

“Secular or Cyclical—It Makes a Difference”

Hammond Associates Conference Call

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I. Overview

Good Morning everyone, and thank you for joining us for the Hammond Associates Quarterly Research Teleconference. With me today are Anthony Brown, our CIO; Shaum Shrinivas, the co-author of our QRR; Mike LeVar, our co-head for Hedge Funds; and Grant Leslie, senior analyst in Private Markets. We appreciate your time, so we will keep our remarks relatively short, and leave time at the close for questions.

In today's teleconference, entitled, “Secular or Cyclical: It Makes a Difference”, we make the case that consumers' response to the present credit crisis will prove secular, or long lasting, and not merely cyclical. Although our economy has avoided a systemic, or system-wide, financial meltdown, it is going to be a long time before we return to full employment, high consumption patterns, and global synchronous growth.

As Alan Blinder, professor at Princeton and past Vice-Chairman of the Federal Reserve pointed out in Friday's Op-Ed pages of the Wall Street Journal, the good news is that the economy has finally hit bottom. The bad news is the same: the economy has hit bottom, and it's going to be a long, uphill climb to get out.

Nevertheless, it is a lot better to be an investor today than 2 years ago, as asset pricing has reduced risk. And while the world, and it's economic behavior, seems to be constantly changing, the principles of institutional investing have not changed: In the end, investors must be adequately compensated for risk. Poorly compensated risks must be shunned. Be cautious, but fearless.

For example, we find stocks fairly valued today, but only just so. However, we are concerned that investors' apparent confidence in a rapid recovery is misplaced. In today's conference call, based on our just-released, ‘Summer 2009 Quarterly Research Report’, we explain how we came to this conclusion. We'll look briefly at the good and the bad in our economy today, the credit bubble and high unemployment, prospective political adventures, where we believe the economy is going from here, and finally, our advice to institutional investors.

Importantly, we are recommending today a reversal of the 5% allocation to equities we recommended adding during our October 10, 2008, teleconference. Simply put, we believe equities have come too far, too fast, and the risk of a substantial fall from today's values is significant. In fact, we will not be surprised to see a considerable pullback in stock prices by the Fall, as investors come to the realization this credit crisis is secular.

With that as an overview, we'll get right into the presentation. Remember, there will be an opportunity at the close for your questions.

II. The Good News

Most folks prefer to start with good news, so let's start there. We'll begin with equities and move on to the good news in the economy.



Equities

The S&P500 enjoyed its best quarter in 10 years during the April—June calendar quarter, earning nearly 16% (non-annualized) in the quarter alone. Since the rally began March 9th, the Dow Jones Industrial Average is up 38.5% in just a little over 4 months—the biggest percentage gain since 1975, 34 years ago. In so doing, the Dow has tacked on more than 3,500 points. Many of you may recall we announced on this teleconference last October 10th, that we thought equities at the time were starting to be a terrific buy, and recommended an additional 5% allocation to equities in our Research Portfolio. We intended to begin a fairly mechanical process of making incremental equity allocations as PEs, and stock prices, dropped further. At the time we were discussing internally whether equities PEs would reach single digits. In fact, markets did continue to fall after October 10th, but not as far as needful to wring out all the excesses we saw in PEs. As a result, clients did not add to equities a second time, but some rebalanced again. Nevertheless, those of you who did add to equities last year or early this year, either through new allocations, or rebalancing decisions, have earned nice gains, principally from your additions to international and emerging market stocks.

In any event, however, today we believe it is time to take that recommendation off, trimming equities by the 5% added last year. More on this later.

Economy

Most agree today that we've averted a systemic collapse in the global financial system, thanks to the leadership of Bernanke, Paulson, & Co. That's certainly welcomed news. There were times in the dark days of last fall when we weren't sure we would, such as in the early hours of October 10th when the Dow dropped 1,200 points on the opening bell, from 9000 (about where we are today), to 7,800. This drop brought the total decline in the Dow for October alone to 22%. When added to the previous month's 9% drop, stocks, at that moment, were down over 30%, seemingly in a nanosecond.

Happily, the economy showed positive signs of stabilization last quarter. GDP contraction, for instance, slowed from the horrendous 6% drop in the 4th Q'08, and the 4% drop in 1st Q'09, to a mere 1.8% contraction in 2nd Q'09. Even though the number is negative, the news is still good.

As businesses replenish inventories this quarter and the Federal government's \$787B stimulus program finally hits Main Street, we actually expect positive economic growth during 3rd Q'09.

III. And Now, for the Rest of the News

Unfortunately, the news is not all good. Essentially, the bad news is that the recession itself is far from over. We find ourselves today with an impaired financial system, a \$15T hole in household wealth, and most importantly, a sizable portion of erstwhile consumers out of work. Consequently, we believe the short-term outlook for the US economy is poor. In fact, like others, we think History may dub this the "Great Recession", as its length will likely dwarf that of any contraction in the last century, save that of the Great Depression.

To wit: in April we surpassed the length of both the 73/75 and 81/82 recessions, considered the worst in the post-war period. At 19 months and counting, only the Great Depression, which lingered a dismal 43 months, experienced a more prolonged slump than this.

Many economists, however, are calling for an end to the recession in the second half of 2009, predicting modestly positive growth in the 3rd and 4th Q'09, due to anticipated replenishment of business inventories and the federal stimulus program. Our guess is that the recovery they foresee, if it happens, will be largely illusory. Alan Blinder's previously-cited Op-Ed piece makes the point that the arithmetic of hitting bottom itself suggests we will see positive GDP growth, even with no growth in GDP. How? When critical components of GDP, like spending on new homes for example, which is now 2.6% of GDP, turns in an astonishingly negative growth of 39% in a quarter, such as it did last quarter, then even if the following quarter's growth is only zero, that change alone would add a positive GDP gain of a full percentage point (2.6% X 39%). Is it a mathematical

gain? Of course, but even so there was no actual growth in the economy.

Sooner or later the economy is bound to stop contracting, and GDP will appear to be positive, even robust, once again. But beware: initially, it may only be the arithmetic of having had truly awful declines, followed by less-awful declines, or even small positive growth. It may be better in the sense that the beating has stopped, but it is by no means “good”. And so, the gains may be merely illusory for a while, until strong GDP growth persists.

But not all economists are so cheery. Some, like Harvard’s Martin Feldstein, opine that inventory replenishment and the stimulus program alone will be insufficient to return the economy to positive growth after the 3rd Q ’09. Dr. Feldstein, for instance, believes we could see a Double Dip Recession beginning in the 4th Q’09. However, if this happens, the National Bureau of Economic Research (or NBER, who officially determines when recessions begin and end) would probably consider it a continuation of the recession, rather than a double-dip. Many past recessions have had positive GDP growth quarters within them.

IV. The Continuing Malaise

To understand the current economic problem better, let’s first review how we got here, and where ‘here’ is, today.

Credit Bubble

The bubble that precipitated this Great Recession was a Credit Bubble, blown to gargantuan size by consumers willing to lever next year’s pay for this year’s gratification. Housing, cars, you name it, we bought it, and financed it. Total credit market debt to all borrowers skyrocketed to 350% of GDP last year, from 143% of GDP in 1951. Interestingly, the last time the ratio of credit to GDP came even close was when it spiked to 265%, just before the Great Depression. Looking at household debt alone, from 1960 to 2007, the ratio of debt to personal disposable income more than doubled, from 55% to 133%. Returning just to the 1998 ratio of 91% household debt to disposable income would require households to pay off \$4.2T of indebtedness, and could take as long as 6-8 years. Imagine the impact on spending as households shift from spending to saving in an attempt to pay down debt equal to almost 30% of last year’s GDP. This shift in spending patterns began in earnest at year-end, such that household savings has spiked, in just over nine months, from 1.4% to 6.9%. This household savings rate is the sum of last year’s savings rate of 1.4%, plus consumers’ cut in consumption of 1.7%, plus new disposable income earned, but saved, of 3.9%, for a total of just under 7%. Incidentally, the sharp increase in disposable income can be entirely explained by the tax cuts and other aspects of the stimulus program, as aggregate wages declined over this period.

No wonder the Fed stepped in. David Brooks, in an Op-Ed piece in the New York Times on June 11, 2009, points out that when the “leverage wave crashed last fall, the US government, facing the possibility of a systemic collapse, stepped in and replaced private borrowing with public borrowing. Federal spending ballooned as the Fed’s printing press ran nonstop. In 2007, the Federal Deficit was 1.2% of GDP. Today, two years later, it is at 13%.

Of course, the Federal government is not the only governmental unit undergoing fiscal pain. US states are projecting an aggregate budget deficit of \$142B for the fiscal year just started this month. Last year’s budget shortfall for states totaled \$113B. Making matters worse for states, tax receipts are falling. Aggregate state tax revenues were off 12% in the 1st Q’09, and were down 20% in the 2nd Q’09. California’s recent financial problems underscore the risk that the Federal government will begin bailing out states, and soon.

Also worrisome is the poor shape of many public, that is, state and municipal, pension plans. The Economist recently cited a study suggesting that the largest 116 state and local government pension plans were underfunded by \$3T (three times the states’ and municipalities’ estimates). Some public pension plans are even leveraging their portfolios by issuing bonds. This is alarming news, and portends another coming political/fiscal crisis. Stay tuned.

High Unemployment: a Systemic Problem

By now we're all well aware of how this happened. First, home values collapsed, then bank net capital ratios evaporated, and banks shut off their lending spigots overnight. Unprecedented waves of large financial and corporate bankruptcies ensued, and continue to the present, costing some 6.5 million jobs to date and still counting (remember; only 60% of the population works). Consequently, we find ourselves today with real unemployment running at over 16% (based on U-6, which includes discouraged job seekers and part-time workers who want full-time jobs). And, it is still rising. This is far above the 9.5-10% rate quoted by popular sources. As a result, mortgage foreclosures, corporate bond defaults, and commercial real estate loan defaults, have yet to peak. In that regard, commercial real property values have declined 24%. The commercial mortgage-backed securities (CMBS) market, which provided fully 20% of commercial real estate loans in 2007, is now completely shut down, and has been for some time. Of the collateralized debt obligations (CDOs) of asset-backed securities (ABS) issued in 2007, 82% have now defaulted. Nearly half (47%) of all ABS CDOs issued since 2001 have now defaulted.

Our point? So long as credit remains scarce for consumers, corporations, entrepreneurs and developers, bad news will continue to be the norm. This Great Recession was precipitated by excess credit in an economy in which US households drove 70% of the economic activity. With \$15T of their wealth flash-fried, 16% of their colleagues unemployed or underemployed, and corporate layoffs continuing in the face of global excess capacity, US households simply can not reasonably be expected to return to their profligate spending ways anytime soon—if ever. Some, such as Martin Walker, a senior scholar at the Woodrow Wilson International Center for Scholars in Washington, are predicting only a return to pre-1980s spending levels, or a “new normal” level. To wit: In 2007, personal consumption, at 70% of our \$13.8T GDP, was \$9.7T. Martin calculates that if it had been even at the upper end of the 1946-1983 norm, at 63%, 2007 consumption would have been \$1T (about 7%) less.

As households deleverage, or reduce their indebtedness, corporations and investors can expect to see slower growth in sales. Profit margins may recover somewhat, but only if present layoffs and other cost avoidance measures become more or less permanent. Income growth needs to exceed household debt growth for several years. Consumers must live below their means in order to reduce debt with new savings.

Politics

What about taxes? While politically alluring during expanding Federal and State budget deficits, levying additional taxes is a financial impediment to growth, and can further damage America's fragile fiscal position. It is unwise, even if politically expedient, to pay for the President's \$1T health care proposal, or any other new cash transfer program, by increasing taxes just when taxpayers need to save the most. Those 1.4% of American taxpayers deemed “rich” by virtue of earning \$350,000 of household income already bear over 45% of the entire US income tax burden. And this is before the expiration of the Bush tax cuts. Sooner or later the US is going to have to face the inevitable, and either reduce taxes and government spending to permit households to discharge their accumulated debt, or adopt a broader consumption tax to discourage spending and encourage savings. In the meantime, increased taxes may well be counter-productive to our economic recovery.

Speaking of political risks, we worry that Fed Chair Ben Bernanke may be replaced in January when his present term expires. His replacement at this point in our economic malaise may be seen as a political expedient to monetizing the rapidly expanding Federal debt. Already the Fed has promised to buy back \$300B of medium- to long-term US debt in an effort to engineer “quantitative easing”, which is “FedSpeak” for keeping interest rates artificially low. So far, the Fed has spent \$150B on this program. If this one-time program is expanded into a practice, the inflation wolf will be soon at our front door. Incidentally, inflation not only has the advantage of diminishing the real value of creditors' claims against you (if you want to welsh on IOUs), but opens the door politically to effectively raising taxes, especially on the middle class, without the irritant of public legislation.

Regarding inflation, Anthony Brown, our Chief Investment Officer, has recently completed a Research Note entitled, “Investing to Protect Against Inflation”, which we recommend for your review. It speaks to the current “inflation or deflation?”

debate, and sets out a case for deflation, or low inflation, in the near term, and substantially higher inflation five years or more hence.

V. Where to, now?

Going forward, we expect new credit issuance to remain constrained. Credit will shift from being broadly available two years ago, to being principally available to high quality borrowers. We don't expect lending to be back to normal for years to come. Total loan losses, to include more prime mortgage defaults, commercial and real estate loan defaults, and credit card and corporate defaults, are expected to total another \$1T globally. This is in addition to the \$1T in loan losses experienced by banks globally so far. As a result, banks are only half way through their deleveraging. Hopefully, they can recognize this \$1T in loan losses slowly, say over the next 4 years or so, and earn their way through their losses.

Not surprisingly, the velocity of money (the number of times a unit of money is spent in a year) is declining, as credit is removed from the system. While M1 increased by over 100% in the last 18 months, M2 (the broader and more commonly used definition of our money supply) rose less than a fifth of that. Today M2 is only half the size it has been in relation to M1 since 1950 (at 5X instead of 10X). This suggests that much of the extra money the Fed is printing is not flowing into the economy at large, but is being hoarded by banks in an effort to shore up their own financial position. This will have a substantial dampening effect on inflation, until the banks begin lending again.

Given the above, it is difficult to imagine getting back to the long-term average economic growth rates of 3% or better in the next 5-6 years. Instead, the recovery will probably be disappointingly anemic. In the short term, this could cause more bankruptcies, more job losses, and more defaults, as the negative feedback loop persists.

What does all this mean for asset prices?

VII. Advice for Investors

Counter-intuitively, this negative news is actually good medicine, albeit painful, for our economy. As we've said however, we think investors have priced into stock prices today a more robust recovery in GDP growth than will be experienced, which means they're likely to be disappointed. We're concerned we may see a significant retrenchment in stock prices. As I've already implied, we wouldn't be surprised to see a 20% drop in stock prices; in fact, we give it a 50% probability.

So what are investors to do today?

That is a tough question. If you believe, as we do, that very low inflation, or even modest deflation, will be the norm in the short term, but higher inflation the norm in the longer term, then anything you do today to exploit future high inflation is likely to increase short-term risk. Likewise, anything prudent in the short-term is likely to be painful or harmful in the longer term.

Ideas? We have a few (13 to be exact).

1. Reduce Stocks: Today's option-implied return distribution curve for stocks is negatively skewed, suggesting significant losses are more likely than significant gains, at least in the opinion of the options pits. Given that and our economic outlook, a reduction in our public equities allocation equal to 5% of our Research Portfolio seems to us reasonable and prudent. The downside of this advice is that the stock market may continue it's upward march, rendering a decision to reduce the equity allocation ill-timed. The rationale for such a continuing run may be that below-average earnings for the next few years has no material impact on the intrinsic value of the market. Nonetheless, we remain concerned by the short-term risks inherent in

the present high volatility.

2. **Pare Back Risk:** We estimate that, at the March 9th low, the typical endowment or foundation was down 13% for 2009, and 35% from the beginning of 2008. The recovery since March 9th probably lifted returns for 2009 into positive territory for most institutions. Nonetheless, we estimate the median NACUBO reporting institution declined about 18% for the fiscal year ending June 30th. A return just to the March 9th low would mean an additional 17% decline, at the portfolio level, for the typical endowment., or a return to a portfolio valued at two-thirds the 2007 value. Consequently, those institutions with less than average ability to withstand additional losses should consider further reductions in risky assets, and additional allocations to fixed income.
3. **Selling Puts:** If you do reduce your public equities allocation now, you may wish to consider also selling out of the money puts. At today's option prices, you'll collect 4-5% for a one-year, 20% out of the money, put against every dollar of equities you sell. The idea is that if you sell a portion of your equities today and stocks do drop by 25% or more, then you'll probably want to buy back into equities at that time, because stocks will be less risky (by definition) and you may want to restore, or even increase, your equity allocation. Put differently, the benefit of selling significantly out of the money puts is that you will receive a cash premium, in advance, for doing what you would do normally if stocks drop.
4. **High Quality:** We continue to favor high quality stocks, both in the US and Internationally, over core and value stocks.
5. **TIPs:** Tips look attractive for the long-term, but only pay a miserly 1.6% real yield today. This won't help much in term of attaining a 5% spending rate, but it will close the door against the wolf of inflation, while providing some protection against a possible stock correction.
6. **Distressed Debt:** We continue to like distressed debt, and find it is best delivered through Private Equity and Hedge Fund programs.
7. **Hedge Funds:** Speaking of Hedge Funds, we still like those with low correlations to the equities markets and low leverage run by well-respected firms. In general, they are better positioned today to take advantage of the remaining opportunities in credit. They are also less risky than they were 18 months ago, so it is unlikely we'll see another down 20% year in Hedge Funds.

8. REITs: We have recommended that clients exit REITs (at the end of May '09). There are still opportunities here, but mainly on the credit side, accessed principally through Private Equity and Hedge Funds. We believe a lot of REITs will not survive this credit crisis because they have relatively high debt to equity ratios (50-60%) and, since commercial real estate has fallen 30%, they are not in a position to roll-over their debt.
9. Real Estate: Commercial real property capitalization rates have risen from 6 in 2007, to 8 today, or near the historic mean. This rise took 25% of the value of commercial real estate with it. A further 2 point rise in the cap rate, to 10, would cost an additional 15% of starting valuation. At the same time, due to unemployment, vacancy rates are rising and rents are falling. Unfortunately, banks, with handfuls of legacy problems and workouts on their hands, are kicking those as far down the road as possible and are very tight with any new loans, typically lending no more than 50% loan to value (LTV). Transaction volume, as a result, has tumbled 80% from the peak. Attractive values are presenting themselves, but primarily on the credit side for now, with the thought that, if bankruptcy occurs, it will be a cheap way to own the underlying real estate (say, at 50 cents on the 2007 dollar). We are actively looking for managers with whom to take advantage of the current credit distress in the real estate market.
10. Natural Resource Stocks: We like real assets at a 15% weighting in most portfolios, although natural resource stocks are positively correlated with public equities in general, and are likely to fall if stocks fall. We prefer to access this market through Private Real Assets programs, as well.
11. Private Equity: In general, private equity is attractive now for those investors with sufficient liquidity. A primary reason is that many, if not most, investors do lack liquidity, creating not only buying opportunities for funds, but, more importantly, the ability of limited partners to gain access to funds that have previously been closed to new investors. There seems to be a major opportunity to be a supplier of capital in a capital constrained world – either as an equity or credit investor.
12. Bank Loan Funds: We are not recommending new allocations to bank loan funds at this time. The recovery in these loans came very fast and the money may be made. Those who did get in enjoyed 35% gains so far this year.
13. US Dollar: Finally, the US dollar is negatively correlated to all risky assets, including equities, now. It should strengthen if the stock market corrects. This will be a double negative for US investors in foreign-denom-

inated securities. Nevertheless, we like international stocks for the long-term and continue to over weight them relative to US stocks in our portfolios.

VIII. Conclusions

David Rosenberg, Chief Economist at Gluskin Sheff, recently wrote, " We are forced to interpret the collapse in credit we are currently experiencing as a secular event. Correctly assessing that reality is undoubtedly the key to the success of our analysis over the next many years." We couldn't have said it better. This is not a mere cyclical movement through a short-lived, and soon-forgotten, economic hiccup. We will live with these issues, and their ramifications, well into the next decade.

Our advice to clients is to expect an era of slow, or "new normal" growth. In addition, be watchful for 2nd order events and unintended consequences from massive deleveraging and governmental fiscal and political intervention. Interesting times, indeed.

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