ECA INVESTMENT GROUP, INC.
QUARTERLY UPDATE

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THE GREAT DEBT UNWIND

- The historically massive stimulus and low interest rates have provided temporary relief to the U.S. economy, but tepid consumer demand and the lack of private sector hiring are slowing GDP growth again.
- This is no classic **V** shaped recovery (typical of past cyclical recessions). As this deep recession rolls along, we now know that recovery (at least for now) will sputter sideways, moving in fits and starts.
- The debt / credit / leverage build up featuring big consumer spending over the last 20 to 30 years is over. We've reached a limit, and now we are experiencing the 'flip side' - **credit contraction**.
- A number of states are also in deep financial trouble, but cannot run deficits or create money like the federal government. States have contractual obligations for excessively structured pension and healthcare plans (example: California firefighters retire at 50 with 90% of final salary life pensions). These costs will likely fall on federal taxpayers.
- New Deal spending in the 1930's was about $500 billion in today's dollars vs. current government debt of $15 trillion (not including future liabilities for entitlements such as social security, Medicare or the new healthcare program). To imagine that this excessive spending will wash through the economy with little negative impact is folly.
- Household net worth has dropped an average 20% since the end of 2007. Reduced homeowner equity is a large part of this drop (50% equity in 1980; now just 2%). This has sobered us up considerably, prompting a new frugality, leading to reduced discretionary spending.
- The 2009 stock market rally was largely influenced by heavy government stimulation – this can only be a temporary solution as we are now witnessing with recent market weakness.
- What would change this disappointing reality? Lower taxes, less government spending and some regulatory relief (especially for small business – the sector of the economy that employs the most). Instead, we're going the other way with higher taxes and more regulations.

DEMOGRAPHIC REALITIES

- The 78 million strong 'baby boomer' median age is about 54. This group has driven practically every sector of the economy over the last 30 (maybe 40 years). And, they have not been afraid to invest in risk assets such as stocks, leveraged real estate, illiquid limited partnerships, collectibles, etc. Boomers are also living longer. On average, among couples age 65 or more, it is estimated that one will make it to age 92.
- Having now experienced a second major bear market in the last decade, aging boomers have become circumspect, realizing they must shift from excess to prudence. To maintain current lifestyles, they are not retiring, making it very difficult for young people to enter the workforce.
- Boomers also want more income from their investments – so, more dollars are flowing into fixed income, stretching maturities to reach a decent yield. Interest rates are a record lows, but may remain so for the foreseeable future despite the massive policy reflation. Notwithstanding the huge increase in money supply, a deflationary environment can last quite a long time following the severe credit collapse – certainly the case in Japan from 1990 until today.
- There is also a trend toward investing in companies providing for basic needs such as consumer staples and commodities, while emphasizing capital preservation and income production – dividends.

POCKETS OF GROWTH – EMERGING MARKETS – DEFENSE - TECHNOLOGY

- As populist policies continue to spawn mountains of debt in the so called developed countries, emerging economy consumer demand is burgeoning. The growth dynamics in China, India, S. Korea, Brazil, Southeast Asia and others are immense, especially for commodities and consumer durables such as cars and appliances.
- China has four times the population of the U.S. and this year for the first time will buy more vehicles (the first in their life for many). The Chinese will also buy more computers, washers, dryers, refrigerators, microwaves and stoves than Americans this year.
- Unfortunately, since the fall of the Iron Curtain, geopolitical unrest and risks have never been greater – terrorism, rouge states going nuclear, Pakistan, Afghanistan, Iran, Iraq, North Korea, etc. The free world must remain diligent which means defense and cyber security stocks will do well.

- Throughout the globe, the need for basic human utilities, energy and infrastructure are profound - clean water and sanitation systems, roads, bridges, rail lines, etc. have never been more important as the populations expand. China and India are literally running out of water! These are strong, continuing, secular investment themes.

- Significant advancement in biotechnology (especially synthetics), genome research and a material number of new health related patents promise eventual practical (and profitable) applications and investment opportunities. Look for more growth in pharmaceuticals, generic drugs, medical devices and personal healthcare products.

THE CORRELATION CONUNDRUM

- Modern Portfolio Theory (MPT) states that investors can reduce risk by combining uncorrelated asset classes (moving independent of one another). For example, combining large cap growth stocks with small cap stocks, international stocks, real estate, bonds, commodities etc. achieves lower portfolio risk. But, the theory did not work in 2008 – everything except for government bonds, cash and gold declined significantly.
- As a result of this conundrum, new, non traditional diversifying strategies have emerged such as distressed assets, private equity, absolute return hedge, directional hedge, market neutral, venture capital, floating rate bank notes, private real estate, natural resources, etc.
- Many of these strategies are illiquid requiring long holding periods and uncertain valuations. However, they encourage investors to again embrace some traditional aspects of investing such as patience, low turnover, quality, fundamentals – and that's a good thing.

BOTTOM LINE

- Three elements are necessary for a healthy and growing stock market: 1) rising earnings; 2) benign inflation and interest rates; adequate liquidity; and 3) reasonable valuations.
- Corporate earnings reports have been good due to cost cutting (mostly from lower employment). But, with falling consumer demand, further earnings increases may be vulnerable. Companies have done an admirable job paying down debt and reducing expenses. Now, top line revenue growth is necessary for further earnings improvement.
- Inflation and interest rates are historically low and have no where to go but up given the mass of new money creation. However, as suggested above, this condition may continue to last until the economy and employment levels rebound. The new money must be circulated (spent) before inflation and interest rates kick in.
- Market valuations are currently neutral with the price to earnings ratio (of the S&P 500 Index) at about 15 times earnings. PE ratios have varied from 9 times earnings in 1982 when stocks were very cheap to 28 times in 1999 when stocks were frothy and over priced.
- There are pockets of opportunity such as emerging market stocks and bonds, high quality, dividend paying stocks that own real assets, infrastructure stocks, water and natural resources, bio technology, commodities and even residential real estate (certain over sold areas).
- And, as has been said before - there is enormous pent up demand for products and services of all kinds from emerging economies. At the same time, don't sell the U.S. short. Americans are not afraid to address problems (including excessive spending and debt). And, Americans still have a strong work ethic, are creative, competitive and mobile – willing to relocate to take new jobs.
- Selective stock picking and dividends have never been more important in achieving better returns than otherwise available in broad index investing, and that's where professional investment advisors can add value.

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