Marathon Investment Management

Volatility, Debt and Profit
2010

Back in my old E.F. Hutton brokerage days I recall admiring a statue on my manager's bookshelf of a brass bull and bear in mortal combat – a battle between profit and loss or optimism and doubt. For 2010 the bull won. This last year the Standard and Poors 500 (S&P 500) rose 12.8% while the Dow Jones Industrials (DJIA) gained 11%. Regarding market volatility consider the following[1]:

- A January DJIA 3-day skid of 552 points
- 8 triple-digit daily point moves of the DJIA during February
- The DJIA closing above 11,000 in April for the first time since the height of the financial crisis in September 2008
- The May "flash crash" where the DJIA closed down 347 points or 3.2% after an initial fall of almost 1,000 points
- May ended with the DJIA down 7.9% for the month – it's weakest performance since May 1940
- The DJIA July gain of 7.1% was its best month in a year
- In August wheat prices surged 8% when Russia banned grain exports and the DJIA fell 4.7% - its worst August in a decade
- August also saw 2-year Treasuries settle at their lowest yield ever
- September opened with a 254 point jump of the DJIA – its best September opening since 1998
- September ended with its best DJIA gain since 1939 and the 3rd quarter ended up 10.4%
- During November General Motors went public and gold topped $1,400/oz. for the first time
- In early December silver hit a 30-year high of $29.705/oz.
- Congress approved far-reaching tax legislation during December
- The year ended with the DJIA up 1,149 points while gold and copper reached record highs.

The returns on the major benchmarks for 2010 are as follows[2]:

Dow Jones Industrial	11.0%
Wilshire 5000 (total stock market)	15.6%
S&P 500 Composite	12.8%
Russell 2000 (small cap)	25.3%
EAFE (international large cap)	4.9%
Crude Oil at $91.38/barrel	15.15%

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Natural Gas at $4.405/mm btu	-20.94%
Gold at $1,421/troy oz.	29.76%
Silver at $30.91/oz.	83.8%

International markets' 2010 results were more diverse but generally positive. European debt and slow growth stalled but did not halt positive returns. The European "PIIGS" (Portugal, Italy, Ireland, Greece and Spain) finished in the negative. The European countries on more solid debt footing allowed investors to focus on corporate recovery and growth.

For Asian markets, with two notable exceptions, market performance was strong due to global investment. New highs were realized by India, Indonesia, the Philippines, Malaysia and Thailand[3]. Both China and Japan – Asia's two largest economies finished in the red – the Chinese Shanghai Composite down 15.7% while the Japanese Nikkei fell 3%.

2010 was impressive for the Americas. Toronto's commodity–driven market rose 14% and despite the drug war, Mexico's market finished at record highs as did Argentina.

The following, in local currency, are the strongest and weakest markets for 2010[4]:

Strongest Countries	Rate	Weakest Countries	Rate
Argentina	51.8%	Greece	-35.6%
Indonesia	46.1%	Spain	-17.4%
Thailand	40.6%	China	-14.3%
Philippines	37.6%	Italy	-13.2%
Chile	37.6%	Portugal	-10.3%
Denmark	35.3%	France	-3.3%
Colombia	33.6%	Japan	-3.0%

Despite widespread concerns to the contrary and with the exception of municipals, the bond market rally continued during 2010. The rates for Treasuries as of year-end are as follows[5]:

3 month	0.12%	5 year	2.01%
6 month	0.18%	10 year	3.33%
2 year	0.60%	30 year	4.37%

Rates generally remained near their lows through most of 2010 with some weakness near year-end. The 10-year Treasury in mid-December topped 3.5%, a seven-month high, before closing at 3.33%. A year ago, the 10-year Treasury yielded 3.84%[6].

2011

Since our company's founding, and even before, investment policies employed by Marathon are based on timeless principles, not on the trend of the day. The stock market returns of last year were about double the historic average of the last 50 years. We did not predict that result yet the overwhelming majority of our clients benefited greatly during 2010. Same with the bond and commodities markets. Yet clients continue to inquire about what "our tea leaves" are predicting for the current year.

Earnings - Front and center to rising stock prices are growth of earnings. We see continued corporate belt tightening along with some still-easy comparisons to fourth quarter 2009 contributing to our optimistic expectations. Analysts at Thomson Reuters anticipate bottom-line growth of the S&P 500 companies of 32%[7].

Liquidity - One of the key sectors of the economy showing solid growth is finance. US banks are expanding their loans to consumers for the first time since the credit crisis erupted. JP Morgan Chase reported on January 14th a fourth quarter jump in earnings of 47% and said its total loans increased 6% since the end of September[8].

Retail Sales - It is generally accepted that consumer spending is the most important factor for economic growth. Retail sales during the holiday season were strong. Retailers extended their hours and took advantage of additional incentives via sales and internet commerce. Same store sales for the November – December period rose about 4%, the best since 2006[9]. Sales of all automobiles totaled 11.59 million vehicles in 2010, up 11% from 2009[10].

Tax Legislation - There is a consensus that with the extension of the Bush-era income tax cuts as well as federal unemployment insurance and lower payroll tax, Gross Domestic Product (GDP) will rise. Other positives, according to most analysts we read, say the extension of the 15% capital gains rate, and the 15% dividend tax rate along with a 35% estate tax rate (with a $5 million exemption) all contribute to capital formation and general economic growth. Businesses of any size can claim 100% bonus depreciation for new assets put in service this year[11].

Workers also benefit this year from a Social Security tax cut. For 2011, the 6.2% tax rate for the employee portion of Social Security tax decreases to 4.2%. This is a tax savings of up to $2,136 per filer[12].

Employment - For the last week in December, initial claims for unemployment benefits fell to the lowest level in more than two years, according to the Labor Department[13]. December private hiring and service sector growth were the strongest in years. The Institute for Supply Management's service sector index rose 2.1 points to 57.1, the highest since May 2006[14]. Private firms had net hiring of 297,000 employees for December, the most since records began in 2000, according to ADP[15].

Often we have mentioned that employment/unemployment rates are a lagging indicator of the economy. At the same time, these rates are key in determining the sustainability of an ongoing recovery, therefore we follow these statistics carefully.

If the economy continues its slow growth recovery as we suggested last year, we may expect the following:

1. As the economy improves we may see continued volatility and yet continued appreciation in our equity markets
2. We may also see the Federal Reserve begin to raise interest rates to prevent potential inflation
3. As the economy slowly improves, the US dollar may gain strength – especially if Europe remains mired with debt crises
4. Precious metals may stabilize or even fall as the US dollar strengthens
5. If inflation does pick up, those investments that benefit most from prices rising will appreciate, i.e. TIPS, commodity-laden equities, etc.
6. Most reports we read anticipate continuing foreclosures at a high rate nationwide – perhaps 2 million more in 2011 and therefore housing prices will not appreciate
7. Overall we anticipate increased GDP in the range of 3.5% to 4% over the approximate 2.8% for 2010 and markets to reflect that.

The Challenge

The U.S. fiscal year ends September 30th and for the last year (2010) spending by the U.S. government totaled $3.45 trillion, second only to 2009's $3.52 trillion. The drop in spending was primarily due to TARP banks repaying their bailout cash, payments to Fannie Mae and Freddie Mac being lower than anticipated, and deposit insurance payments falling about $55 billion lower than expected. Excluding the above savings, spending actually rose about 9% in 2010 over 2009 according to the Congressional Budget Office[16].

Overall, the government's spending accounted for nearly 25% of the country's GDP. This rate is well above the post World War II average of 20%. The deficit is the measure of how much less the government receives in revenue (taxes, fees, etc.) than it spends in a single year. The country's deficit for fiscal 2010 was $1.291 trillion[17].

As of the last day of 2010, the U.S. Treasury website reported that the National Debt stood at $14,025,215,218,708. If took just 7 months for the National Debt to increase from $13 trillion on June 1, 2010 to $14 trillion on December 31st [18]. What do these numbers mean and what is their effect on our economy and markets?

By using more government revenue to service the interest on growing debt, all other needs provided by the government are squeezed. In Japan the national debt is approximately 200% of GDP[19]. It's annual budget includes $867 billion of spending, though total government revenue amount to $501 billion. Entitlement programs which service Japan's aging population make up 53% of total spending – and as in the U.S., Japan's baby boomer population is beginning to retire. What has been happening in Greece, may soon happen in Japan and possibly here – skyrocketing interest rates to encourage investors continuing appetite to buy sovereign debt; increasing government spending for debt service; raising taxes to help offset debt services; ultimately less funds available in the private profit-making economy – less money to spend on food, clothing, housing, charitable contributions. The result can be lower quality of life standard for all.

After World War II, the U.S. cut federal government spending dramatically. In 1945, federal government spending as a share of GDP peaked at 31.6%, and by 1948 it was down to 14.4%. Private real GDP (GDP less government purchases) for the three years 1946, 1947 and 1948 grew at a 7.5% annual rate. During the Clinton years where the budget was balanced and the economy was stronger federal government spending as a share of GDP was cut by over 4% to 18.8% in 2000 from 22.9% in 1992[20].

There is an annual report, similar to a corporate annual report, that measures the economic freedom of 177 nations worldwide. The 2011 Index of Economic Freedom published by <u>The Wall Street Journal</u> and <u>The Heritage Foundation</u> uses 10 criteria to record countries' commitment to the free enterprise-capitalist system. These criteria include fiscal soundness, openness to trade and investment, government size, business and labor regulation, property rights, corruption, monetary stability, and financial competition. The good news is that globally there was improvement among developed and emerging market economies. Economies that stick to the principles of economic freedom are recovering more quickly from recession, and are growing faster than countries where governments try to spend their way out of trouble[21]. In this index the U.S. dropped to ninth place from eighth (its lowest economic freedom score in a decade) – to "mostly free" from "free." Those countries ahead of the U.S. are: Hong Kong, Singapore, Australia, New Zealand, Switzerland, Canada, Ireland, and Denmark. Those nations (and probably the poorest) at the bottom of the index are North Korea, Zimbabwe, Cuba, Eritrea, and Venezuela (in ascending order).

I find this annual study significant – and keep this report throughout the year. The economic growth rates among the countries classified as "free" averaged 6.8% in 2010[22]. With few expectations international investors dramatically benefited over the years by buying stock in countries that are "free" or "mostly free."

In the spirit of Index of Economic Freedom clients sometimes inquire about the macro-economic challenges we face today in developing a successful investment strategy going forward. In this letter I have already suggested several. They and others are:

- Fiscal policy where federal and state spending needs to be earmarked toward economic growth by fostering a climate of entrepreneurship and opportunity. The most prosperous countries in the world are also the most entrepreneurial and competitive.
- Limit government spending to what is obtained by tax and fee revenues. Perhaps legislation may be required to rein in Congress, for example, to limit spending increases to the CPI minus 1%, except in national emergencies.
- Create an atmosphere where entrepreneurs are able to access capital to grow and expand their companies. The National Venture Capital Association, in a recent study estimated that 92% of all job growth within publicly traded U.S. companies occurs after the company goes public[23]. This may require reforming tax policies, streamlining the 2002 Sarbanes - Oxley financial regulations as well as the recently passed regulations. Also creating enhanced incentives to attract the best talent in engineering, computer science, and investors worldwide.
- Reform Social Security and health-care entitlements to reduce their explosive future growth. I do not believe the recently passed health-care law improved this situation.
- Pass regulations that are clear, simple, transparent and clearly show cost-benefits by relying on market-based incentives as much as possible.
- Monetary policy should be less discretionary and more rule-like based on strengthening the U.S. dollar and supply and demand strategies. What happened to the Federal Reserve's "exit strategy" anyway?
- Modify the Bush/Obama approach of "to big to fail". Legislation is needed to allow municipalities and states to go bankrupt allowing existing contracts that are fiscally irresponsible to be rewritten. Currently, the combined under-funding of pensions in all municipalities is $574 billion. States have an estimated $3.3 trillion in unfunded pension liabilities[24]. One report stated that for California, 80 cents of every government revenue dollar raised goes for government employees' pay and benefits[25]. Bankruptcy can be an option for states and municipalities as well as large corporations.

We anticipate progress on these challenges facing all of us, and we will be adjusting portfolios accordingly. We wish you a very happy and successful 2011!

Warm regards,

George Gumbiner
President

Footnotes:

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