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AMI Investment Management
Registered Investment Advisor

Quarterly Investment Commentary

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The stock market continued its advance despite a brief hiccup in late January. The S&P 500 was up 5.4% for the quarter. The bond market posted a 1.5% return as interest rates dipped and then returned to previous year-end levels. International stocks trailed domestic issues and REITs posted a strong quarter. Economic data remained mixed. While capacity utilization and industrial production increased, employment figures and housing data continued to disappoint.

We view the next six months as important in determining the trajectory of the worldwide economic recovery. While we generally dismiss the notion that certain economic periods have more “uncertainty” than others, we are anxious to see how the summer and fall will play out. The valuation of financial assets is based upon (a) future expectations of cash flows and (b) the interest rates used to discount those cash flows. When we say we are “bottom-up” investors, we mean that our primary determinant of investment action is researching individual securities and comparing their price with their intrinsic value, calculated as the sum of their cash flows discounted at an appropriate interest rate. However, “top-down” input is necessary because macroeconomic factors such as economic growth, inflation and interest rates affect the forecasts of cash flows and the applicable discount rate. When valuations are so low that even dire forecasts of growth and the use of elevated discount rates render the conclusion that financial assets are underpriced, top-down concerns are less important. With the rise in asset values over the last year, however, securities are hovering around fair values, making macroeconomic assumptions more relevant.

There is a great debate among analysts and economists as to whether the economy is embarking upon a standard economic recovery or is still in the grips of fallout from a less typical financial crisis. The disagreement manifests itself through views on the future path of inflation. In an article published on April 4th, the Wall Street Journal reported that even leaders of the Federal Reserve are split on the issue. Potential inflation rates are of great concern for investors – after all, it is the real (inflation-adjusted) rate of investment return that matters. Proponents of the higher inflation argument claim that the explosion in the monetary base and long-term fiscal concerns will lead to rampant inflation. Messengers in the opposite camp argue that the U.S. is in a liquidity trap, a la Japan, and deflation, or at least disinflation, remains the chief concern.

Where do we fall? If experts at the Federal Reserve fundamentally disagree on the assessment, it is obviously a tough call to make. But after spending much time researching the issue, we have trouble picturing a surge in inflation near-term, despite serious long-term threats. Economist Milton Friedman’s famed statement that “Inflation is always and everywhere a monetary phenomenon,” has been remarkably well assimilated into popular culture. However, money is a complex and often misunderstood topic. Yes, the Federal Reserve has massively increased the monetary base, but that increase has not shown up in the “money supply.” Inflation is often explained as too much money chasing too few goods. In order for money to actively chase goods, the “velocity” of money – the speed with which money moves through the economy – must be high. Despite increases in the monetary base, though, banks and individuals aren’t circulating money through the system at a pace rapid enough to increase the general price level. Instead, funds are sitting unused in bank vaults. The key cause for this occurrence is the “deleveraging process” that we have often discussed in our commentary. U.S. citizens took on far too much debt over the last two decades and are now struggling to deleverage. It is estimated that a quarter of all homeowners with mortgages are now underwater, meaning they owe more on their house than it is currently worth. Accordingly, Americans have cut back on spending and reduced their demand for new loans. Risky individuals and businesses who wish to borrow funds are being turned away by financial institutions that are in their own process of deleveraging.

The direct result of a large portion of the population increasing their savings rate and risky borrowers being denied funding is a falloff in the level of aggregate demand in the economy. Less new debt equals less new houses, new autos, new televisions, etc.

Think of it on a personalized basis – are you familiar with someone that would have purchased a new car, house or television set two years ago, but given their present situation they have decided to "cut back"? The drop-off in aggregate demand has lowered the velocity of money – consumers are demanding less goods, instead choosing to hold their money in the form of bank deposits or reduce their debt load (which still ends up with the bank, which isn't relending the funds rapidly). This process restrains inflationary pressures. Excess capacity in the system, resulting from a drop in aggregate demand, reduces the pricing power of economic parties. Workers can't push for higher wages because of excess supply in the labor market. Manufacturers are having trouble raising prices because of weak end-user demand and heavy competition for a smaller customer base.

Our research indicates that there are enough similarities between current U.S. difficulties and those witnessed in Japan beginning in the early 1990's to suggest relevancy. Japan's government debt has continued to rise over the last two decades (now topping 120% of GDP), yet the country has continued to fight *deflationary* forces.

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These views lead us to the belief that the economy will most likely stage a weak recovery. Drastic inventory destocking last year will lead to economic growth and there will be a snap-back in demand for products whose purchase can only be temporarily delayed (e.g. businesses eventually have to buy new computers). But sustained levels of unemployment and continuing struggles in the real estate market should lead to further deleveraging and defaults, pressuring economic expansion.

This isn't to say that inflation is not a threat. The Federal Reserve will have an incredibly difficult task when economic growth reemerges. Fed leaders will need to quickly drain excess money from the system once monetary velocity increases while trying to avoid stomping out a budding economic recovery. It is unclear how successful they will be. Further, the government's long-term fiscal picture is dire. The stimulus plan and federal bail-outs are actually a small piece of the larger problem. In fact, the government's short-term intervention in the economy has been a key to propping up aggregate demand in the face of deleveraging by consumers, financial institutions and local governments. It is difficult, though, to envision how political leaders will deal with the long-term challenges of our entitlement programs, especially given pressure on revenue generation from decreased levels of economic activity. The recent debate and passage of health care legislation does not inspire confidence that political leaders can find ways to effectively tackle entitlement reform. There are three possible solutions – raise taxes, decrease expenditures or inflate the debt away. Inflation is the worst of the three (although none are pleasant), but registers as the common choice of governments historically. Washington is walking a tight line. The debt has increased to a point where a rise in interest rates would become incredibly costly to U.S. taxpayers, worsening the fiscal situation further.

How should investors react? Despite casting our hats in the short-term disinflationary camp, we won't make any large active bets against inflation. In fact, we will look to add inflation protection instruments *on price weakness* given longer-term concerns. Although inflation may still be a few years out, the key variable is inflation *expectations*, which will likely lead actual inflation data. We are maintaining market duration on our fixed income portfolios, but are not participating in fixed debt instruments with long-term maturities. Thirty year Treasuries trading at 4.7% may someday be remembered as a bubble. Despite low yields, fixed income offers protection against deflationary environments and stability given heightened equity valuations. Select alternative investments provide important portfolio diversification and will become more useful as inflationary concerns grow. Disciplined absolute return strategies should help protect portfolio value in the event of any downward adjustment in the markets. Real estate and commodities may struggle amidst deflationary pressures in the short-term, though longer term opportunities are encouraging.

Our most favored investment remains high quality stocks. Such issues continue to trade at attractive levels relative to other stocks, financial assets and historical valuations. Specifically, we want to own companies that exhibit a strong degree of pricing power, protecting investors in inflationary and deflationary environments. Consider Frito-Lay, a division of PepsiCo (PEP). Frito-Lay, which owns Doritos, Tostitos, Fritos, Lay's, Ruffles, Cheetos and Sun Chips, commands 70% of the domestic chip market. They control their own inventory within retail stores and to raise prices they simply reduce the number of chips inside a bag as opposed to marking up the gross sales price. Consumers typically don't notice the move (especially when it occurs across at least 70% of the aisle). Frito-Lay has been able to increase chip prices on average 4% per year and did so at even higher rates during the depths of the economic crisis. While PEP is not trading at valuation levels quite in-line with our margin of safety requirements, we use it as an example of the kind of blue-chip companies that have for the most part not participated in the market rally. These companies are not only relatively cheap, but appear to offer the best risk-adjusted returns given a range of economic scenarios.

Sincerely,

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