

# OSTERWEIS CAPITAL MANAGEMENT

## Strategic Investment Outlook

October 2011

During the third quarter, the stock market plunged as investors' hopes for a sustained U.S. economic recovery dissipated and fears of a world-wide economic slowdown and possible U.S. double-dip recession increased. The U.S. faces several major structural headwinds including a moribund housing sector, high unemployment, bank credit restraint, and a growing and worrisome federal debt. Underlying these and other problems is the depressing effect of the end of the debt super cycle, which we discuss in greater detail below. On top of all this was the fiasco in Washington over the simple task of raising the debt ceiling. If our elected representatives could not handle such a routine task, how, investors asked, can they possibly tackle the real issues of tax and entitlement reform? The short answer is they can't or won't. In other words, we face the prospect of a rather bleak future.

But for all our problems in the U.S., Europe has it worse. Greece, with government debt approaching 170% of gross domestic product (GDP), has little chance of avoiding a default or restructuring. Either way, European banks will likely require major capital infusions to offset their losses on their Greek debt holdings. What is not in doubt is that Greek living standards will plunge – some say by up to 40%. Other Club-Med countries (Spain, Italy and Portugal) also face highly uncertain futures.

There is still plenty of growth in emerging markets, but it is slowing. In sum, there is a slowdown in growth world-wide and apparently no easy way to turn it back up. Interest rates are already approaching zero in the U.S. Fiscal stimulus could help temporarily, but it is not at all clear that traditional Keynesian stimulus is the answer to our current economic challenges. Progress reforming the tax code and entitlements could go a long way to restoring confidence, but nothing substantive is likely on this front until after the 2012 presidential election, and even then may prove elusive.

As our readers know, we have been talking for two to three years about why the current economic upturn would likely be anemic compared to prior post-war recoveries. So far we have been right but have been surprised by the vigor of corporate profits. Clearly companies became much leaner enabling them to enjoy enormous operating leverage as demand recovered. Now, we worry that the operating leverage may have played out and a slowdown in demand will in fact have negative leverage and result in profit disappointments. This is clearly part of what the recent drop in stock prices anticipates.

While our comments so far sound rather pessimistic, they should not be interpreted as completely bleak. As always, there are certain counter-forces and natural cures at work. In the space below we look at the key elements of the current environment.

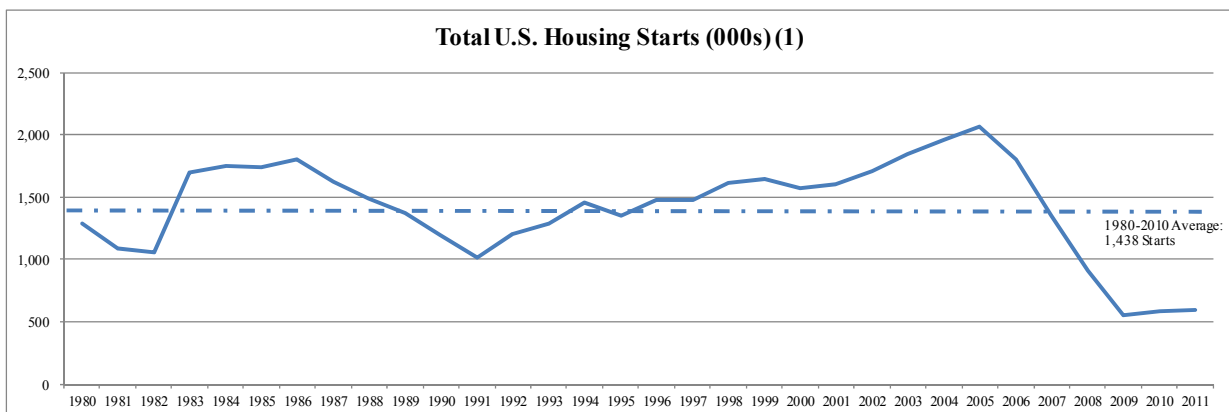
## Housing

The essence of the economic challenges facing the developed world today stem from excess leverage built up over the last decade. After the tech bubble burst in 2000, the Federal Reserve (Fed) pursued a policy of easy money to stimulate the economy. The resulting low interest rates coupled with increasingly lax credit standards ignited a housing bubble of epic proportions. This debt-financed asset boom enabled consumers to borrow against their inflated home values and to embark on a consumption binge that propelled the economy even higher. For a while, the savings rate dipped near zero as consumers borrowed and spent as if there was no tomorrow.

But, of course, tomorrow came in 2007 and the housing bubble swiftly deflated. The ensuing financial wreckage threatened a world-wide collapse in 2008. This was avoided, but only after several iconic banks and investment banks either went bust or were forced into shotgun marriages with stronger institutions. Numerous smaller banks failed and more are expected to do so.

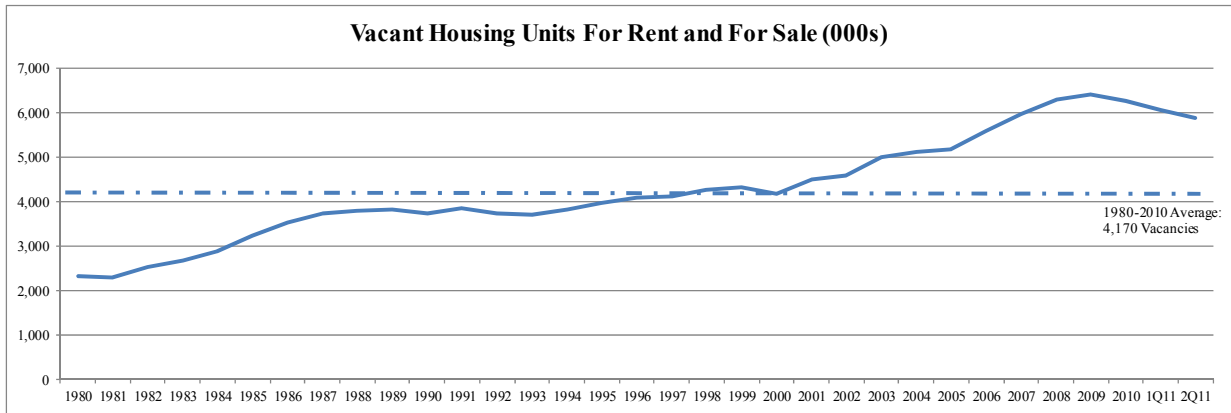
From a peak of 2.1 million housing starts in 2005, starts fell 73% to a 50-year low of 554 thousand in 2009 and remain near that level (Chart 1). To put this into perspective, over the last 50 years, housing starts for a full year were never less than 900 thousand units. At current levels, starts are more than 50% below the average of the last 30 years. Because some 2.9 million homes are in foreclosure and 5 million more are expected to enter the foreclosure process, there remains a huge over-supply of unsold homes (Chart 2), which will suppress the need for new homes for years. Moreover, housing prices have collapsed in many markets, effectively wiping out their owners' equity. Consumers who had viewed the equity in their homes as savings must now rebuild savings.

**Chart 1**



(1) 2011 represents annualization of YTD August 2011 Housing Starts data.  
Source: U.S. Census

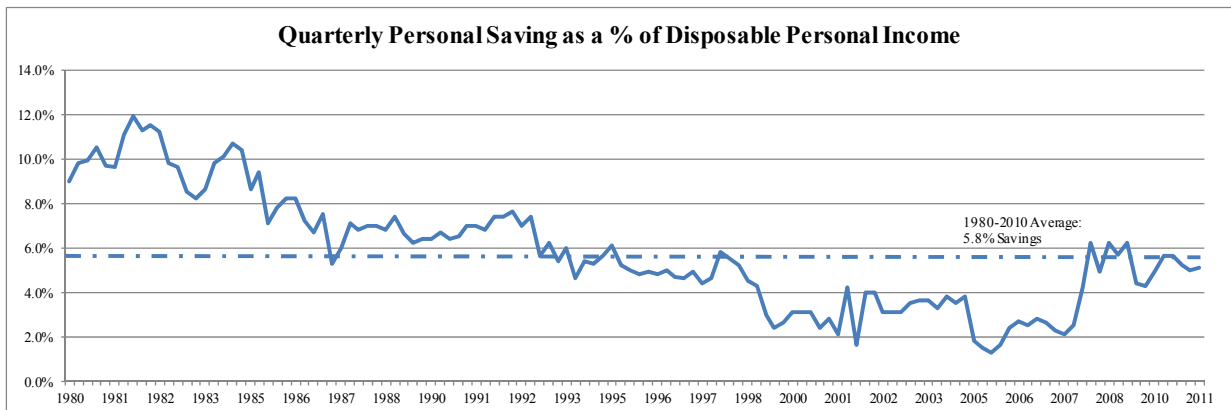
**Chart 2**



Source: U.S. Census

From a low of approximately 1.5%, the savings rate has climbed to about 5% (Chart 3), resulting in reduced consumer spending. Since consumer spending represents about 70% of total demand in the economy, overall economic growth has been, and will likely remain, somewhat anemic.

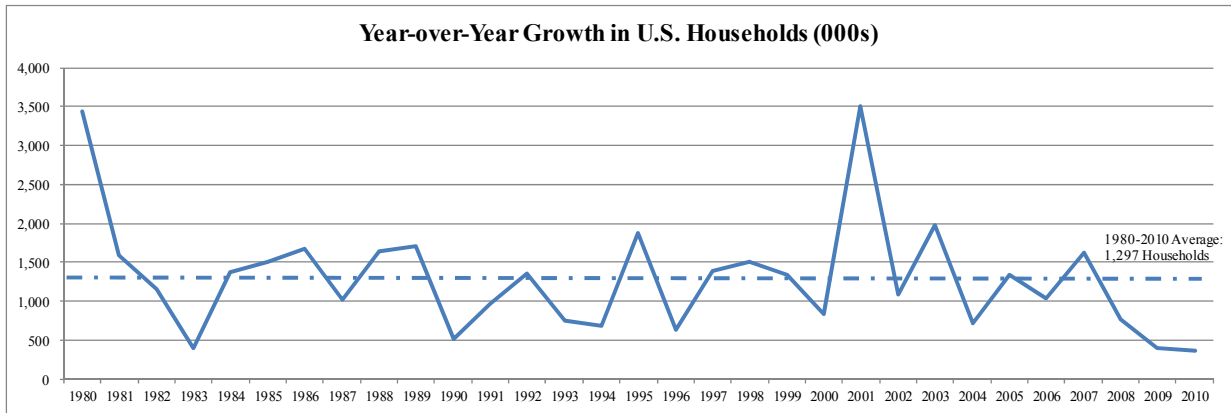
**Chart 3**



Source: U.S. Bureau of Economic Analysis

One silver lining in all this is the fact that household formations, which determine the long-term need for housing, normally grow by about 1.3 million per year (Chart 4). A weak economy and high unemployment have depressed household formations but, over time, demographics suggest this should rebound back to the trend line. When that occurs, the inventory of unsold and foreclosed homes and the need for more new homes should begin to rise. Housing starts may turn up, driving the economy higher. When exactly this will occur is hard to say, but we would guess sometime in the next two to five years.

**Chart 4**



Source: U.S. Census

**Labor**

The unemployment rate has remained stubbornly close to 9% ever since the housing bust. Economists estimate that in addition to those unemployed, there are numerous “underemployed” workers and others who have gotten discouraged and are no long looking for work. Altogether, the true unemployment rate may be closer to 15%.

The following table illustrates the stark changes in the employment landscape between the peak in 2007 and today:

**Employment within Non-Agricultural Sectors (millions)**

	2007	Aug 2011	Change	
			millions	%
Mining, Oil and Gas	0.7	0.8	0.1	10.9
Construction	7.6	5.5	-2.1	-27.6
Manufacturing	13.9	11.8	-2.1	-15.3
Trade, Transportations & Utilities	26.6	24.9	-1.7	-6.4
Information (Telecom, Media, etc.)	3.0	2.6	-0.4	-13.2
Financial Activities	8.3	7.6	-0.7	-8.4
Professional and Business Services	17.9	17.2	-0.7	-4.1
Education and Health Services	18.3	20.0	1.7	9.3
Leisure and Hospitality	13.4	13.2	-0.2	-1.6
Other Services	5.5	5.5	--	-0.6
Government	22.2	22.0	-0.2	-1.2
<b>Total Non-Agricultural Employment</b>	<b>137.6</b>	<b>131.1</b>	<b>-6.5</b>	<b>-4.7</b>

Source: U.S. Bureau of Labor Statistics

There are over 6 million fewer people employed today than in 2007 – approximately 2 million fewer in construction, approximately 2 million fewer in manufacturing, and nearly 1 million fewer in financial activities. Only education and health services have shown any real growth. Even government has shrunk a bit and with budgetary pressures on state, local and federal governments, we would expect further cut backs in their employment levels.

Again, the good news is that at some point in the next few years housing starts are apt to rebound, bringing construction employment levels up. Longer-term manufacturing jobs are likely to return to the U.S. as wages in China and other developing countries rise. China's one child policy and rapid urbanization could eventually result in labor shortages and upward pressure on wages, making U.S.-based manufacturing more competitive. A rise in the Yuan may also speed this process.

### **Credit Constraint**

From the profligate credit expansion of the pre-crisis era, banks have been forced to adopt a more sober approach to lending. As a result, individuals and small business in particular are having trouble getting credit. Even though housing prices are down sharply and housing affordability is correspondingly higher, tighter lending standards are preventing potential buyers from actually buying.

Perhaps more significantly, small business (normally thought to be the engine of new job creation) is having trouble accessing bank credit. As a result, big business which relies more on the capital markets and less on banks for credit has been able to expand and add more jobs this cycle than has small business. When this unusual pattern will reverse is anybody's guess, but we do not think it will be soon given the still-weak state of many local and community banks in the country.

Given the problems of the Club Med countries in Europe, banks across the pond are severely threatened. The ensuing credit constraint does not bode well for growth on the continent.

### **Europe**

Euro-land is a mess. The southern countries have been acting like grasshoppers while the northern regions worked like ants. Greece is hopelessly over-indebted. No amount of cost cutting and government austerity will enable Greece to work down its massive government debt. Most economists we respect believe Greece must inevitably default or restructure its debt. How to do that without sinking a number of European banks that hold Greek sovereign debt is the \$64 billion dollar question. Inevitably, European tax payers will somehow end up paying for any restructuring. Europe's growth is likely to suffer.

The Greek government has already cut pensions and government wages by 20%-30%. The economy is slowing and suicides are reportedly rising. We have seen estimates that the Greek standard of living may fall by as much as 40% before things eventually bottom out.

In Spain, whose recent boom was like ours (largely construction related), unemployment is rampant at almost 50% among 18-24 year olds. These are not happy times in Europe.

## **Emerging Markets**

As the developed economies of the West and Japan sputtered over the past few years, the superior growth rates in emerging markets attracted investor attention. In particular, Brazil, India, China and Southeast Asia have shown impressive strength and resiliency. Over the past few decades these countries made political and economic changes that have been conducive to investment and economic development. This economic growth has led not only to booming export and infrastructure growth, but also to rising consumer demand due to the rapid emergence of a large and growing middle class.

The strength of emerging market economies relative to the West has convinced many investors that emerging markets are the place to invest (directly or through U.S. and European exporters) and will be the growth engine that will ultimately lift Western economies out of their current funk. We tend to agree on both fronts but caution that even strong secular growth stories will experience periods of cyclical weakness. It is axiomatic that growth in rapidly growing economies will periodically overshoot targets and lead to unhealthy and unsustainable levels of investment, consumption, inflation and currency appreciation. This has been the case in Brazil, India and China this year. In response, the central banks in all three countries took policy actions to cool off their economies. Not only has this led to bear markets in their respective equity markets, but it also raises concern about corporate profitability of multinationals doing business in those countries.

After a pause that could last for several more quarters, the odds favor a resumption of strong economic growth in emerging economies. Large populations with pent up potential demand for consumer goods, continued infrastructure build-out needs and competitive manufactured goods sectors suggest that overall GDP, imports and exports may all resume their growth in the years ahead.

## **Debt Super Cycle**

Our friends at the *Bank Credit Analyst* have referred to the financial underpinnings of the Post World War II era as the debt super cycle, by which they mean the layering on of additional government debt each time the economy faces a business cycle crisis. At some point, the debt level reaches a limit, as it has in Greece, and the super cycle ends.

To some extent, the U.S. is fortunate in that the debt cycle is uneven throughout the economy. Corporations are actually in good shape. They have reduced leverage and have very

strong balance sheets. The consumer, who levered up in the housing boom, is now deleveraging. Short term, this will reduce aggregate demand in the economy but longer term it bodes well for economic strength. The risk, of course, is what is referred to as the “paradox of thrift” – as people try to save more, they spend less and the economy suffers, making it difficult for others to maintain incomes and save more. To some extent we are caught in this trap now, but we still expect the consumer to gradually repair his balance sheet.

The government is another question. Even three years after the last financial crisis, it is still running massive deficits and expanding its debt level. The great debate is whether the government should do whatever it takes to stimulate the economy now – as John Maynard Keynes would have counseled – or try to balance the budget, which would suck demand from the economy and likely lead to a recession or worse at this time.

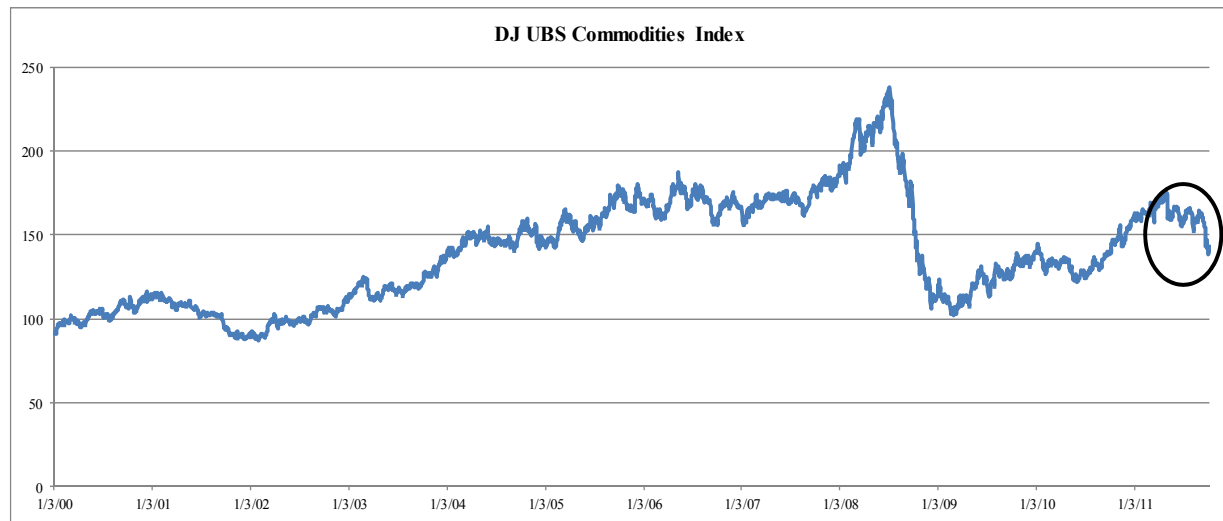
Our belief is that the correct solution is to maintain stimulus now while, at the same time, addressing the two main structural risks, namely the tax code and entitlements. It seems unlikely that our representatives in Washington can put aside their partisan squabbling long enough or soon enough to address these issues, but sometimes crises have a way of focusing attention. As Winston Churchill once said, “You can always count on Americans to do the right thing - after they’ve tried everything else.”

### **Inflation/Deflation**

Given the extent of post-crisis monetary easing, many observers feared that inflation was inevitable. But despite easy money, banks were deleveraging and not lending freely, so the “money multiplier” collapsed. Easy monetary policy did not result in too much money sloshing around. About the only things that did inflate were financial assets, gold and some commodities – the latter reflecting demand from expanding economies around the world.

The recent slowdown in economic growth, however, has caused commodity prices to retreat. The price of gold has fallen in sympathy. And the price of equities has dropped to reflect lowered profit expectations. Instead of inflation, the greater risk today is deflation. The good news is that lower commodity prices for such items as gasoline and food should free up consumer spending for other less essential items (Chart 5).

**Chart 5**



Source: Bloomberg

## Investment Policy

Investing in this environment is tricky. The U.S. economy is slowing and may be headed toward recession. The sovereign debt crisis in Europe keeps metastasizing with the European politicians either unwilling and/or unable to address the magnitude of the liquidity and solvency issues afflicting the PIIGS<sup>1</sup> countries. As a result, a banking crisis is underway and now a European-wide recession looks likely. Deflationary pressures now seem to outweigh inflationary ones. Corporate profits that, until recently, surprised on the upside due to cost cutting, may now surprise on the downside. The stock market has already experienced a sharp correction and stocks are cheap by many measures. But they could get cheaper. On the other hand, investing during times of great stress and uncertainty has the potential to be extremely rewarding. So, what to do?

First, we think that in the face of so much uncertainty it is only prudent to maintain higher than normal cash and fixed income allocations. Second, in our opinion, careful security selection is paramount to successful equity investing. One must avoid companies with excessive debt and significant earnings vulnerability. Instead, one needs to focus on companies with strong balance sheets and growing earnings. Finding companies whose earnings can grow despite weak economic conditions, and whose stock price does not already reflect it, is difficult, but not impossible. Right now, that is our central focus.

In addition, we believe that in a period of slow growth and low interest rates, companies with significant and growing dividends have unusual appeal. Our mantra, therefore, is strong balance sheets, growing earnings and growing dividends. Not every stock in the portfolio will exactly match this profile but, if it does not, it will have some other offsetting virtue.

On the fixed income side, we continue to favor shorter-term high yield securities. While the high yield market<sup>2</sup> has generally been under pressure due to fears of lower economic growth,

lower gross domestic product growth does not necessarily translate into weaker credit fundamentals. In the last two years, many companies have focused on refinancing while liquidity was available due to robust capital market activity and low interest rates. The median cash-to-debt ratio for high yield corporations is approximately 12.3%<sup>3</sup> currently, which compares favorably to a cash-to-debt ratio of 8.9% in 2007. In addition, only about 6.5% of high yield bonds and loans will come due by the end of 2012, meaning that default risk should remain low. Our view for this asset class remains constructive for the next 24 months, as we believe defaults are unlikely to occur at the levels the market seems to be pricing in. With an average yield of over 9%<sup>4</sup>, we believe the high yield market<sup>2</sup> is very attractive.

We currently view Treasury bonds as a high risk sector. This view may fly in the face of those who deem them to be the best shelter against market turbulence. Valuations at one hundred times earnings were the tipping point for the tech market a decade ago. We believe a parallel may be drawn for U.S. government bonds now. On September 22nd, 10-year Treasury bond yields fell to about 1.7%, which is the lowest recorded yield since Fed figures began in 1953. Even though interest rates could still go lower from current levels, we believe the upside potential for Treasury bonds is quite limited while the downside risk is enormous if the economy finds its footing or if inflation becomes a concern again in the near future.

On a positive note, we think that investors should not rule out a meaningful, coordinated global policy response to the rapid slowing in economic growth that has occurred over the past few months. We are not sure what form it may take nor when it may occur, but some are calling it the “Big Bang.” Our guess is that at some point the Fed, the European Central Bank (ECB) and China’s central bank will come together and announce a new initiative to re-stimulate. When that time comes, we would not be surprised to see nearly all so-called risk assets (equities, non-investment grade bonds and commodities) respond with a sharp rally. In the same vein, growth in the emerging markets should also rebound at some point in the next 12 months once campaigns by the monetary authorities in Brazil, India and China to slow growth this year in order to cool off incipient inflationary pressures come to an end. Resurgent emerging market growth should benefit many U.S. multinational companies and, therefore, our economy. We are living in a time of adjustment, which involves both opportunity and threat. Our job as investors is to seek the former and avoid the latter.

We end by thanking our clients for the faith you have put in us to make the right decisions. We appreciate your confidence and never take it for granted.

Sincerely,

  
John Osterweis

  
Matt Berler

  
Carl Kaufman

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<sup>1</sup> Portugal, Italy, Ireland, Greece and Spain

<sup>2</sup> The high yield bond market is represented by the Bank of America Merrill Lynch U.S. Cash Pay High Yield Index.

<sup>3</sup> As of 3/31/2011

<sup>4</sup> As of 9/2011

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*The Dow Jones-UBS Commodity Index is a broadly diversified index that allows investors to track commodity futures through a single, simple measure. The index is composed of futures contracts on physical commodities. The Bank of America Merrill Lynch U.S. Cash Pay High Yield Index is an unmanaged index that tracks the performance of below investment grade U.S. Dollar denominated corporate bonds publicly issued in the U.S. market. These indices include reinvestment of dividends and/or interest. These indices do not incur expenses and are not available for investment.*

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