



What A Difference A Year Makes

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Looking back over the last year we all feel a sense of relief that might not have seemed possible only 12 months ago. It is true that the financial system survived it's most significant challenges since the Great Depression, and thanks in part to unprecedented actions taken by our Government, stock markets around the world staged a remarkable recovery. The maxim that "stock markets climb a wall of worry" proved true once again. That we all know, what is less clear is where does this leave us? The challenges that we are facing as investors are many, but so are the opportunities. Change is difficult and right now our economy is undergoing significant transitions. Some change is self-imposed; some of it is being forced on us. The economy is in the midst of a painful move from easy credit, mass consumption and no savings, to one that has a more sustainable trajectory. The long-term implications are good; the immediate impacts are difficult as our economy struggles to adjust.

It was only a couple of years ago that American's had a negative savings rate. For every dollar we earned we spent something like \$1.03, the difference being made up by borrowing, often from equity in our homes. Today, American's are saving again (although at rates that are still below long-term averages) in part because we are making a conscious decision to cut back, in part because we no longer have access to cheap/easy money. The pure and simple fact is that in an economy that is so dependent on the consumer, the drop in spending will have dire short-term consequences (particularly when it happens so fast). *As consumers de-lever, companies will go out of business (there was not enough demand to support both Circuit City and Best Buy) workers will lose their jobs, and economic growth will be flimsy.* That's the bad news. *The good news is that when growth does re-emerge it will be sustainable and real.* What we saw in certain asset classes, like real estate, was faux. The availability of easy credit and low rates created a real estate bubble that in no way, shape or form could be supported by the fundamentals. Barring policy mistakes, recovery may be sluggish, Darwinist, but real. While the forces of change are hard at work a number of areas merit specific mention:

Government debt, inflation and the dollar:

The current trajectory of the federal deficit is staggering (measured in trillions of dollars) and without a significant change in course could result in devaluation of the dollar and high levels of inflation. Heightened inflationary

expectations and the demise of the dollar have been in place for some time now. The reality is that inflation is not an issue at present, and the dollar has actually rallied against a number of developed countries' currencies. This has caught many by surprise, but the fact is that with little economic growth and a lousy job market the fuel for significant inflationary pressures is absent. That doesn't mean that we are free and clear, quite the opposite. We find ourselves in a position where rates are low and inflation is low, but expectations for both rising rates and rising inflation are high. Investors must prepare for this by keeping cash available for investment (even if yields on cash are currently low) avoid buying long-term bonds (which will drop in value with the onset of inflation) and look to gain exposure beyond our own country (overseas earnings are worth more when the dollar weakens).

When will the Fed start raising rates and when will cash start earning more?

The Central Bank's thinking may be to keep short-term rates ultra low, which in turn encourages investors to move money into riskier assets (why keep money in cash when rates are so low?). This policy is being followed in order to discourage savings and encourage spending, thereby stimulating the economy. With gradual improvement in the economy the Fed must execute a delicate balancing act by deciding when to raise rates (hoping to be preemptive without pushing the economy back into recession) or keep them low (which could set the stage for the next bubble). As investors we must be careful about falling into the trap that the Fed has set and exercise patience. Remember, it was only a few years ago that money market rates were at 5%. The decision to invest should be based on the fundamentals, the merits and risks each investment carries and not based on 'encouragement' by the Fed to take more risk.

The market has run-up, is there any value left?

Those who want to talk about the market need to remember that it is really a market of individual stocks not a stock market. What we mean by this is that thousands of individual companies make up the 'stock market'. The performance, fundamentals and outlook for these businesses are all going to be different. When the media talks about the stock market being fully valued because it is trading at its long-term average, it also means that roughly half of the stocks in the market are trading *below* their long-term average. It was the stocks that dropped the most in 2008 that performed the best in 2009 (financials, tech stocks, small cap stocks). But remember, when you drop a lot it is much harder to get back to where you started and many 2009 star performers are trading at a fraction of where they were at the start of 2008. As investors if we look beyond the headlines and examine fundamentals we find that there is value in the stock market. Maybe it's not as abundant as it was when sentiment was at all time lows in March of last year (right before the market began its recovery) but its there. By focusing on fundamentals (cash flow, balance sheet

strength, businesses that produce valuable products and services) and by exercising patience, value can be uncovered.

The decade that was:

A common headline in January was about the lost decade for investors, where \$100,000 invested on January 1, 2000 in an S&P index fund would be worth only \$89,000 in December 2009 - 10 years in the market and one has less than one started with. But all hope is not lost. For investors who followed a balanced approach to investing and included bonds and international stocks that same \$100,000 would be worth \$145,000 in December 2009¹ - sub-par returns by historical standards, but remember the last decade included not one, but two bubbles bursting (tech bubble in late 2000 and the real estate and credit bubble in 2008). *The point to all long term investors is that a balanced approach and sound asset allocation principles can produce results that are better than the broader market.*

Where does this leave us as investors?

We must be prudent, prepare for the worst and hope for the best. The risks are out there, whether they come from deficit spending and inflationary pressures or from further deterioration in the commercial real estate market (to name a few). But the economy is on the mend, and what is emerging is a more balanced economy than the one that was dependent on credit-driven spending and under saving.

What is this decade's mega-trend?

The past decade saw savers and investors subsidizing borrowers, spenders and speculators. That dynamic as reversed and those who are savers and investors will be at a distinct advantage in an interlinked world economy. In the decade that was the stock market turned in a negative result; in the decade that will be, the equity risk premium will likely return.² We have said many times that economics and investing is part science and part art, but it is possible to make reasonable estimations of long term outcomes. Despite obstacles the economy will grow in the long run and sensible investments will present themselves.

¹ All figures were taken from a New York Times article that we would be glad to share if anyone is interested.

² The difference between the risk free return (e.g. Treasuries) and the total return from a risky investment (e.g. stocks).