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"It's not always easy to do what's not popular, but that's where you make your money. Buy stocks that look bad to less careful investors, and hang on until real value is recognized."

*John Neff**

General Observations

The recent setback in risk assets represents an overdue correction, and we believe not the start of a new bear market phase. Retrospectively, there was just too much complacency about the economic outlook a few months ago, and it now would appear there is too much pessimism.

The big picture is for sustained, but moderate, economic growth in the U.S. and globally, with low inflation and central banks that are slow to tighten policy. Those conditions should sustain a grinding uptrend in risk asset prices as the rest of the year unfolds.

Greece could choose or be forced to abandon the euro within the next several years, but the rest of the single currency zone should hold together. The underlying fundamentals for most of the major currency zones look poor, but the U.S. is the best of a bad bunch. This suggests that the dollar will remain firm over the next year.

The Chinese authorities have succeeded in cooling the property markets and will soon ease up their tightening policy. A soft rather than hard landing is the most likely scenario.

The cyclical uptrend in stocks is likely to resume soon, and investors who have been underweighted should use the recent weakness to gradually build exposure.

The Economic Outlook – It Was Never Supposed to be Easy

- ❖ Recovering from the greatest economic and financial meltdown of the post WWII period was never going to be a straightforward process, given the deep scars inflicted on consumer, business, and investor confidence. An unprecedented policy response succeeded in breaking the self-feeding spiral of falling asset prices and imploding economic activity, but rebuilding damaged confidence was bound to take some time. As recent experiences still linger in investors' memories, it does not take much to cause a renewed retreat from risk.
- ❖ Concerns about the euro sovereign debt and China's hard landing provided a good excuse for investors to pull back from equities and other risk assets. A 10-15% correction in equities after a 70% rise is hardly a great cause for concern. In fact we have been rather surprised how resilient global markets have been given the far from robust pace of the economic recovery.
- ❖ Investors are now in panic mode, and the near term trend in equities looks gloomy as most indexes are breaking below their 200-day moving averages. Despite these technical market concerns, we believe that these are only temporary indicators and not the onset of something more serious.

- ❖ A decision about the appropriate investment strategy largely boils down to a judgment call about the big-picture economic outlook. And there are certainly many diverse opinions about the driving issues amongst market soothsayers. At this juncture we support a middle ground approach, neither the Armageddon scenario where the global economy falls back into recession rendering policymakers impotent and markets collapse, nor the alternative that the U.S. ends up like Japan pressured by chronic deflation with long term bond yields falling to 2% or below. We still hold the argument that the U.S. and global economy revives with much debate over the strength of the expansion. Never the less, the next stage we expect is a self-sustaining revival that takes hold. Stocks become the preferred assets of choice in either scenario.

The Bullish Case

- ❖ Monetary policy remains biased toward accommodation and the Fed “shares your concerns”.
- ❖ Corporate sector finances are in good shape.
- ❖ Lower oil prices and bond yields provide a reasonable offset to falling equity prices. Inflation is still trending down with core inflation rate at 1.0%, the lowest level since the early 1960’s. There is little risk that inflation will pick up any time soon.
- ❖ Double dip recessions are extremely rare.
- ❖ World trade and production continue to forge ahead, and stimulates corporate spending. Orders for capital goods are in a clear uptrend and should continue. The recent firming of the dollar has not to date materially disrupted export growth.

Key Economic Data to Watch

- ❖ The Labor market trends. We are assuming that the employment picture will gradually improve, bolstering consumer incomes, spending and revival in the housing sector.
- ❖ Money velocity and credit trends.

Conclusion:

There was too much despair about the economic and financial outlook in early 2009, and perhaps too much complacency a year later. Thus markets were primed for a reality check as it became apparent that recovering from the meltdown would be a difficult process. It is clear that for the economies of the world and their markets it will be a mending process that will move forward and retrench. But we conclude that it still will move ahead and we view the recent turbulence as a corrective phase, not the leading edge of a plunge back into destitution. We recognize that it’s most difficult to maintain a high level of conviction when so many economic and financial trends seem to be in uncharted waters. The speed and viciousness of the economic declines in late 2008/early 2009 was horrific and unprecedented, and the policy response was equally exceptional. The resulting deterioration of fiscal balance sheets across the developed world has placed a good deal of uncertainty as to what the future holds.

We believe that the normal workings of the free market system, together with extreme policy initiatives, will support a steady recovery in the global economy over the next several years. And if that occurs, then equity prices should climb their way higher, given their current relative and absolute undervaluations. This is not to say that there aren’t storm clouds lingering on the horizon in terms of how the past fiscal excesses will play out over the ensuing years. However, we believe that the resolution is still uncertain and can change in the years ahead. Although the returns prospect for stocks is much more modest than previous decades, they don’t have to be particularly high to beat returns offered for lower-risk assets.

* John Neff managed the Vanguard Windsor Fund from 1964 to 1995, and authored “John Neff on Investing”. When the Windsor Fund closed its door to new investors in 1985, it was the largest mutual fund in the U.S..

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