

No Time for Incrementalism

Except for a handful of really old timers, no one in finance has ever experienced anything like what we have been witnessing this fall in the stock market and the economy. I'm old enough to remember that the American automobile companies were outstanding examples of our industrial achievements. In the 1950s Harlow Curtice of General Motors was on the cover of *Time* with a very favorable article inside. I had a '57 Chevy and thought it was perfect. Now the chief executives of the auto companies are testifying before a skeptical Congressional committee hoping for tens of billions in financial aid. This year Harvard University's endowment has lost \$8 billion. Recently, Harvard had broadened its financial aid program to include more middle class families and some observers were wondering why the school's development office bothered to raise more money at all. We should have known trouble was coming.

The "policy portfolio" concept used successfully by many university endowments may require some serious reevaluation. It is based on the idea that various asset classes have delivered specific returns over time and while there may be short-term deviations from historical levels, the concept of reversion to the mean prevails in the long-term. The task of asset allocation is to make judgments on what level of volatility you are willing to endure for a certain level of return. This approach has worked over the past several decades, but it is likely to be seriously tested in the future.

We have all become used to the idea that the market suffers serious setbacks from time to time but it recovers and goes on to higher highs. This idea is the basis of the case against market timing and trading and the foundation of the buy and hold philosophy of investing. If you believe, however, that the worldwide deflationary recession will be prolonged and that the unwinding of excessive credit will require extensive government intervention, then it may be some time (if ever) before we get back to the highs the market achieved in the last cycle. I think, for example, that neither Western Europe nor the United States is likely to show real growth of better than 3% any full year in the next five. If that turns out to be the case and inflation stays low, reducing pricing power, then earnings may only have a gradual recovery. Unless multiples rise significantly, the stock market could go through a tough period. Moreover, in a slow growth, compressed margin environment, I believe bankruptcies are likely to increase causing a rise in loan and bond defaults. Large government deficits and heavy borrowing abroad to finance them could cause interest rates to rise, putting pressure on the bond market and these conditions could persist for some time.

Across the country, investment committees for endowments and universities are meeting to address the problems caused by a significant decline in the value of the institution's assets. In most cases they will make small changes in the allocation to various categories. In the case of private equity, this may be difficult because of future capital commitments. My view is that this may be a time for major, rather than minor, changes because the world is likely to be a very different place over the next five years. To some extent the sharp decline in financial assets has already reflected some of that, but it may be some time (if ever) before returns revert to the mean. The structure of portfolios should be altered to reflect that reality.

This is not a time for incremental changes or small adjustments. There may need to be radical revisions to policy portfolios. For example, private equity may not provide strong returns for some time because of sluggish business conditions, a lackluster new issue environment and an inability to borrow funds to leverage up acquired companies. This may also be a time when credit instruments are more attractive than equities because they are selling at distressed prices, providing a satisfactory current

return and offering the opportunity for capital appreciation if the economy improves. If conditions worsen, credit is senior to equity on the balance sheet. In these conditions I would be raising allocations to credit (including performing mortgages) and reducing private equity in institutional portfolios.

As for the economy, we have entered the Age of Interventionism, as I wrote last month. We have already seen how important the federal government has been in providing support to the financial service industry. We cannot expect this aid and investment to be given without some government involvement in corporate decision making. It remains to be seen whether this impairment of the concept of free markets limits risk taking and profitability. If it does, there are important valuation implications. Right now investors are focused on survival for the system and certain companies like the automobile manufacturers. Many stocks look very cheap on any historical basis, but it remains to be seen how relevant history is in the period going forward.

It is also clear that there will be a considerable government role in supporting the housing industry. The objective will be to keep as many people in their homes as possible even if they have fallen behind in their mortgage payments. Aid to delinquent borrowers, however, must meet a fairness test in order to avoid disadvantaging responsible mortgage holders who have worked hard to keep up their payments. You can't offer a delinquent borrower a 4.5% mortgage when his next door neighbor, who kept up his payments, continues to pay 6.5%. Some homeowners who are clearly in houses beyond their means will have to be relocated. The resolution of the housing problem will require an elaborate administrative effort and considerable time. None of these steps to resolve past housing excesses will revive the home building industry and that remains a significant challenge.

The Obama administration has to balance its program to resolve past problems in finance, auto and housing with the need to provide jobs and provide stimulus to the economy going forward. Obama has set an objective of creating 2.5 million jobs, but even that may be too timid an objective. The loss of 533,000 jobs in November understates the problem. When you add in the number of people who would like to have a job but have stopped looking in despair, plus the number who have part-time jobs but would like full-time work, the "under" employment rate swells to 1.2 million.

The administration, therefore, also has to avoid incremental thinking. Providing the stimulus needed to get the economy growing will require an unprecedented administrative and financial effort. The objective for Obama's first term may have to be five million new jobs and the budget deficit may soar to over \$1 trillion in his first year in office. Fortunately, interest rates on U.S. Treasury securities are low because the flight to safety has attracted domestic and foreign investors to our government notes and bonds. We should issue as many ten- and thirty-year bonds as we can because we will surely need the money. You can see the pressures building by looking at the Federal Reserve balance sheet where liabilities have risen from \$700 billion to \$2.1 trillion this year. Longer-term, the cost of correcting the problems in the financial system and providing the stimulus to get the economy growing again may cause interest rates to rise and the dollar to weaken, but we'll have to deal with that tomorrow, as Scarlet O'Hara said. If we approach our economic challenges today on an incremental basis and don't take extremely bold steps, we may not get to tomorrow in any shape conducive to cope with the challenges that may develop at that time.

The leverage unwinding process is likely to continue for several years because it has been building throughout this decade. Earlier this year I pointed out that in the 1950s every dollar of the debt taken on by the economic system produced \$0.73 of gross domestic product growth. In the 1960s and 1970s this ratio of growth to GDP declined slowly, but since 1980 the decline has been accelerating and in the current decade a dollar of debt has only produced \$0.19 of GDP growth. Therefore to keep the economy expanding, leverage was increased enormously. In order to resolve these excesses the federal government will have to take on more debt, making the problem worse before it gets better.

Longer-term the deleveraging process is likely to mean that the United States is entering a prolonged period of very modest growth. Henry Kaufman, the bond pundit, has looked at the problem of debt accumulation in relation to growth and points out that the savings rate has declined from 9% in the period from 1960 to 1990 to 1.4% now and averaged 4.7% from 1991 to 2000. He argues that the savings rate must increase and debt levels must decline. But that is only likely to happen in a slowly growing economy.

In a discussion last week of the Bush presidency, Karl Rove said that the economy grew at an 8% nominal rate from 2001 to 2007 and that was one of the achievements of the current administration. He did not address the issue of debt accumulation to achieve that level of growth and the implications of excessive leverage. Over the past decade economic observers have celebrated the increasing productivity of labor enabling American companies to produce increasing amounts of goods and services with fewer workers. This focus on labor productivity has ignored the fact that capital has become increasingly less productive and that has led us into our current crisis. The challenge for the Obama economics team will be to develop a program where the productivity of both labor and capital increase in tandem.

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