VICTORIA
Capital Management, Inc.

GLOBAL FINANCIAL MARKETS PERSPECTIVE

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SURVIVING GLOBAL AUSTERITY

For a small country, Greece has certainly had a major impact on the world's financial markets in the past few months. Intense focus on Greece's sovereign debt issues led to an analysis of the financial condition of many of the countries in the 27-nation European Union (EU), as weaknesses in other member nations were revealed, one by one. (It is important to note that the EU is not structured like the US where there is a single government body that has unlimited power to finance. Members of the EU are like our states where governments are responsible for maintaining balanced budgets. Each country has to manage their spending by maintaining a certain ratio of deficit to GDP). When these guidelines were violated, countries were required to adopt austerity measures to move their nations back into acceptable ratio bands.

Making matters worse was the euro, used by 16 of the 27 nations, fighting for its very existence as a major global currency. Several meetings of EU finance ministers along with the head of the European Central Bank (ECB) provided some encouragement in this crisis as to how the central bank would work with wealthier nations to help weaker nations avoid a financial collapse. The International Monetary Fund and European Union established a $1 trillion eurozone bailout fund to rescue any nation that should need it. European nations, one by one, began introducing austerity measures to cut ballooning deficits.

Greece, France, Spain and Italy all increased their retirement ages. Germany and Britain raised theirs in prior years. Britain froze public wages and revealed plans to cut spending and raise taxes in moves that could account for as much as 8% of GDP in the next five years. They also charged U.K. bankers and those at U.K.-based subsidiaries of overseas banks a one-time bonus tax amounting to $2 billion for U.S. bankers and announced an ongoing bank levy on domestic lenders and U.K. operations of overseas banks. France and Germany also announced plans to impose bank levies. Germany said it will cut $98.5 billion from its deficit before 2014. France will cut its deficit to below 3% of GDP in 2013 from 8% this year. Spain plans to cut $18 billion from its budget deficit, currently 11.2% of GDP, through wage cuts, pension reform and tax increases. Portugal, Ireland and Italy also have introduced austerity measures.

Here in the US, efforts will have to be made to reduce the $1.4 trillion deficit that accounts for 9.4% of gross domestic product. US policymakers have been urging other governments to spend more to stimulate growth and bolster the still-fragile global economic recovery, but leery of following Greece into junk bond rating territory, other EU countries seem to be embracing the notion that now is the time to begin addressing large deficits.

And if Greece wasn't enough…

A healthcare bill was "pushed through" via questionable tactics, a jobs bill passed that created very few jobs, a financial reform package crafted by elected officials that have never run a business let alone grasp basic economics has passed the House and we still have the economic Chernobyl in the Gulf– a tragedy that should have elicited a massive and immediate response in the first week following the Deepwater Horizon error. What we got is a slow-footed response that would not allow non-U.S. flag ships, which were offered and had the capability of capturing 90% of the oil, to sail into U.S. waters and address the situation -- driven by political fears of upsetting various labor unions. President Obama has appointed a group of men and women to "study the causes of the Gulf of Mexico spill and make recommendations for the future of off-shore drilling". Amazingly, this group consists of environmentalists and academics, but doesn't include ANYONE from the oil industry! This situation is not a difference between Republicans and Democrats but the burgeoning lack of common sense inside the beltway.

We had expected a strengthening economy through yearend as both individuals and businesses accelerated income into 2010 to lower taxes paid on that income from 2011 where taxes will be higher. The problem is that austerity measures will mute that transfer of income and suggest economic growth in 2011 will be even slower due to the expiration of the Bush tax cuts.

President Obama has acted forcefully to lift the economy out of recession. His cash for clunkers program and his home buyers' credit program gave some lift to the economy. However, these measures only serve to temporarily stimulate economic activity. Real stimulus comes from increased government spending, a strategy that is coming under increasing fire. The latest plan to extend unemployment compensation was defeated in the Senate suggesting that a mood of austerity is sweeping the U.S. Congress.

Battle lines are forming over what comes next. Paul Krugman, Nobel laureate, emphasizes more government spending to buoy the private sector until it can get back on its feet. Alan Meltzer, economist and professor at Carnegie Mellon University, points out that major tax cuts during both the Kennedy and Reagan administrations were the basis for strong economic recoveries. More conservative voices just argue for the government to reduce spending. This battle may rage on through the November elections, the outcome of which could determine what solution is implemented.

BIG GOVERNMENT OR BIG BUSINESS?

The economy should be experiencing a normal business cycle recovery after going through a deep recession yet this recovery is not going according to plan. Over the past year and one half the recovery has been hampered by government intervention and regulation that may be affecting the effective functioning of the private sector. The financial crisis set the stage for greater federal government involvement in the private sector. First, the "too big to fail" financial institutions were bailed out by the government. In the process the government imposed certain regulatory restrictions on such important inputs as executive compensation and employee perks. A knee jerk response financial reform bill was introduced in the Congress that exceeded 2,000 pages with a broad array of new regulations that were the equivalent of the regulations that were enacted following the crash of 1929. The irony is that massive re-regulation in the finance industry did not include any regulatory response to FNMA and FRE, the two mortgage entities that had more to do with the financial market collapse than anybody. Undoubtedly, the costs of these regulations will be borne by the individual investor primarily through rising fees on financial transactions.

The recently passed healthcare law is also targeted to take market share away from the private sector and give it to big government as national healthcare takes on new meaning. Once again the consumer, both individuals and big business, will have to pick up the increased costs of this legislation. Rather than healthcare legislation, this law did most to affect the insurance that covers healthcare with increased cost controls and regulation on the private sector providers of healthcare. Imagine, there is now a 10% federal tax on tanning salons!

The virtual nationalization of the auto industry was another example of big government involvement. The firing of the chief executive of General Motors by the federal government and the confiscation of bond holder funds for the sustenance of labor unions violates the contract laws of our legal system. The event also produced a broad attack on the use of executive jets for transportation as the heads of the Big Three flew to Washington. As you can imagine the manufacturers of private jets suffered as a result of this criticism. Of course big government politicians' use of jets to travel from coast to coast received little media attention even though the taxpayer picks up that bill.

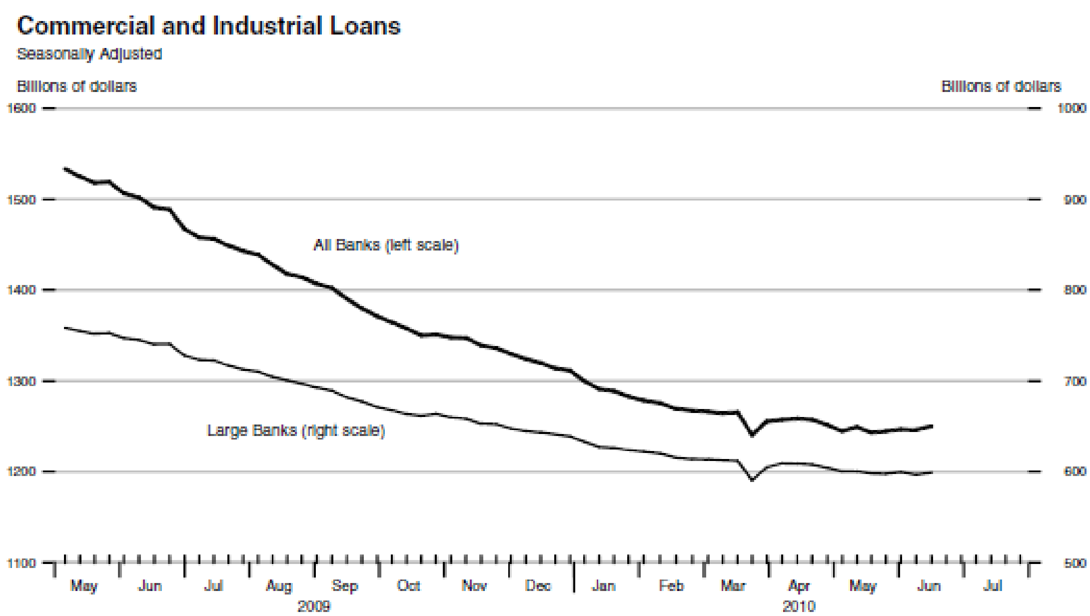
Lastly the BP oil spill and the federal government response reflect many conflicts of interest and some disdain for both the private sector and states rights by the government. As the blame for the spill correctly fell on BP for a variety of reasons, the federal government's initial response to the spill was surprising—let BP alone deal with the problem. This option made little sense since BP attempted to capture escaping oil rather than seal the well. Even though other nations offered help to control the spill, the U.S. refused. Individual state efforts to halt the spread of oil were actually hindered by various government agencies. The knee jerk response by Interior secretary Salazar to issuing a moratorium on all offshore drilling penalized thousands of workers and hundreds of companies that work on those wells. A local judge suspended the moratorium recognizing that the BP blowout had nothing to do with hundreds of other well drilling activity. An appropriate comparison might be if the U.S grounded all international flights because one flight crashed in bad weather.

Each one of these breakdowns in the private sector leads to greater government involvement, regulation and related costs and the prospect for greater investor risk. Common stocks rely on earnings growth or dividends for their attractiveness. In the short term, corporate earnings have been improving due to productivity increases and some rise in gross revenues due mainly to the upswing in the business cycle. However, by yearend, the run in corporate profits may be over and volume growth will be the key to further increases in business sales and profits.

THE CHANGING ROLE OF THE FEDERAL RESERVE

Recent comments by Fed chief Ben Bernanke provided relief for investors who feared that the Fed would begin raising interest rates this year. With the Fed funds rate near zero (this is the rate that the Fed controls and is the rate that member banks lend reserves to each other) and unemployment in the double digits, the Fed announced a commitment to keep interest rates unchanged. When Fed policy moves towards ease or maintains low interest rates it is likely that stocks will increase in price. The Fed won't be manipulating the Fed funds rate any time soon but it will be managing monetary policy to encourage greater job creation and to minimize sizeable bankruptcies should they threaten the economy. The Fed's job is to be a lender of last resort through either lending to banks directly through the discount window or lending to the economy through the purchase of overvalued mortgage securities. Over the past two years the Fed's balance sheet has ballooned with home mortgages rather than the traditional government securities that the Fed would buy to increase money in the economy.

The interaction of Fed policy and bank regulation has put a major damper on bank lending. Many banks are threatened by the prospect of making bad loans and then being held liable for those bad loans. As a result, there has been no increase in commercial and industrial loans in this economic upswing. The exhibit below demonstrates that such loans have actually been falling all through 2009 and have only leveled off starting in the second quarter of this year. So even though interest rates have fallen near record lows, there has been no stimulation of bank loan volume. It is not that bank loan demand is not there; what is missing is the willingness to lend.



THE GLASS IS HALF FULL

So far our narrative does not provide a lot of excitement about the outlook for investments. However, the good news is that corporate America is faring well with a few exceptions. Outside of the housing boom/bust cycle and a stingy credit environment, businesses have been benefiting at the bottom line by implementing, of all things, measures of austerity. One reason unemployment is so high is that corporations are making due with fewer employees. Enhancements in technology at all levels give companies a way to maintain output at a much lower cost. In some cases a company can flourish by bringing a variety of new products to market that become indispensible for the average consumer. Take Apple Inc. that launched the iPhone and iPad resulting in record sales. The result is cash of $40 billion on the balance sheet to fund future research and development or acquisitions. Even though the overall economy may experience malaise until a viable policy emerges to get us back on a confirmed growth path there will always be investment opportunities.

Profit growth is still the lynchpin of corporate success. Profits at US nonfinancial companies have risen for five straight quarters and they are sitting on more than $1.84 trillion in cash and liquid assets, up 25% from the prior year -- the greatest percentage increase since the start of record-keeping in 1952. Given the low level of interest rates and relatively low stock price/earnings (p/e) ratio, the stock market is undervalued and a wind down in the financial risks in Europe could help stock prices get back on a positive track.

CONCLUSION

A smooth track to economic expansion has been interrupted by another financial crisis in Europe, a tragic man-made disaster in the Gulf of Mexico and a series of government interventions into free markets that could be viewed as constraining growth. Plans for austerity measures around the world in response to large budget deficits may impede the continuation of the global expansion that got underway last year. In addition a big tax increase in early 2011 might also be a roadblock to better economic times. On the other hand corporate profits should remain strong for at least the next four quarters with dividend-paying companies increasing payouts. Unfortunately, yields on the safest investments will remain near zero and extending the maturities of bonds will be the only way to boost that income short of going into stocks with modest yields.

The juxtaposition of a strong corporate sector and a wobbly municipal sector will set the stage for more market volatility during the summer and fall. Depending on the size of these swings we may get some legislative relief from the tax increases planned for next year. If rumblings in the political sphere live up to expectations, November will be the Super Bowl of mid-term elections that match the surprises of 1994.

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