

## FEAR MAKES A COMEBACK

And so it continues. After 13 months of largely feeling that the worst of the financial crisis was behind us, the S&P reached a cycle high of 1217 on April 23<sup>rd</sup>. We have been consistent in our belief that investors should be “bullish until the bill comes due.” Of course the tab can arrive in the form of deflation and a run on U.S. Treasuries just as easily as in the form of inflation and the concomitant rise in long-term interest rates. The developments in Greece and their aftermath appeared to convince investors worldwide that its private sector debt problems had only been transferred to the public sector. **Simply put, the bill in the 2<sup>nd</sup> quarter came due in Athens, not in Washington, as we had expected.** The U.S. and its reserve currency status makes it special of course, and it is still difficult for many equity investors to understand why the people are willing to pay an almost infinite multiple on cash and 34x earnings on the 10-year, and yet still seem unwilling to pay up for large-cap high quality stocks loaded with cash and thus totally un-reliant upon the credit markets. (We prefer large and mid-cap names over small-caps in periods of economic and market dislocation).

Ironically, the problem for large American companies, at least at the moment, isn't the economy or even liquidity. Indeed, we believe pent-up demand for capex and still remaining fiscal stimulus in the U.S. make a double-dip unlikely. In addition, the Fed's Flow of Funds analysis tells us that U.S. non-financial corporations have more cash as a percentage of assets than ever before. Our current crisis, it appears, is simply one of confidence. We suspect that few companies are comfortable taking undue risks in an environment in which a small number of policymakers in Washington, Brussels, and Beijing, rather than normal cyclical forces, are dictating the future character of the global economy. This might not be so bad if at least some modicum of altruism or competence on the part of the political class were evident. March's passage of a comprehensive, yet largely politically unpopular health care bill, the failed attempts to contain BP's oil spill, at times almost tribal contentiousness of European economic policymakers, and, most recently, the wrangling over a 1,900 page financial reform bill, haven't helped in this regard. There appears to be a fear that if you make money, you could become a political target – together, the Financials, Energy, and Healthcare sectors comprise 40% of the S&P 500 which have been in front of Congress recently. Responding to this sclerosis and venality, the common stock investor appears to have all but given up – there have been net outflows from equity market mutual funds despite the 83% increase in the S&P from the March 9, 2009 low to the April 23, 2010 high. Two fifty percent declines in stocks in the past decade, serial misdeeds on the part of Wall Street, and, finally, the May 6<sup>th</sup> “Flash Crash” may have convinced the few remaining die-hards that the dice are stacked against them. This circumstance doesn't necessarily need to be permanent, but it seems unlikely to be resolved until the “rules of the game” become clear. With the 2-year note at 62 basis points and the 10-year Treasury yielding 2.95%, it wouldn't be hyperbole to suggest that the private sector has gone to the mattresses. The widening spread between Euribor and Libor might also indicate that the ECB's game of chicken with fiscal policymakers on the Continent might be getting dangerously close to a policy mistake. Discretion may be the better part of valor for equities until greater clarity on European monetary policy, or the American political landscape, becomes evident.