From: Research
Subject: ECA Research Note
Date: Wednesday, March 24, 2010 1:24:25 PM

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March 24, 2010 www.ecaig.com

Perception vs. reality on today's equity markets:

- Short term moves in the equity markets are often 75% perception; 25% reality.
- Perceptions (or herd type thinking) can sometimes carry on for very long periods. But, ultimately investment values reflect reality.
- Perceptions are always difficult to discern, especially the timing part – when will perceptions change? When will reality set in?

Right now, investment / economic perceptions seem to be that:

- The U.S. is experiencing a normal economic recovery even though we just went through the most serious credit crisis in history (other than the Great Depression) accompanied by unprecedented government intervention.
- Problems are being addressed and resolved in Dubai and other economic basket cases such as the euro zone PIIGS (Portugal, Ireland, Italy, Greece and Spain) and California.
- China will respond favorably to U.S. pressure to increase the value of the Yuan vs. the dollar (in order to reduce our trade deficit).
- This pressure (in the form of protectionist talk in Congress) is just 'saber rattling" – it will never happen. Global free trade will continue unabated.
- Government's massive monetary and fiscal re-flation is working to revitalize (albeit slowly) the economy and the markets. The stimulus and 'too big to fail' bailouts worked to stave off depression. Bank credit will start to expand.
- We will soon work our way out of systemic unemployment / underemployment (now over 16%).
- U.S. consumers (75% of the economy) are coming out of their lethargy, beginning to spend. Housing demand and values are picking up (despite a 21 month over-supply).
- The U.S. economy can withstand 10% + annual deficit spending and a debt burden exceeding 100% of GDP without consequence. U.S. sovereign debt will continue to be rated AAA, enjoying strong demand from the rest of the world, especially China.
- We can afford another massive entitlement (national healthcare) on top of so many others being operated at serious annual deficits, particularly Medicare, Prescription Drugs, Medicaid and Social Security (carrying $50 trillion + unfunded liabilities).
- Increased taxes, regulations and mandates on business should not discourage additional hiring or the formation of new businesses.
- Higher tax rates and new taxes (in the form of 'cap and trade' etc.) will increase government revenues. Middle class taxes will not go up.

What have we learned from history about these perceptions?

- In 1930, Hoover cut interest rates and pumped up deficit spending by $2.6 billion (3.3 trillion in today's dollars). Then Congress passed the Smoot Hawley and Fordney McCumber tariffs. Hoover also raised taxes.
- Roosevelt then passed a series of nationalized programs (including the big one – Social Security), draining capital from the private sector. For the first time, he introduced corporate, payroll, dividend, inheritance, gift and excise taxes. The top individual income tax rate was raised to 79%.
- Government policies of the 00's are very much like Hoover and Roosevelt. In the early 2000's, there were steel tariffs followed by a massive education bill, a record farm bill, prescription drugs for seniors and a $15 billion airline bailout.
- From 2002 to 2004, the Federal Reserve was very accommodative, raising the monetary base over 40% while cutting interest rates all the way to zero.
- By mid 2004, fearing inflation, the Fed reversed course, pushing up short rates with a reduced money supply. This more restrictive policy continued well into 2008, despite the collapse in housing and looming recession.
- In late 2008, the Fed reversed course again, more than doubling the money supply and slashing interest rates to zero.

Stock values have rebounded in response to all the new money, but the economy continues to languish.

- The same thing happened from 1932 to 1937 – responding to government pump priming stocks re-gained more than half of the previous 87% loss (from '29 to '32), but, the economy fell into a second depression and stocks dropped again (by about 47%).

- As in the 30's, the Fed is trying to offset the deflationary credit squeeze with easy money. History teaches that this will ultimately lead to a lower dollar and inflation after suffering through a long deflationary period and volatile equity markets.

- We cannot depreciate (inflate) ourselves into prosperity. A sovereign debt bubble is building in western economies, particularly U.S., U.K. and Japan – there will be consequences.

- Unfavorable demographics render state social spending actuarially unsound.

When short term perceptions are finally exhausted, reality will take over. That is why it is critical to:

- Immunize portfolios with disciplined asset allocation and diversification among outstanding companies that pay dividends, have a history of strong dividend growth, good cash flow and low debt.

- Focus on capital preservation and hedge.

- Be careful with stock selection. In-depth company analysis is vital. Easy index style investing that worked well in the secular bull market of the 1990's will likely contain more volatility in this environment.

- Take advantage of opportunistic entry points - markets will be volatile.

- Allocate a portion of investments in certain 'emerging economies' that are in better fiscal / debt shape (with more pro-business policies) than a number of advanced economies (suffering annual deficits exceeding 10% of GDP).

- Invest in the fixed income of worthy issuers with a capacity to survive and good balance sheets. Consider TIP's (Treasury Inflation Protected bonds) as an integral part of the fixed income portfolio.

- Be watchful of municipal debt, emphasizing necessity type revenue bonds (water, sewer, roads, etc.).

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