

ECA INVESTMENT GROUP, INC.

QUARTERLY UPDATE

March, 2010

Volume 24 Issue 1

After 23 years of publishing our newsletter, we thought it was time for a change. The newsletter has always been an opinion piece – an effort to explain how current economic trends and policies impact financial markets and investment portfolios.

That editorial style will continue, but perhaps less philosophical and more pragmatic. Like the ECA Notes, the newsletter will also be posted on our website rather than sent out as an attachment to an email.

*If we do not have your email address, the newsletter will be sent by regular mail. **However, eventually, it will be available only in electronic form by email or on our website. So, if you have email and can access the Internet, please provide your email address.***

THE POWER OF CASH

- The 2000's are becoming known as a 'lost decade' for stocks (down an annualized 1% ending in 2009). But there were up years in the decade along side some really awful years. Stocks were actually positive 6 out of 10 years – a 5 year run 2003 through 2007 and in 2009.
- We submit that the up years were due in large part to the 'power of cash'. Y2K fears and the 9/11 terror attack at the beginning of the decade prompted the Federal Reserve to adopt an easy money policy and very low interest rates to stave off recession.
- The confluence of easy money and excessive leverage (brought about by liberalized loan and margin policies) created a virtual tsunami of cash, encouraging mal-investment in all manner of assets, especially real estate. Much of this easy cash also found its way into the stock market.

FREE MARKET RESILIENCE

- In the 2001 / 2002 recession, businesses were resilient – even though revenues fell, they did the only thing they could to protect profits – cost cutting (particularly labor costs) while improving productivity with better technology.
- U.S. GDP (gross national product) was positive, but declining on a year over year basis. Even in a tepid economy with very little top line revenue, earnings gains were significant. Result over the next 5 years – '03 through '07, stocks rose an average annual 13% (much better than the 60 year 8% average).
- It's clear, then that the 5 boom years were (at least in part) due to heavy financial leverage (such as consumers borrowing against their homes). Home equity loans were a significant source of consumer spending. Added cash emerged from Federal Reserve infusions of liquidity into the economy while keeping interest rates artificially low.
- In other words, the 5 year bull market was not a product of real demand for goods and services – just a lot of cash and heavy debt accumulation.

THE CRASH

- As this over leveraged condition was discovered in late 2007, the stock market swooned - almost 57% from the October 2007 peak to the final low reached in March 2009.
- Real estate values collapsed and they are still falling (albeit at a slowing pace). A frightening percentage of homeowners are now 'inverted', owing more on their mortgages than the market value of their homes.
- In the meantime, Fannie Mae and Freddie Mac are charged with the responsibility of propping up billions of bad mortgages instead of letting them default. This, ostensibly to protect banks from rolling over while the Fed keeps the money spigot open and interest rates just above 0%.
- The crash of 2008 (in all asset classes) corrected much of the mal-investment. It was quite pervasive - nothing left untouched - stocks, bonds, real estate and commodities.

REFLATION

- The strong 2009 stock market recovery has trimmed the loss to about 28% from the late 2007 peak, but stocks have been basically flat since the beginning of this year.
- Why have stocks bounced off the March 2009 lows if the economy hasn't improved (in fact experiencing 4 consecutive negative GDP quarters)?
- One reason is clearly investor over-reaction and panic that seized many as we watched the appallingly leveraged financial system melt away. One giant, iconic company after another succumbed to a mountain of debt, begging for a taxpayer bailout.

- The other reason is less obvious, but probably more powerful – ‘hair of the dog’ reflation. It’s déjà vu, repeating the same over stimulating mistakes following the 2002 recession.
- Unprecedented liquidity is again being injected into the economy along with huge government spending programs. At the same time the Fed is keeping interest rates extremely low.
- Much of that money has found its way into the stock market as investors scramble for dividend yields doubling or even tripling paltry money market / CD rates.

BOTTOM LINE

- The S&P 500 Index is selling at about 16 times expected 2010 earnings - right at the historic average. We believe the market will be range bound for some time given the overly indebted condition of consumers and governments.
- The financial system failure is so serious and systemic that the general deflationary environment (mostly in developed countries) will grind on for some time, stifling revenue growth.
- But, there are always individual companies that excel, stepping up to meet healthy global demand for all the wonderful things Americans take for granted.
- That is why retaining skilled investment management is so important – stock picking (vs. just broad index type investing) is preferred in this environment.
- Debt burdens of consumers and government are smothering economic growth, but many businesses are in increasingly good shape, ready for serious earnings growth when the economy improves.
- And, there is enormous pent up demand for products and services of all kinds from emerging economies. The American consumer is also on the mend, slowly beginning to reduce debt and saving more.
- Well capitalized companies are prepared to deliver – therein lies the opportunity. But markets will move in ‘fits and starts’, so purchase entry points are important.
- Selective stock picking and dividends have never been more important in achieving better returns than otherwise available in CD’s and money market funds, and that’s where professional investment advisors shine.

DANGERS

- The process of free market ‘creative destruction’ will eventually prevail, but full economic recovery is postponed with public support programs and artificially low interest rates (a la Japan) or worse, stagflation.
- Bailouts and taxpayer dollars continue to prop up bad loans (through Fannie and Freddie) and ‘too big to fail’ companies. Governments do not have an infinite capacity to assume private debt (replacing corporate and mortgage debt with government debt).
- Low rates and the big debt burden (now close to 100% of GDP) continue to weaken the dollar, eventually resulting in inflation and higher interest rates.
- But, we have a temporary reprieve as our troubles are relatively fewer than those of the euro / yuan / yen zones. The dollar still has ‘safe haven’ status, but that could change rapidly (let’s say if China ‘free floats’ its currency vs. the dollar).
- Higher tax rates also loom large as government scrambles to close deficits and reduce debt. Off balance sheet unfunded liabilities – government guaranteed pensions, social security and Medicare grow out of control.

Edward S. Crooks
President

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