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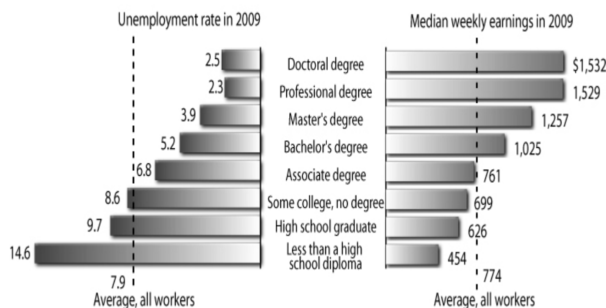
APRIL 2011

Market Commentary

Outside of the Financial and Homebuilding sectors, stocks have largely recovered from the 2008 financial crisis and recession. Earnings for the Technology, Industrials, Consumer Staples and Discretionary sectors are at or above their 2007 peak. This recovery came faster than we had thought likely. In early 2009 we did a back of the envelope calculation that projected the S&P to recover to a level of 1600 and $100 in trailing earnings by the end of 2014 – currently the index trades around 1300 and 15.3 times 2010 earnings of $85. Consensus projections for 2011 earnings now stand at $97. Unfortunately, this recovery has come without a significant increase in job creation which leaves unemployment still near 9%. Less skilled workers bear a disproportionate amount of this burden. An analysis by the Bureau of Labor Statistics shows that in 2009 the unemployment rate for workers with a Bachelor's Degree averaged 5.2% compared to 7.9% for the entire workforce and 9.7% for high school graduates. The difference can likely be accounted for by the collapse in the construction industry which comprises one of the largest sources of employment for less skilled workers.

Education pays



Source: Bureau of Labor Statistics, Current Population Survey

With the recovery in corporate profits and spiking commodity prices, speculation has increased about when the Federal Reserve will start to wind down its zero interest rate policy. The investment management firm PIMCO and at least one Federal Reserve Governor recently stated that short term rates could increase as soon as year-end. Inflation, which was 1.3% in 2010, would begin to approach 2.5-3.0% over the remainder of the year. The corresponding increase in the ten year Treasury yield would likely be 100-150 basis points from the current level of around 3.5% - enough to cause a 8-12% decline in price.

Commodity Prices do not Cause Inflation

Commodity price shocks, while painful, generally do not cause sustained inflation unless "monetized" by central banks expanding the money supply to compensate. The oil price shock in 2008 led to a recession and deflation, not broad increases in prices. If a consumer has to spend an extra $100 per month on gasoline, that is $100 that cannot be spent on other goods, so all else being equal, the increased costs of energy would be offset by falling prices in other goods and services due to decreased demand. In reality what happened in 2008 was that higher gas prices were the catalyst that collapsed the credit bubble. A significant number of consumers began to miss mortgage payments because of higher energy prices and the increased costs of transportation made new houses in distant suburbs less attractive. The result was a sharp recession that triggered the financial crisis.

Two Mechanisms for Inflation

The 1970s saw a phenomenon that came to be labeled the "wage / price spiral.
" Compared to less than 10% today, over 20%

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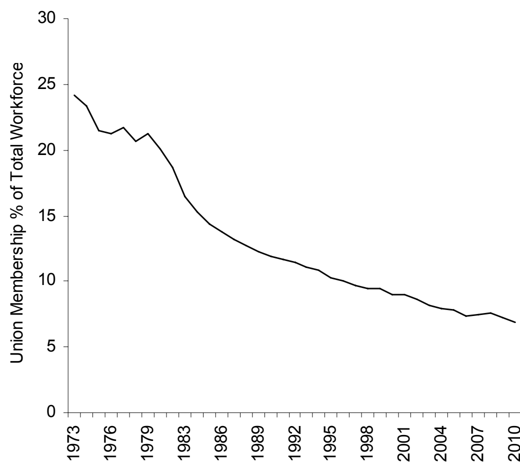
of the private workforce in the 1970s belonged to a union. The unions in the 1970s were able to negotiate automatic cost of living adjustments in wages, increasing them at or above the current rate of inflation. These benefits were then extended to non-union employees. Companies passed through price increases to consumers who then received matching wage increases resulting in a feedback loop that led sustained inflation. This was also the mechanism behind the Brazilian hyperinflation of the 1980s. With high levels of unemployment and very little ability for labor to negotiate wage increases, it is hard to see how the cycle can sustain itself in the US.



The other avenue for inflation is credit. The Federal Reserve's purchases of Treasuries with freshly created money (quantitative easing) does increase the money supply, but only within the banking system. The additional step needed for inflation is for banks to lend against these newly created reserves. If the roughly $2 trillion in new reserves on the Fed's balance sheet were lent out by the banking system at typical ratios of 10-1, then $20 trillion of new credit – roughly 1.3x total GDP - would enter the economy causing at least a doubling of the price level. The combination of banks' reluctance to lend and weak loan demand has led to these assets remaining within the banking system where over time they will mature and the cash will re-enter the economy gradually and without the lending multiplier. This lack of lending is why quantitative easing failed to generate any inflation in Japan when it was attempted in 2001.

German worker sweeps worthless Marks into the gutter during the 1920s

It's all about Deficits

Ultimately the US (and the rest of the developed world) will have to get their budget deficits below their nominal rate of GDP growth. If inflation is 3% and real GDP growth is 2%, then a budget deficit equal to 5% of GDP would result in a static Debt / GDP ratio. This is of course made easier if both inflation and GDP growth are growing at higher rates. With a current deficit of 9% of GDP, the deficit needs to be cut in half over the next several years to prevent a sovereign debt crisis in the US. The deficit is the annual difference between expenses and revenues, as distinguished from the National Debt which is the total amount borrowed. While no fixed level for debt as percent of GDP denotes a hard limit, at some unpredictable moment confidence evaporates and there is a crisis. This is currently happening in Portugal and occurred last year with Ireland and Greece. These countries differ from the United States in that they cannot print their own currency and owe most of their debt to foreigners. Despite the headlines, foreign ownership of public and private debt is proportionately lower for the US than for most developed countries. The ability to print currency and the large domestic base of Treasury Bond owners mean that the US can sustain an insolvent and dysfunctional public finance system longer than most other countries, but ultimately budget deficits must be brought under control.

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How to Protect Your Portfolio

Owning high quality productive assets provides the best long term protection against inflation. While the prices of precious metals or other commodities may continue to appreciate, it is not prudent to invest more than 5 or 10% of a portfolio in an asset with no income or earnings. One also would need to know how to time entry and exit points correctly. Failing to sell gold after it peaked in the early 80s resulted in large losses. Likely due to their lackluster performance in the 1970s, common stocks are underappreciated as an inflation hedge. However, equity investors generally fared better in the 1970s than bond investors. An extreme example of inflation is provided by Germany. The country went through one of the most infamous cases of hyperinflation in the early 1920s, with prices increasing over a trillion-fold. German stocks recovered from the severe inflation and went on, according to researchers Dimson, Marsh and Stauton, to return 5.8% annualized net of inflation for the decade. This is because the goods produced in factories had value in the new German Mark, just as they had value in the old one. Stocks represented a legal claim on a share of the value of these goods and adjusted to changes in the units of the currency. Bonds and cash equivalents, on the other hand, became worthless. While the German situation in the 1920s was extreme and very unlikely to be repeated in a developed economy, it provides a lesson in how owning high quality real assets can allow one to survive a worst case inflationary scenario. Fortunately, high quality global companies remain attractively priced and offer the potential to deliver 5-6% real returns, well above bonds or more speculative stocks. Maintaining reserves of short to intermediate term high quality fixed income equal to five to ten years of cash needs limits the amount at risk of loss from inflation and rising interest rates. Furthermore, holdings of high quality stocks and bonds can be complimented with various opportunistic investment strategies and real assets.

Commentary by
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Smart Investing Webinars

Join us each month as we discuss current market trends, wealth transfer planning, and investment related topics. For more information or to listen to the recordings of past calls, please visit our website **www.paulcomstockpartners.com** under Smart Investing Resources/Conference Calls.

NEWS

- Comstock launches new, improved website: www.paulcomstockpartners.com
- Empowering Beneficiaries LLC hosted Peter Buffett, son of Warren Buffett, for a conversation about wealth transfer and empowering the next generation. To listen to the recording go to: www.EmpoweringBeneficiaries.com and click on the Blog section.
- James Engelbrecht, Senior Research Analyst, attended the IFG Wealth Management Forum held in Phoenix, AZ April 11th-13th.

Questions?

If you have questions about the commentary, the markets, or specific to your portfolio, please give us a call! (713) 977 2694

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