

SAYBROOK CAPITAL
INVESTMENT OUTLOOK

First Quarter 2011

Amidst tectonic changes across North Africa and the Middle East, surging oil prices, catastrophic natural disasters in Japan, and domestic budget battles, investors may be overlooking a new potential trend: an asset allocation shift into equities in general, and U.S. stocks in particular. Recent geopolitical events have certainly increased the level of concern about economic growth rates and commodity inflation. Nevertheless, the resiliency of our stock market in the face of first quarter events may be indicative of broader asset flows into equities.

Shift towards U.S. Stocks

A broad-based asset allocation shift appears to be underway in the U.S. and around the world. Equities are increasingly being viewed as desirable investments versus other asset classes, and within global equity markets, U.S. stocks appear to be relatively attractive. In recent months, we have noticed many signs of this apparent trend.

Over the past decade, many pensions, endowments, and other institutions underweighted common stocks and became disproportionately invested in less-liquid asset classes such as real estate, timber, commodities, private equity, and other investments that were seen as hedges to the volatility of equities. During the financial crisis, many of these alternative assets were down as much or more than traditional stocks. Furthermore, because of large allocations to illiquid investments, several prominent university endowments faced serious cash flow short-falls during the 2008-09 period. Since then, some institutional investors have been adjusting their strategic allocations and gradually increasing public equities. At a conference last month, for example, the head of the University of Virginia's endowment told us that they are in the process of reducing commitments to private equity and hedge funds that require capital to be locked-up for many years, while increasing their allocation to managers that focus on high quality stocks. Notwithstanding this shift, institutions remain underweighted in stocks. According to data from

the Federal Reserve, private pension funds are currently only about 50% allocated to stocks, versus allocations of more than 60% to stocks a decade ago.

A telltale of a broader shift from alternatives back to stocks came to us from a highly regarded investor in Real Estate Investment Trusts (REITs). In a surprise January letter to clients - after years of fantastic performance – the investment manager announced that he was closing his fund and returning the limited partners' capital. Why? Simply stated, when he started the fund over ten years ago, stocks were expensive and REITs were cheap. Today, it is the reverse. And, as he wrote, among the headwinds now likely to face REITs is “the potential for investors to rotate back into good old-fashioned stocks.” Even more interesting from our perspective, he told us that after liquidating his fund he plans to reinvest his substantial personal capital largely in stocks. For the next decade, he will build a portfolio of predominantly U.S. blue chip stocks that have large international exposure and pay good dividends (in fact, he mentioned several of Saybrook's core holdings). The following is an excerpt from a chart in the letter:

	January 2000	December 2010
S&P 500 Price	1,455	1,257
REIT Index Price	2,376	8,348
S&P 500 Price/Earnings Ratio	31.3x	15.8x
REIT P/E Equivalent Ratio	9.9x	21.8x

This allocation shift into U.S. stocks is also evident among global institutions. Anecdotally, we recently heard about a prominent Australian institutional investor with a global mandate who now believes that the best way to get broad international growth and foreign exchange exposure is to invest in U.S.-based companies that generate revenues world-wide. Another such example comes from the Government of Singapore Investment Corp. (GIC), one of the world's most active sovereign-wealth funds. In a recent interview, the head of GIC, Dr. Tony Tan Keng Yam, said that more than one-third of its holdings are currently invested in the U.S., and that GIC will continue to allocate its assets into American markets. Dr. Tan also noted that: “[Negative sentiment is a] problem when I talk to Americans. They don't see the potential in their own economy, which is one of the most innovative, open economies in the world. Foreigners seem more optimistic [about the U.S.]”

America could increasingly become the developed market of choice for global investors. While not to downplay our own serious issues, America's prospects look relatively attractive against the backdrop of current challenges in Japan and Europe. The economic impact of Japan's horrific earthquake, tsunami, and nuclear crisis are not yet quantifiable; however, it is clear that the country's long-struggling economy now faces huge rebuilding costs and supply-chain disruptions. The European debt crisis continues with Portugal becoming the third country (after Greece and Ireland) forced into a euro-zone bailout. Attention now shifts to the much larger economy of Spain, and many argue that a more fundamental debt restructuring process is needed to prevent further contagion. In England, which is one year into its own controversial austerity program, the economy is slowing.

Emerging market investors also face a growing list of risks. Beyond the uncertain consequences from the Arab Spring upheavals, clear inflationary pressures are mounting in China, India, and Brazil. Policy makers in these countries are struggling to stabilize prices without drastically slowing underlying economic growth. In China, now the world's second largest economy, the inflation rate is accelerating despite four interest-rate increases over the last six months and further attempts to prevent an overheating economy by slowing the pace of bank lending.

Amidst these concerns, global fund flows may be indicating a broader move into U.S. stocks. After years of outflows, the first quarter of 2011 witnessed notable flows back into domestic stock funds, outpacing capital going into bond funds and emerging market equities for the first time since the credit crisis began. Furthermore, as the table below indicates, the U.S. stock index has outperformed international markets over the last six months, perhaps suggesting the beginning of a strategic rebalancing, even from emerging markets which have attracted so much capital over the past several years.

	Price Performance 9/30/10 - 3/31/11
S&P 500 (U.S.)	16.2%
STOXX (Europe)	7.5%
MSCI Emerging Markets	5.8%
Hang Seng (Hong Kong)	5.2%
Nikkei 225 (Japan)	4.1%
Bovespa (Brazil)	-1.2%
Sensex (India)	-3.1%

Out of Bonds

In maintaining an essentially 0% rate on Fed Funds for over two years and deploying a second round of longer-term bond purchases (quantitative easing, or “QE2”), the Federal Reserve has accomplished one of its near-term objectives: rising stock prices. Fed Chairman Bernanke argued, in his now famous *Washington Post* op-ed late last year, that a consequence of QE2 is that: “higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending...[and] further support economic expansion.” Since QE2 was anticipated last year, U.S. investors have moved steadily out of low-yielding bonds (and “no-yielding” cash), and into stocks.

Benchmark 10-year U.S. Treasury bonds, which ended the first quarter yielding 3.45%, do not offer compelling value. They look even worse if (or *when*) we get an acceleration in inflation. Indeed, there is growing sentiment among investors of the probability of capital losses on Treasuries purchased at current levels as the yields move back up towards more historical rates of over 5% on the 10-year bond.

Although the Federal Reserve could extend its monetary stimulus programs, the anticipated end of QE2 in June has increased the level of uncertainty among bond investors. As PIMCO bond manager, Bill Gross recently wrote: “Who will buy Treasuries when the Fed doesn’t?” The answer to that rhetorical question, of course, is that yields will likely have to rise in order to attract new bond buyers after the Fed’s buying program ends. Although tighter monetary policy may not be good for bond prices or even stock prices initially, it would signal stronger underlying fundamentals.

Monetary and Fiscal Imbalances Must Be Addressed

Whether recent stock market results indicate a lasting, secular asset allocation shift towards U.S. equities may ultimately depend on our ability to meet our own big economic challenges. The U.S. must create more jobs so that our economy can grow without the crutch of massive monetary stimulus. And we must summon the political will to enact a real, long-range fiscal deficit-reduction plan.

The sooner our economic recovery becomes sustainable enough for the Fed to permanently end quantitative easing, and raise its short-term rates, the better. America's overreliance on loose monetary policy has been a distorting influence on financial markets, fueling near-term growth. But monetary stimulus is not infinite – at some point it must end. While the Fed hopes to have the flexibility to wind it down gradually and without igniting inflation, there are potential risks that could force its hand sooner. One such risk, of course, is a further spike in oil prices, which have already run up 25% this year due to Middle East turmoil.

Our growing fiscal deficits pose a more structural risk. While austerity can harm a fragile expansion, a failure to address fiscal issues could restrain our long-term economic growth potential. Likewise, a further decline in global investor confidence in the dollar could be inflationary and force higher interest rates. Dealing with our fiscal challenges will not be easy, particularly amidst the rancor of our current political environment. Furthermore, any credible deficit-reduction plan will require a broad national compromise and shared sacrifices – inevitably including some elements that investors will not like.

Congress and the White House have finally brought the fiscal debate to the national forefront. And, perhaps significantly, a bipartisan “Gang of Six” senators has been quietly putting together a legislative package modeled on recommendations by the president's Bowles-Simpson commission. Honeywell's CEO, David Cote, is a member of that commission, and we had an opportunity to talk with him during a break at the company's investor conference last month. He had just met with the senators from the commission and told us that the emerging plan would seek to significantly reform and simplify the tax code. Our conversation gave us reason to be hopeful that a meaningful plan will be developed and eventually enacted. The wild card is: when? While few expect it, there is a small chance for a congressional deal in conjunction with the controversial upcoming vote to raise the legal limit on our \$14.3 trillion federal debt. More likely, any real reform will have to wait until after the 2012 elections. Nevertheless, we are optimistic that this will ultimately be done.

In conclusion, we might be in the early innings of a longer lasting asset allocation shift back into U.S. stocks, particularly if we can address our underlying fiscal challenges. If not, domestic stocks, as “the best house in a bad neighborhood,” may still outperform other asset classes. We own a high-quality portfolio of undervalued stocks that should benefit in either scenario.