PREPARING FOR POTENTIAL POLICY ERRORS
APRIL 2012

In response to a series of financial crises, central bankers and governments have been issuing and restructuring debt and taking dramatic actions in order to access cash and transfer payments. Immense liquidity pumped into the global system by central banks found its way into equities. With Europe struggling to control debt concerns, a slowdown in parts of Asian economies, interest rates on savings accounts near zero and short term bonds offering little to offset inflationary costs, US equity markets were simply the easiest place to park all that excess liquidity.

Record setting government actions appear to be lifting asset values and are undeniably helping certain industries and specific countries work through the crisis. It is worth noting that governments can be very fluid in their transfer of money and they enjoy the ability to generate cash through many different channels. Corporations have access to capital markets and can be flexible in securing the cash needed to address risks by issuing bonds or stock or tapping credit lines. Meanwhile, households have few viable options. When a household is hit with an unexpected crisis or the loss of a job, individuals cannot issue securities or print money. They must rely on savings or sell assets or go into debt. With over 70% of our economy reliant on household spending, our economic recovery will ultimately come down to the health of the American middle class.

Liquidity from various government actions and profits from corporations turning cheaply borrowed money into earnings are both helping boost the stock market and giving rise to economic conditions. But margin expansion and liquidity derived from artificially low interest rates are temporary respite and not permanent healing. Borrowing rates are at all-time lows and tax rates are low relative to historic rates. These should help the economy to grow and should spur entrepreneurial initiative. If economic growth does indeed pick up, interest rates and tax rates are likely to rise and growth will need to be strong enough to withstand higher the costs of inflation, interest rates and taxes.

The market rally in the first quarter felt good, and was welcomed by investors and pensions alike. The rally was driven by liquidity, massive (trillions) but temporary. Governments gained some time and corporations have taken advantage. Now households need quality jobs, wage growth and stable price inflation if the middle class is to heal and to again drive the growth of this country.

Cash is still king…
Cash is king. It is a popular saying. Simple and yet profound. Often, it is said in reference to the flexibility provided by cash during tough times. Tough times come and go throughout life, and in the midst of these crises, the old “one in the hand is better than two in the bush” saying sure rings true. For households, cash is important to pay expenses, avoid foreclosures on property, and pay for unexpected costs. Cash is important to corporations. For paying wages, buying back shares, acquiring companies, and navigating tough business cycles. An unexpected situation is always easier when cash is available.

When it comes to the global economic system and debt-laden countries, that old saying “cash is king” might be more aptly stated “liquidity reigns supreme.” Cash is considered a liquid asset but liquidity refers to the flow of cash, the supply of money available, and the speed at which assets can be sold without the risk of a price decline. Like blood, cash is best when it is flowing through the system without obstruction.

In the first quarter of 2012, corporations took advantage of the Federal Reserve's "zero interest rate policy" and issued record levels of new bonds. In aggregate, over $300 billion in new debt was issued and demand for quality debt remained high during the quarter. Who can blame companies like Microsoft from issuing new debt? If the company can raise $3 billion and only pay 1% interest, it makes sense. Microsoft has a long history of earning far higher rates on their capital, so 1% borrowing costs can easily become profitable. However, for some companies and for many households and most governments, the issuance and use of debt, even when it is a low interest rate, is less assured of a positive outcome. The borrower must have the ability to pay off its debts or lenders will ultimately demand more payment (higher rates) to offset their risks.

Much of the newly issued debt now sits on corporate balance sheets as cash. Some great companies are using cash hoards to raise dividends, buy back shares and make strategic acquisitions. These companies offer great investments as they will reap huge rewards for their shareholders. Other companies are only marginal operators and are replacing higher cost debt in order to reduce their interest expense. The recovery cycle and low interest rates are helping this middle group of companies improve their balance sheets and some will be good investments while others will repeat mistakes and again become overleveraged. The bottom-tier of companies should be avoided. No favorable economic cycle can help a business that has lost its market position, or has weak leadership, or old products.

A simplistic view on how to distinguish a good company from a bad company is to look for companies which are forcing change and to avoid those that only change when forced (or even worse, companies who can't change even when their market changes).

Governments are also issuing debt and raising cash to pay for budgets and to replace maturing debt. Unlike many great companies who have a track record of investing debt proceeds in a way that creates value, politicians have a poor track record of spending these funds in any "value-adding" manner. Far too many countries are borrowing long-term money to finance short-term operations, saddling future generations with debts and running the risk of losing control of spending limits.

Failures of key banks and insurance companies caused the system to temporarily shut down and liquidity to dry up during the "Global Financial Crisis." Problems in Greece and other Mediterranean countries are symptomatic of the same type of crisis. Heavily leveraged systems require liquidity to meet obligations and any disruption can be deadly. Trillions of dollars and Euros have been supplied to the markets in order to encourage growth, to provide more time to heal, and to replace bad debts. Those actions are pushing up the level of many assets. Stock values are rising and real estate values have slowed their decline. In some areas, they have even started to rise. These asset classes are vital to pensions and to homeowners whose balance sheets were devastated by the crisis. Underfunded pensions need a stock rally or the corporations and governments who sponsor the plans will have to add billions more into them.

Benefits and Consequences

But, commodity prices are rising rapidly and putting immense pressure on household budgets. Consider two commodities integral to everyday life: crude oil and corn. It is most common to think about crude oil prices as it relates to gasoline prices. But crude oil is also a feedstock for asphalt, lubricants, plastics, rubbers, tools, lotions, perfumes, tires, ammonia, waxes…..the list goes on and on. Likewise corn is estimated to be an ingredient in over 2,500 foods. By one account, over 70% of the foods in our local grocery stores contain corn or a corn by-product. And because both oil and corn are input costs to raise beef and other animals, meat prices have risen significantly.

While it is beneficial that stocks and real estate are performing better, the average standard of living is in decline. In preparing to write this letter, I researched my own family budget. Curious about how these items are impacting my own budget, I reviewed the cost of food, gasoline, utilities and health insurance during the first quarter of 2012 versus this same time last year. Our food costs rose by 5%, our gas expenses rose 12%, our utilities rose 8% (mostly water), and our health care insurance premiums rose 11%. I compared my own personal budget inflation with national averages and my cost increases appear to be fairly in line with published surveys.

Household income has fallen significantly in recent years. According to a recent study published by Sentier Research, their real median household income index has fallen by 9.8% since 2007. The combination of lower median income and rising commodity prices are weighing heavily on the American middle class.

Last week, two reports on the health of US consumers showed an increase of 0.2% in wages and a rise of 0.8% in spending. This news helped the recent surge in stock prices continue to move higher. But, it also suggests that spending is outpacing income. Wage growth and spending should be more closely aligned. Larger portions of budgets are being used to cover basic necessities and apparently savings or credit cards are being used to finance expenditures. We will need more jobs than are currently being created and for the pace of growth to become more robust if we are to sustain the economic expansion. Central banker liquidity and political spending is a temporary solution, without sustainable and permanent growth from small businesses and the American middle class, we will hit the proverbial wall.

Allocation of Assets
Innovation and productivity are drivers of sound investments. There are companies who force change and there are companies who only change when forced. In terms of risk and reward, high quality companies continue to look attractive. If the current market rise is sustained, high quality companies will participate in the rally, and if we hit a financial speed bump, money will flow from speculative stocks into high quality stocks. Either way, we like the reward-to-risk ratio of the world's dominating brands versus companies with too much debt and too little cash. Flexibility is the key to working through a volatile time in history and companies with strong brands and strong cash flows have the most options.

Due to the absolute size of the world's debt loads and the growing risks of monetary and policy errors, we continue to model large downside risks must factor in a domino-style waterfall that could occur if any single country defaults. We see many good investment opportunities trading at decent prices. But let me be clear: there are sovereign risks and enormous imbalances that would affect an entire economic system. These risks are entirely outside the control of corporate executives and their boards. It's all about liquidity. A policy error by a country's political leaders or a monetary error by central bankers would far outweigh any good news coming out of corporations.

The Federal Reserve has stated their intention to keep interest rates near zero until at least 2014. Given this outlook, we are limiting our purchases of short-duration bonds, opting to focus more on intermediate-term bonds. This is because short-term bonds yielding just 1-2% present significant reinvestment risk when they mature. Suppose you have the choice to invest in a 3-year bond yielding 2%, or a 7-year bond yielding 5%. While the 7-year bond might feel risky, the 3-year bond poses a significant reinvestment risk. If you buy the 3-year bond yielding 2%, hoping to reinvest the proceeds in a higher-yielding bond when it matures, you would need 4-year yields at 7.2% in 2015 to make this decision profitable. Yields have not reached that level in 14 years, and we think it's a bad bet to assume they'll *soar* that high in the near-term.

Our target maturity of bond portfolios has been 3-4 years, but due to better risk/reward ratios in the intermediate-term, we are lengthening our average duration to 4-5 years by buying quality bonds maturing between 2017 and 2020. Corporate bonds with stable and improving credit metrics still offer good returns with low risk. Select municipal bonds, particularly school district GO issues, are also attractive.

- **Primary Themes:**
  - Remain liquid and flexible
  - Replace any variable-rate debt with fixed rates
  - Review budgets, estate and trust documents, financial plans
  - Focus on income generation in your portfolio (stocks, bonds, real estate)

- **Equities:** Equal to target allocations, emphasis on
  - Dominant global brands
  - Energy (oil, natural gas)
  - Health Care (pharmaceutical, HMO, disposable devices)
  - Technology (innovators and brands)
  - Utilities (water)
  - Food (brands, distribution, growers, seeds)

- **Bonds:** Equal weight, lengthen duration 1-2 years to receive higher income
  - Emphasis on corporate investment-grade quality
  - Corporate bonds with improving credit metrics
  - 2017 to 2020 target range for new buys
  - International government bonds
  - Select municipal bonds with reliable revenue streams

- **Real Estate:** focus on valuing as an income asset
  - Rental properties with positive cash flows

In closing

America's middle class helped make this country great. Small businesses are the country's employment engine: generating 65% of the net new jobs in the past 17 years; employing half of the private sector workers in the country, and hiring 43% of the country's engineers, scientists and computer programmers. The US economy is 70% consumption and our middle class is the majority of that consumption. Without a healthy middle class, a country is susceptible to social unrest, lower tax revenues and higher deficits. The recent crisis and the subsequent liquidity actions to solve it have created structural imbalances and moral hazards. So-called "too big to fail" entities still pose big risks for everyone.

Somehow in this recovery, the middle class will need to regain its health and participate. So far, large corporations (especially banks) and a narrow segment of the population is benefitting from the recovery, we will need it to broaden.

Sincerely,

Van Hulzen Asset Management's Investment Committee