BROWN ADVISORY

ALPHABET SOUP: THE SHAPE OF RECOVERY

In a remarkable reversal of financial conditions and investor emotions, the focus of debate in investor circles has shifted from the depth of the downturn to the shape of the recovery. It helps, of course, that the stock market has rallied over 50% since the lows of March, but the surge in sentiment extends well beyond the market itself. As economic optimism gained traction in recent months, tentative talk of "green shoots" yielded to arguments over which letter of the alphabet will most resemble the shape of the recovery—U, V, W, or (out of alpha sequence) L.

Although we're not economists—and, in fact, spend our time and energy primarily on analyzing company fundamentals rather than divining the future course of the economy—investment strategy will ultimately be affected by the nature of the recovery. As a result, we listen carefully to the forecasts of a number of leading economists, form our own views, and factor them into our thinking with respect to asset allocation and portfolio construction. Consensus thinking, confirmed recently by Federal Reserve Chairman Ben Bernanke, is that the economy has reached bottom, but there is far less agreement on how strong the recovery will be over the next year or two. Will it be a U-shaped recovery with growth of 1-2%, or V-shaped (4+%)? Or perhaps a W, with a sharp near-term bounce followed by further decline? Or even an L with no growth for an extended period? In terms of corporate earnings and how one should be positioned in the markets, there is a meaningful difference among the scenarios.

Formula for Growth

To introduce a few more letters, every "Econ 101" student will recall the simple formula that summarizes the main components of Gross Domestic Product:

GDP = C + I + G + NX

*In which **C** = Consumption*

***I** = Investment*

***G** = Government*

***NX** = Net Exports*

In reality, the factors behind each component in the formula are complex, rendering the forecaster's task much more challenging than it appears. What we do know for certain, however, is that "C" accounts for approximately 70% of GDP and is thus the big gorilla in the economy. Without some help from that sector, the recovery will eventually stall, leading to mediocre equity returns or worse.

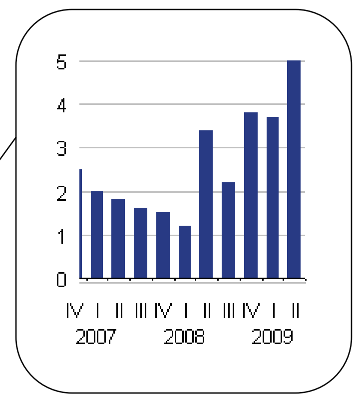
It's not difficult to construct a scenario in which GDP will grow at a rate of 2-4% over the next couple of quarters, *without* much help from consumption. Recent data suggest that a turn in inventories and housing may already have begun. Inventories are exceedingly lean, as companies cut stocks to the bone during the depths of the recession. Realizing that they could be losing sales due to lack of inventory on hand, many companies are beginning to re-stock. Capital spending, too, could be stabilizing or improving. A recent *BusinessWeek* survey found that 45% of the companies in the S&P 500 increased their spending sequentially in the second quarter from the first quarter, more than double the percentage that increased spending in the previous quarter. Housing is another form of investment that seems to be rebounding, partly from pent-up demand and partly because of attractive prices and low mortgage rates. Finally, the weak dollar, coupled with a pick-up in foreign economic activity, is driving improvements in the trade balance (i.e., net exports). To be sure, some of these "positives" are one-time factors representing rebounds from overly depressed levels. Unless there is sustained follow-through by the consumer, they could roll over after their initial jump.

Probably the most important driver of consumption over the next several years will be jobs growth. Starting from today's low point, employment should grow slightly faster than the labor force, which is projected to increase almost 1% annually due to demographic factors. This scenario would be consistent with a gradual reduction in the unemployment rate—clearly a major objective of fiscal policy. In addition, the long-term rate of growth in real wages per worker is above 1%, and with continued gains in productivity it seems logical to conclude that this rate will continue. The third key variable is tax rates, which appear likely to rise, given the effect of the recession and stimulus programs on projected federal deficits. Adding these factors together leads to a projection of 2-3% growth in real disposable income, below recent trends but still reasonably positive.

Wild Card

A change in the consumer's rate of savings and willingness to take on debt could alter the outlook significantly. As savings have taken a beating over the last two years, this factor is a bit of a wild card in the economic debate. One of the most staggering indicators of stress in the consumer sector is *The Bank Credit Analyst's* estimate that some $17 trillion of net worth virtually evaporated between the second quarter of 2007 and the first quarter of this year—approximately a third of total U.S. household wealth. This massive destruction reduced the ratio of net worth to income from about 650% to 450%, wiping out the entire effect of the housing bubble and the bull markets of the late 1990s and earlier this decade in less than a two-year span. What's more, today's circumstances are considerably worse than those faced by consumers in the mid-1990s, as they now attempt to rebuild balance sheets in the face of weak labor markets and an impaired financial system.

Personal Savings as a Percent of Disposable Personal Income



Even though consumers lately have been reluctant to add debt, and mortgage obligations have been reduced through foreclosures, the ratio of debt to income remains near its all-time high. According to BCA Research, the ratio now stands at about 1.4 times, up from 1.0 in 2000 and less than 0.4 in the early 1960s. If incomes were to rise while the assumption of debt stays constant or declines, this indicator would begin to retrace its huge increase of recent years. The ratio, however, can be misleading. More important in some respects than the *level* of debt is the ability to *service* debt—the percentage of income that goes to pay fixed obligations. The Federal Reserve calculates what it terms the Debt Service Ratio, or debt payments to disposable personal income. Since 1980, the DSR has grown from 11.2% to 13.5%. Adding in other fixed financial obligations (automobile lease payments, homeowners insurance, etc.), the total "Financial Obligations Ratio" in similar fashion has risen from 13.8% to 17.3% over the 30-year period. These may not seem like alarming increases, but it's important to keep in mind that they occurred during a time when interest rates were *declining* precipitously. The prime rate, for example, dropped from the high teens to just over 3% during the period. If rates were to rise—a likely prospect over the next two to five years—the burden of carrying debt could serve as a significant drag on consumption. Thus, it's difficult to envision consumers adding to debt in order to maintain their spending. Some degree of deleveraging seems more likely.

Reduced Thrift

There are several ways to measure the rate of consumer savings, but all point to a dramatic reduction in thrift in recent years. From a high in the 10% range in the early 1980s, savings as a percentage of disposable personal income dropped to less than 2% for most of the current decade. Until recently, the decline was not necessarily a major concern since the cumulative amount of savings (i.e., net worth) was at record levels in both dollars and as a percentage of income, thanks to buoyant equity and housing markets. As mentioned above, the setback in both home equity values and securities prices has taken net worth as a proportion of income back to levels not seen since the 1980s. In view of this setback and the still-heavy debt load, it remains to be seen how long an aging consumer sector can defer savings and still expect to pay for retirement. The answer would appear to lie in a significant increase in the savings rate, and there are already some signs that this may be occurring. The financial crisis frightened consumers into spending less, and last spring's tax rebates were saved in many cases. The savings rate is back over 5%, but the gain could prove temporary as the recovery lifts confidence and pent-up demand is unleashed. It's worth noting that growth in savings is generally associated with high interest rates (witness the 1980s), so if rates rise as the recovery matures, they could entice people to save more.

Besides trying to add to their inadequate retirement savings, many older consumers have re-entered the labor force or are planning to do so, in an attempt to maintain their lifestyles. According to a Census Bureau survey, 23% of adults between 65 and 74 were either in the labor force or actively looking for a job—and that was in 2006, before the recession and its devastating effect on household net worth. The problem with this strategy is that, despite today's longer life expectancies, health issues and declining skills prevent older workers from earning at anything like the rates they did as younger employees. One recent study showed that men experienced a 39% drop in income and women a 19% decline, when rejoining the labor force. Savings still need to be padded if workers are to retire comfortably.

Weighing the various factors, it seems likely that savings rates will exceed the low levels that we've come to accept as normal over the last decade or so. Coupled with the deleveraging of personal balance sheets, an increase in savings will lead to a reversal of the combination of mounting debt and dwindling savings that caused spending to grow more rapidly than incomes for so many years. Going back to our original formula, sluggish growth in consumption will probably mean a relatively slow recovery in GDP—although, as always, it's unlikely to be a smooth progression.

Investment Positioning

From an investment perspective, a moderate growth outlook, if coupled with low inflation, should be favorable for equities while it lasts. As we covered in last quarter's letter, the unusual amount of slack in the global economy seems likely to keep inflation at bay for the next couple of years. Production has declined dramatically in the U.S., and capacity utilization is 10-12 percentage points below the average of recent years. Nor are labor costs expected to contribute to inflation, with unemployment near 10%. The main worry has been commodity costs, which could get a further boost from growing demand in emerging economies, but commodities alone may not be sufficient to drive inflation rates. If inflation remains at bay, interest rates will be range-bound for the next year or so. The Federal Reserve appears to be more concerned about preserving the still-fragile recovery than reining in growth. Back in June, bond futures suggested a 50% probability that the Fed would begin tightening in November, but that possibility is now extremely remote. Looking ahead, futures indicate a 50-60% chance that rates will remain the same through next March. The larger issue is what will happen to inflation and interest rates over the long term as a result of continued deficit spending.

Despite a benign inflation outlook for the near term, we are monitoring economic variables for signs of inflation and keeping maturities short (i.e., in line with our benchmarks) in an effort to mitigate interest rate risk in our bond portfolios. The steepening yield curve means that returns at the short end are extremely low, but we are hesitant to extend average maturities more than a few years out the curve, thereby taking on the risk that inflation pushes rates up. The dilemma is that one cannot make money by staying short. As fear has subsided in recent months, investors generally are beginning to move money out of short-term money market funds and into longer-duration bonds in search of yield. The risk with this strategy, of course, is that bond prices could come under pressure when and as interest rates eventually rise. We found the following formula humorous in this regard:

1.0018^N=2

N>375 years

…meaning that at current Federal funds rates of 16-18 basis points it would take at least 375 years to double your money

—not exactly a compelling investment! Still, because of the volatile investment environment it makes sense to keep cash for liquidity purposes and to take advantage of timely opportunities.

In equities, we believe the markets are attractive on an intermediate-term basis despite the last six months' advance. Price/earnings ratios remain just below historical averages, but when adjusted for today's low inflation and interest rates, valuations are relatively inexpensive. More importantly, we continue to find under-priced stocks whose fundamentals, in our estimation, will weather the challenging economic environment. Given the moderate growth period we foresee, we are reluctant to weight our portfolios toward stocks whose earnings are heavily dependent on a V-shaped recovery. This strategy has served our clients well in terms of performance, even though some of the largest percentage gains have been turned in by companies that were close to extinction at the depths of the decline (and may still be). Within equities, we believe that smaller-capitalization growth stocks offer better-than-average prospects because of their rapid growth resulting from the ability to innovate, differentiate their products or services, and serve rapidly growing niche markets. Although small-cap growth stocks have performed relatively well so far in 2009, their historic periods of out-performance during periods of recovery tend to be long-lived.

In alternative asset classes, we are seeing a number of very compelling opportunities to put money to work, albeit with limited liquidity. Our hedge fund exposure is positioned to participate meaningfully in distressed credits, a sector in which continued market dislocations offer the potential for out-sized returns. The financial crisis dramatically increased the size of this market, yet the number of hedge funds able to take advantage of it has declined, resulting in particularly attractive prospects for those who remain and have the expertise to capitalize. We are also investing in a partnership that focuses entirely on the distressed debt space while bringing world-class technology sector expertise to bear in making investment decisions. In real estate, we have invested in several partnerships as they raised fresh capital to put to work primarily in commercial properties. These markets are likely to remain under pressure from overcapacity and funding problems and thus offer the potential for those with requisite cash and expertise to achieve significant long-term gains. In addition, we are currently evaluating how best to participate in the U.S. government's Public-Private Investment Program, designed to improve liquidity in the mortgage-backed securities markets. Finally, we have been active in private equity, as history suggests that investing in this asset class near the bottom of the economic cycle is rewarding. Energy has been a particular area of focus, as the combination of a weak economy and the pull-back in oil and gas prices appears to offer an exceptional opportunity.

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