SAYBROOK CAPITAL

INVESTMENT OUTLOOK

Third Quarter 2012

In these last weeks of a contentious campaign season, we look ahead to the great post-election policy challenge of putting the finances of our nation on a sustainable trajectory. As we wait to see if our elected officials are up to that task, central banks on both sides of the Atlantic took bold monetary actions in September, driving the third quarter stock market rally. But nearing a 'fiscal cliff,' we are mindful of the political and economic risks of this deleveraging era. And, while there have been recent indications that 2013 may be a tough year for the global economy, there are also encouraging domestic signs of an economic revival emerging.

Buying Time

Last month was an important period in the monetary policy evolution of the last three years. The European Central Bank (ECB), in a departure from its incremental approach to the euro crisis, announced it will print money to buy the debt of struggling European governments – and will do so without limit under certain market conditions. This marks the beginning of a more decisive phase of action that was telegraphed by ECB chief Mario Draghi back in July when he said: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro…And believe me, it will be enough."

Subsequently, the U.S. Federal Reserve announced additional purchases of mortgage-backed bonds in what is now the third iteration of its quantitative easing program ('QE3') and said it will keep its funds rate, currently near-zero, at "exceptionally low levels" until at least mid-2015. What makes QE3 different is that it will continue as an open-ended commitment until clear progress has been made in bringing down unemployment, even at the cost of higher inflation. The Fed hopes these actions will help change expectations, inducing businesses and investors to deploy cash reserves rather than see them eroded by higher inflation in the future.

In a broader context, European and U.S. monetary policies continue to buy time for elected officials to put their respective fiscal houses in order – no easy feat after years of *kicking the can down the road*. But now, at least in the U.S., an impending fiscal threat has finally brought this long-term goal to the forefront of policymaking.

The 'Fiscal Cliff'

If no action is taken before year-end, taxes rise and automatic spending cuts take effect (the former primarily as a result of the expiration of the decade-old Bush tax cuts, the latter because of *sequestration* legislation created after last year's contentious debt ceiling negotiations). Although the deficit could be substantially reduced under this scenario, the huge fiscal drag could tip the economy back into recession.

The phrase, 'fiscal cliff,' was coined by Fed chairman Bernanke, who warns that an abrupt regime of higher taxes and indiscriminate government spending cuts might severely damage our still-fragile economy. The admonishment is supported by private-sector economists and the nonpartisan Congressional Budget Office, all predicting a negative fiscal impact on growth next year ranging from -1% to -5% of GDP – a significant risk given that our economy only grew 1.3% in the second quarter.

After the election, Washington will have a rare chance to forge a grand bargain that achieves meaningful fiscal reform. But after so many false starts, there is little faith that a majority of our elected officials possess the willingness to compromise. The prospect of continued intransigence is certainly a threat to any progress, especially as ideologues increasingly replace the moderates who are leaving Congress. Without political compromise, we face grave risks to the underlying strength of our economy.

Yet, we remain optimistic and believe that there are several reasons a deal could actually be achieved following the election – the period in which presidents have the most political capital. First, as cited above, no action by the President or by Congress would greatly increase the probability of a recession in 2013. Second, inaction would lead to automatic defense budget cuts that could jeopardize national security interests. Other catalysts for a deal include the need to raise the debt ceiling again early next year. An increased debt ceiling unaccompanied by meaningful deficit reduction would force rating agencies to downgrade U.S. bonds, jeopardizing financial markets. We cannot imagine either political party willing to face blame for *any* of these outcomes. While there is a risk that bickering politicians send us over the fiscal cliff, that looming cliff, itself, provides real leverage to forge a budget compromise.

There is a growing consensus that such a deal should include deficit-reduction which is phased in over the medium-term and based upon a mix of spending cuts and increased tax revenues, along with tax-reform that reduces deductions and simplifies the overall tax code. This approach follows the core recommendations of the Simpson-Bowles commission which has wide-spread support from the business community and respected figures from both political parties. And it is worth remembering that before collapsing in July 2011, the budget negotiations between President Obama and House Speaker Boehner came close to a deal along these lines.

It is anyone's guess exactly how negotiations proceed. Senate leaders are reported to be working on a framework for a deal during the lame-duck period after the election; and Congress may try to delay the pending tax hikes and spending cuts for six to 12 months in order to allow relevant committees to draft the details of a fiscal reform plan. Whatever the process, it is likely to be messy and contentious. We are not expecting an all-or-nothing result, rather a deal somewhere in between resolution and implosion – recognizing that too much delay without enforceable deadlines would be received negatively by financial markets. Any deal that moves the country towards real fiscal reform would require everyone to tolerate changes that are not in their immediate interest (e.g., investors would likely face higher taxes on dividends and capital gains). But, because expectations about the capacity of government to reform itself are so low, any meaningful progress is likely to increase confidence and would ultimately be bullish for the stock market.

Investment Posture

Irrespective of whether reform is achieved in Washington, 2013 may be a tough year economically. Against a backdrop of already sluggish GDP and employment growth, manufacturing indicators weakened over the summer, coinciding with a broad slowdown in global trade volumes. The deepening recession in Europe and moderating growth rates in emerging markets are all factors. China, in particular, is experiencing a slower economy as its exports stall and the country undergoes its once-a-decade leadership transition.

Closer to our desks, several companies that we follow have warned that the slowing global economy will negatively impact their upcoming results. Companies such as FedEx (which we do not own) and Norfolk Southern (which we do) have pre-announced disappointing results for the current quarter. These two companies are part of the Dow Jones Transportation Average, an index which is down year-to-date even with the broad stock market up significantly. This divergence could be viewed negatively, as the performance of transport stocks has often been a good predictor of economic activity. In short, there are near-term (cyclical) risks to the economy in addition to the political and fiscal concerns.

Nevertheless, some emerging domestic trends encourage us about the longer-term revitalization of the U.S. economy. Households have reduced their debt as a share of after-tax income over the last half-decade, setting the stage for stronger future demand. The current U.S. energy transformation (see first-quarter Outlook letter) is helping fuel a budding domestic manufacturing renaissance.

After many false starts, there are even convincing signs that the housing market is improving. Half a decade after the collapse, construction activity, home sales, and real estate values have increased notably in recent months. This development has been driven partly by record low mortgage rates, but also pent-up demand due to higher rents, new household formation, and prospective buyers who have waited on the sidelines. Additionally, the rate of sub-prime delinquencies is ebbing, marked by September's five-year low in foreclosures. Any improvement in housing can be meaningful for the economy, as construction projects create jobs, and improving home values help to increase consumer sentiment, mend bank balance sheets, and encourage more lending.

Saybrook's portfolio reflects our effort to navigate these economic crosscurrents. A preference for equities has served our investors well, even in recent years when many others seeking to invest "safely" have shunned stocks, instead flocking to cash, bonds, gold, and hedge funds. And, while our undervalued growth equities have performed well on a relative basis over a difficult decade, we believe that our stock portfolio will become *much* more valuable as our economy revives over time and prospers. Mindful of looming fiscal risks, and, eventually, higher inflation rates (which severely erode the value of bonds and cash), we own high-quality companies with pricing power and the capacity to pay dividends.