1st Q 2010 Quarterly Letter

A Changing World

The first quarter of 2010 was interesting to put it mildly. The markets finally pulled back, ever so slightly, and then rallied sharply to finish the quarter in positive territory. Most broad market averages finished the quarter up approximately 4.9%. The interesting aspects of the quarter were punctuated with the passing of the largest healthcare reform bill in the history of our country. The political landscape is tumultuous at best, and the battles we see in the November elections will be turbulent. Our economy is continuing to be “not as bad as it was” and the job market is anemic, at best. From a positive perspective, corporate America has done an excellent job managing through this crisis. In spite of a very weak economy, with no real growth in demand, companies continue to deliver solid profits. This has been very encouraging, and executives at companies all over the U.S. deserve credit for making the best of a bad situation. Eventually, the companies have to see demand increase and be in a position to sell more goods and services, but for now businesses have done a wonderful job managing costs.

If one reads the paragraph above carefully a couple of things should jump out. First, there are some budding concerns that have not gone away. They just went out of focus. Secondly, the positive results reported by companies have come from cost controls. Translation of “cost controls” – cutting people and cutting discretionary spending. The world seems to be in unison when they say, “If we can just hold on until the economy really recovers, we will be just fine”. Unfortunately, the market’s rally increases the risks to the downside. This is an obvious statement, since when stocks go up they can fall farther, but many people forget that higher expectations are the only thing that can cause stock prices to go up faster than the growth in cash flow of the underlying business. That is where real risk comes into play. Investing would be easy if stocks only went up or down by the same amount as their company cash flows rose or fell. But this is DEFINITELY not the way the world works. Stocks move much faster, up and down then their cash flows change. That is the function of those powerful words of fear and greed. When stocks go up faster than cash flow growth, the risks rise at an exponential rate because if/when cash flows begin to drop and/or expectations change, stocks will fall very fast.

This is what makes the investment world so very interesting. It is almost more a function of psychology than economics. As we have quoted Mr. Buffet many times, “In the long run the market is a weighing machine, in the short run the market is a voting machine.” Right now the market is voting for higher prices. Whether that is because a “real” recovery is close at hand, or because no one wants to sit with their money in the bank and earn zero, really does not matter. The votes are cast daily and will ALWAYS drive prices higher and lower than they should go.

Status of the Foundation

Right now we feel like we are looking at the foundation of a house. There are some cracks appearing in the walls and those cracks appear to be getting bigger and more pronounced. When you have cracks in your home do you immediately rush to repair your foundation? No, you wait as long as you can to make the necessary repairs. Why? Because it is very expensive, it disrupts your daily life and is very unpleasant. First you “hope” that the problems will go away. Next you try any “patch” and alternative solution you can find before you finally have no choice and you have to “bite the bullet” and tackle the problem head on.

This is precisely what we feel is happening in this country. Everyone sees the cracks and knows that they signify structural problems in our “economic foundation”, yet the leadership seems content to just push off the inevitable and “hope” that the problem will simply fix itself. What are these cracks? Massive levels of government and consumer debt definitely tops the list. Stubbornly high unemployment, sluggish consumer and business spending, and tax policies that do not encourage business expansion are serious issues. The amount of dependence that our country has on foreign sources of energy and an incredible dependence on the willingness of foreign investors to finance our monolithic deficits and government debt provide for a very fragile situation.

We continue to try to find “quick fixes” and push the problems into the future whether it be with another new “housing recovery plan” or another couple of hundred billion dollars of “stimulus” money. The end result is going to be the same that it always is. Eventually we are going to have to make hard choices and attack the problems head on, instead of simply “kicking the can down the road” and pushing the problems onto a future generation of politicians and tax payers.

When will the foundation crack to such an extent that we don't have any choice? That is impossible to answer, but it is inevitable. We have just learned that the Social Security system has crossed an ominous landmark. This is the first quarter that the amount of benefits paid out were MORE than the amount of money taken into the system. The combination of a reduced employment base and a rising retiree population has caused this threshold to be reached nearly 10 years ahead of schedule. As the baby boomers retire at an accelerating rate this trend is unlikely to be reversed, and we have begun the slide down the slippery slope which is the quarterly drain of the Social Security surplus. This “third rail” of politics has been off the radar screen as a result of the financial crisis and healthcare reform, but it is going to have to be addressed.

Imagine what would happen if the Chinese stopped loaning us money? We currently owe the Chinese just under $1 Trillion. The amount of power that the Chinese government is gaining over our country is disturbing. The Chinese, along with a majority of the Middle Eastern countries and other countries around the world, are financing a very uncomfortable level of our federal debt. That means that they are the ones loaning us money to support the government “stimulus” programs and our deficit, and they don't have to do this. They can choose to stop at any time. Even worse, they could choose to sell the debt that they have purchased from our country. The impact of those sales, or even the reduction in the amount of the money they are willing to loan us, would be devastating. Will it happen any time soon?

No matter how one feels about the manner in which our government is trying to accomplish the objective of providing healthcare to everyone, it is impossible to argue that it is not going to be incredibly expensive. This cost, which no one seems to be able to truly put their arms around, is going to weigh on the economy. That fact is irrefutable, and we will only realize the true cost with experience. The facts that have been supported by all parties involved verify that every single employer will incur larger expenses in the future. The impact of this is also irrefutable. The new costs will slow the pace of new hiring, if not increase the rate of personnel reductions and those costs will eventually be passed along in the form of slower wage growth and higher prices. That translates to slower growth in spending and less economic expansion.

Space does not permit the detail of every "crack" in the foundation that has to be addressed. We have previously discussed the pending commercial real estate problems, the likely failure of another 300 small banks and continued pressure on home owners. Ultimately, the cracks will continue to gain visibility and they will have to be addressed. The biggest crack that has to be addressed, though, is our countries debt burden. Without an unprecedented increase in economic expansion, which is unlikely given the current state of affairs, there are really only two ways to address the unwieldy levels of government debt that currently exists. We are either going to have substantial tax increases or we will see high levels of inflation. The first solution will choke off economic growth, and the latter creates a whole host of problems. Suffice it to say, we are going to eventually be forced to deal with the problems brewing below the surface.

Where do we go from here?

So where does that leave us. As was the case at the end of the year, the markets are caught in the cross currents of these substantial forces. Corporate profits continue to be the bright spot against a dark backdrop of macro-economic forces. Stocks continue to push higher as "Cash and Career Risk" motivates the masses to simply hold their nose and buy. We are maintaining a "2" on the CAZ Scale, albeit with a negative bias, as it is very difficult to see what will be the catalyst that forces the hand of policy makers. One thing that we can say with total confidence, interest rates are going to go higher! If the economy falters, long term rates may drop a bit first, but the laws of supply and demand are going to drive rates higher. There is no way to avoid it. The main asset class that will be negatively impacted by rising rates is long term bonds, although numerous other asset classes will see ancillary affects.

We stated last quarter, and we will reiterate it here, if you have not reviewed your overall asset allocation, it is important to do so at this time. All asset allocations have shifted dramatically as a result of the large stock market increase since the March lows. To be clear, we constantly monitor the target asset allocations for our clients and will proactively review those to confirm they are within target ranges. However, we know that many of our clients have other assets that we do not oversee. Whether they are company retirement plans or investments in other asset classes, we strongly encourage you to speak to us about your overall allocation to make certain that it currently meets your objectives and risk tolerance. Fixed income investments should not be excluded from this discussion. As we indicated above, we see interest rates rising sharply from currently levels, and long term bonds are going to lose substantial principal value if that does indeed occur. This is not a time for complacency.

This is the first quarter that our statements have been created under the Inroads Capital Management systems. The format has not changed, only the headers. Our joint venture is getting off to a great start, and we are excited about the opportunities ahead of us. For clients who only have separately managed accounts with us, this is the only report and letter you will receive. For clients who have both separately managed accounts AND pooled investment vehicles with us, you will receive this quarterly report, which summarizes all of your investments that we oversee, this quarterly letter and an additional letter that discusses the pooled vehicles. Please do not hesitate to let us know if you have any questions regarding the reporting you receive.

As always we value your relationship and appreciate the confidence you have in our organization. We look forward to seeing you soon, and please let us know what we can do to assist you in any way we can. We send our very best to you and your family.

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