drivers behind earnings, we are pleased to see that corporations have been able to expand profits through effective cost controls. Restoring profitability is essential to creating an environment from which investors can commit capital, make new investments, and take risk. We expect that the low-hanging fruit here has been already plucked. Headcount reductions are likely to become more difficult as additional headcount reductions begin to impede the operating efficiency of the business and jeopardize the ability of companies to respond to growth should it emerge. Investment in new

capacity should remain constrained near-term, but we could envision a scenario where business consolidations accelerate to essentially "buy" revenue and seek cost saving synergies. Investment in productivity could also be justified under this same rationale to some extent. Hence, cost controls remain a bright spot in the profitability equation.

Beyond margin improvement, we still see top-line growth as a challenge for the reasons discussed earlier. To reiterate, the ongoing deflationary pressures in the economy, coupled with slack demand create the conditions where incremental revenue growth may prove more difficult to come by than in past recoveries. Therefore, our models for earnings see top-line growth as being a smaller contributor to earnings recovery this time around.

Tax and interest burdens are not likely to contribute to net earnings growth because we do not see the same kind of reductions in interest rates and tax rates as seen in past cycles, either. In fact, it is far more likely that tax rates on corporations will increase in response to severe Federal and State budgetary pressures.

Lastly, leverage remains a swing factor in driving profitability for the S&P 500 companies. While the household and financial sectors attempt to limit leverage after a long period of unsustainably rapid growth in debt, the aggregate companies that make up the S&P 500 have not exhibited the same kind of expansion in leverage ratios. There is some question, however, about the financial market's willingness to provide cheap and abundant financing in the absence of a strong economy. Hence, we assume that there will be no material increase in leverage for the S&P 500 at this time.

Lastly, we believe that the accounting losses that resulted in last year's unprecedented charge-offs to bank balance sheets is behind us that further contraction in S&P 500 book value will moderate.

When we combine each of these factors, the composite picture on earnings becomes somewhat more clear. We remain optimistic that earnings growth will reach a trough in the third quarter of this year and improvement will follow. However, we remain somewhat skeptical that the overly optimistic assumptions put forth by analysts are betting too heavily on rapid earnings recovery that does not appear to be supported by fundamentals.

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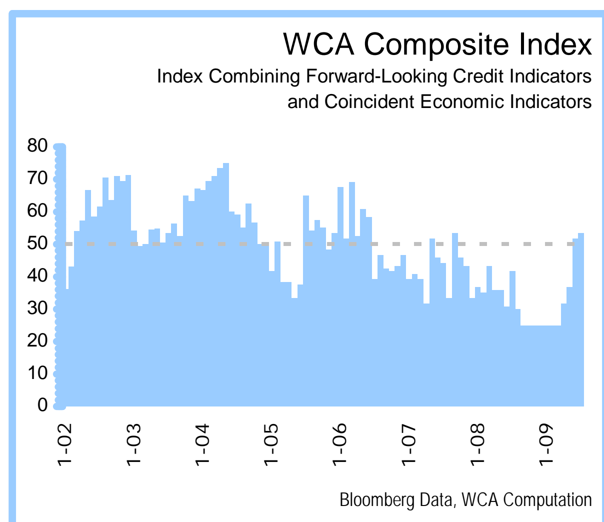
Addendum: Diffusion Indicator Update

We continue to monitor changes in the economy through our diffusion indicators for credit, domestic economic activity, and foreign trade. Our "composite indicator", which tracks all of these variables, has returned to a reading just above 50% from a low point reached last December. This indicator suggests that a more neutral mix of stocks and bonds is appropriate and we have increased our equity exposure accordingly with an emphasis on small capitalization segments of the market.



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