MARKET COMMENTARY April, 2009

The Market

Equity investors continued to struggle painfully in the first quarter of 2009 but, unlike late 2008, there were positive signs of change. In many ways the quarter felt like a continuation of the fourth quarter of 2008. Overall markets continued to lose value with the S&P 500 and Dow declining about 11% and 12.4%, respectively. Just as in 2008, there were significant statistical and historical declines in returns during the quarter. During 2008, equities fell by percentages not experienced since the Great Depression. The first quarter of 2009 saw major Index values reach levels not seen for 12 years. Price declines of this magnitude have only occurred twice in the last 80 years; in 1932 during the Great Depression and again in 1974 when the world was reeling from oil shocks and political turmoil.

In fact, we believe that historians will view the fourth quarter 2008, and the first quarter of 2009 as a continuum marked by further “price discovery” in financial assets, greater realization of the depth, complexity and inter-related nature of the losses sustained in the global financial system and the resulting geometric growth in global government recognition and policy response to the problems at hand.

While it hasn’t been pretty, one could argue that the last two quarters also mark a period of not insignificant positive achievement and that a durable bottom in equity prices has been reached. First and foremost, we elected a new administration that is now firmly in place. Leadership is critical in righting a market dealing with rumors, lack of confidence and uncertainty. The new administration has expanded the already massive policy response and there is a relief in the market that someone is again at the helm. Second, the rate of change of negative surprises, revelations and shocking headlines related to the global financial system and economy seems to have waned. That doesn’t mean we are in the clear. Make no mistake, we are going to see a stream of less than inspiring reports from corporations and weak economic data going forward. On the other hand, government and corporate leaders, as well as the individual investor, are now well conditioned to the enormity of the task of recovery from the global economic downturn. Moreover, there is some inkling of actual, real positive information flow from burgeoning international commodity demand, better than expected housing data to harbingers of bank profitability and rumors of financial firms paying back their share of government relief. Finally, amidst all the turmoil and doubt, the market (a predictive mechanism) seems, at least for now, to have recovered from its low set in March.

Emerging Markets To Lead Global Recovery

We believe economic recovery will be inherently global, led by China, Brazil, India and the other emerging economies of the world. Indeed there are some indications this recovery is already underway. The recent G20 meeting in London underscored the power-shift in economic and financial markets from the industrialized nations (the G7) to the BRICs (Brazil, Russia, India and China) and the other developing economies. Emerging markets are likely to account for all of global growth in 2009, and the IMF estimates that in 2010 EMs will grow by about 4% while the industrialized economies (U.S., Japan, Canada and Western

Europe) will collectively only grow at 0%-1%. We may look back on the global financial crisis of 2008-2009 as the turning point for the worldwide economy where the center of gravity shifted from West to East, from the industrialized to the developing world.

Over time it is also likely that investment and financial activity follow commerce and economic growth toward the emerging markets. Not only do the emerging markets offer faster growth and favorable demographics, but significantly better "balance sheets" as reflected in trade surpluses, generally positive fiscal account balances, and high savings rates. In fact, the major developing powers could be called the surplus countries. China, Brazil, India and Russia hold 45% of the world's foreign exchange reserves versus only 6% for the western economies of Europe and North America.

Given the nature of the emerging new global economy, we continue to favor leading resource and commodity producers who will benefit from a strong rebound in demand for materials and infrastructure in the industrializing BRIC economies. Holdings such as Exxon, Petrobras and BHP are all major participants in this trend. Other portfolio holdings like Procter & Gamble, Diageo, and Nestle will be long term beneficiaries of rapid growth of the middle class and rising consumer demand as savings are redeployed to stimulate domestic demand growth in China and elsewhere. Finally, companies like General Electric and Emerson Electric are major providers of basic infrastructure for economic modernization and will also be significant long term beneficiaries of the emerging market story.

Green Shoots Through The Permafrost

What Ben Bernanke likes to refer to as "green shoots" of early stage economic recovery have begun to appear, particularly in the U.S. and China, over the past few weeks. It is too early to tell whether these green shoots and the recent rally in stocks around the world will actually mark a turning point in the road to recovery but, as the recession now enters its 6th quarter, it is at least a possibility to contemplate. Only time will tell, but we thought it might be helpful to highlight a few of these recent positive developments:

- Global commodities have bounced considerably off the bottom. Copper is up more than 60%, Oil 50%, and Corn and Soybeans roughly 25% from their lows of a few months ago.
- Wells Fargo and Goldman Sachs reported surprisingly strong first quarter earnings, showing some winners may be starting to emerge from the financial crisis.
- Good news out of China that indicates its stimulus programs may be working: Industrial output grew 8.3% in March after a very slow first two months of 2009; oil imports in China rose 33% in March over February; China's Purchasing Managers Index (PMI) rose to 52.4 in March, its first reading above 50 in six months; finally China bank loans and M2 are growing at a rapid pace (50%) over the past 3 months.
- Structural market reforms in the U.S. markets:
  1) Modification of "mark to market" rules pressuring bank balance sheets.
  2) Reinstatement of rules to restrict short selling and restore the "uptick" rule which had served the markets well for the last 75 years.
- Global credit spreads and liquidity indicators have returned to near normal values.
- Improving trends in housing and auto sales at the margin, as inventories have declined to unsustainably low levels.
- Continued global cooperation and unprecedented policy response to the global downturn. At the recent G20 meeting, an additional $1 trillion was allocated to the IMF for support of emerging markets (well above consensus) and a commitment to maintain free trade and avoid protectionism.

Channeling Irving Fisher
MV=PQ

We have to admit that not much in macroeconomics makes sense. But Irving Fisher, one of the pioneering monetary economists who lived during the Great Depression, is rightly remembered for an important theory on the purchasing power of money: MV=PQ. Fisher said that there was a positive relationship between prices or the nominal value of expenditures and the quantity of money: more money and/or more economic output equals higher prices. That is, Fisher's theory of the quantity of money held that the supply of money (M) times its velocity (V) – the rate at which currency circulates throughout the economy – is equal to price level (P) times output or the real value of expenditures (Q). While you will not normally read a treatise on macroeconomics from us, we think this relationship is worthy of mention because of the tremendous budgetary expansion both globally and in the United States. As output (Q) has declined in this downturn, our government's reaction to the financial crisis and economic slowdown is a dramatic, historic acceleration in spending fueled by debt. We are expanding money (M) at very significant levels. The velocity of money (V), however, has declined as consumer and corporate confidence has declined and entities have a tendency to hoard money. The policy game has been to get MV up enough to counteract the decline in Q so that prices (P) do not decline further and we suffer the disastrous deflationary impact of broadly declining price levels in a modern economy. The vehicle to increase money (M) has been huge borrowing against the country's balance sheet while simultaneously running a big fiscal operating deficit. The current US budget deficit is estimated to be $2 trillion, about 14% of GDP. Our outstanding debt is growing to historic levels on an absolute basis and as a percent of GDP. In short, we are creating money (M) like there is no tomorrow. By accelerating spending at a tremendous rate, our government has made a pact that they are willing to fight higher prices tomorrow rather than try to deal with a general price level decline today. This is strong medicine.

We think the velocity of money is linked directly to confidence. As confidence is restored over time, velocity will improve and price levels will increase. The problem is that while a little inflation is probably a good thing, a little inflation is a hard thing to maintain. When the global market gains some traction, the huge global supply of money may translate into perhaps more than a little bit of higher prices or inflation. Given that the level of inflation, once stimulated, is hard to manage and that money creation is at historic levels, we think channeling Irving Fisher is an important concept when thinking strategically about future equity and fixed investments. As we have discussed in past letters, we continue to build positions in companies like Barrick Gold, the world's largest gold mining company, and other gold related investment plays. In addition, we are adding to energy and resource holdings at favorable prices which will also be a beneficiary and a hedge against rising inflationary risk and a weaker dollar. Consider us more than a little wary of the future effects of the strong medicine our government is administering today.