Capital INVESTMENT SERVICES of America, Inc.

Perspective

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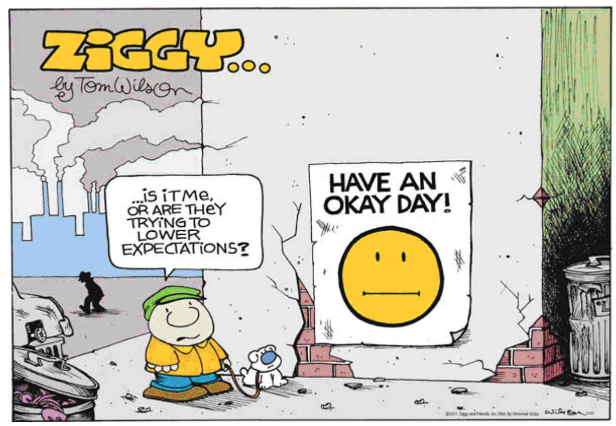
In This Issue . . .

- ✓ While outright pessimism seems to have waned, a healthy amount of skepticism reigns, creating an environment for higher stock prices.
- ✓ It appears as though the escape from FUD (fear, uncertainty, and doubt) we have written about in the past remains intact.
- ✓ While corporate earnings growth has been strong, the rate of change may begin to slow.
- ✓ As a result, separation can occur among companies that can sustain higher growth rates from the rest of the pack.
- ✓ Stock valuations remain at modest levels despite the two year rise in stock prices. Stock market tops typically don't occur until valuations rise well above today's levels.
- ✓ In the bond market, risk remains uncomfortably high for what is intended to be a low risk asset group.
- ✓ The Fed's moves, especially QE II, are keeping interest rates lower than normal. However, that program is nearing its conclusion.
- ✓ We expect bond yields to move higher in anticipation of actual Fed moves.
- ✓ Instead of deflation, we're likely to get modest inflation (2-3%) as the economy continues to expand.

Do We Need a *New* Economics?

Are America's best days behind it as some are forecasting? Are future generations doomed to a lower standard of living? After two recessions within 10 years, lots of government pump-priming and yet still very high unemployment, and a moribund housing market, does the field of economics need a *new* economics?



We take a crack at addressing these questions and related topics in a few moments. But first, our perspective about the nearer-term prospects for the financial markets follows.

A couple of old quotes recorded by two notable investors in history seem especially relevant for investors today.

Regarding the stock market:

> *Bull markets are born in pessimism, rise on skepticism and die from optimism.* John Templeton

Regarding the bond market:

> *More money has been lost reaching for yield than at the point of a gun.* Ray DeVoe

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Stocks rising on skepticism

Templeton's quote suggests three psychological stages underlie stock bull markets. So far, the current stock price advance seems to be tracking his stages. Consider that back in March of 2009 when pessimism was rampant and fears of a Great Depression rerun were prevalent, the current stock bull-run—one of the largest price moves in U.S. history—began.

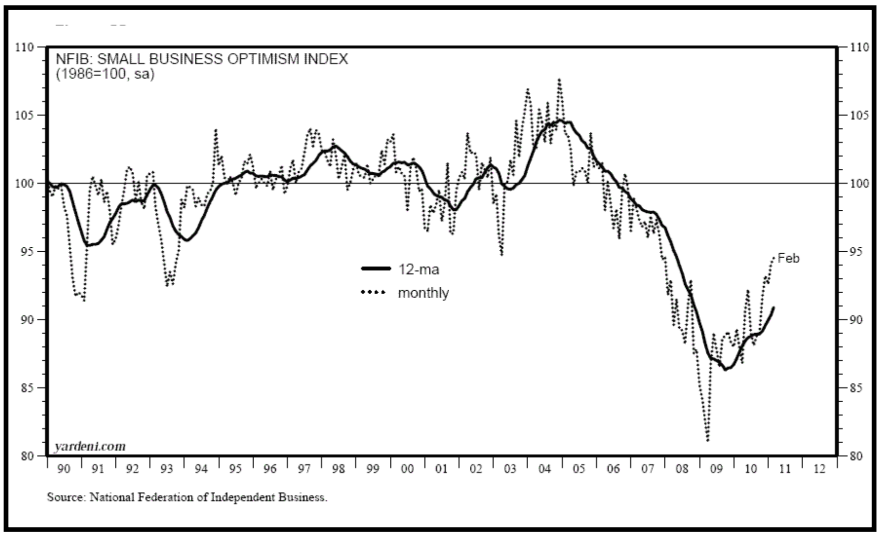
The abject pessimism of two years ago has abated some, and stage-one of this bull market may, indeed, be over. However, plenty of skepticism reigns and signs of optimism that characterized an aging bull's stage-three advance are lacking.

Consider one of our favorite barometers of the general prevailing state of mind – the themes reflected in comics and cartoons. In the nearby cartoon, Ziggy is set against a dismal backdrop of a decaying city (country?), speaks of lowered expectations, and the "have a nice day" mantra of years back has given way to only "have an okay day". Not much optimism suggested here.

More rigorous data such as surveys of small business optimism (Chart 1) or general economic confidence (Chart 2) paint a similar story. Small business owners may not be as pessimistic as they were in the recent past, but can hardly be characterized as optimistic. Similarly, reported economic confidence has barely budged from a deep funk. And, note the survey periods in both Charts 1 and 2 were before the tragedy in Japan occurred, which has likely (and understandably) soured the prevailing mood even more.

Chart 1

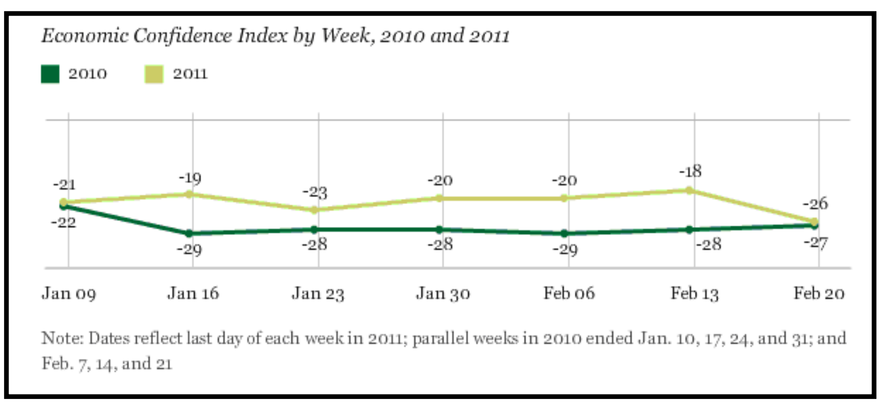
Small Businesses: less pessimism, but a long way from optimism



Even more relevant for investors, skepticism about the economy's resilience is well expressed within the stock market:

Chart 2

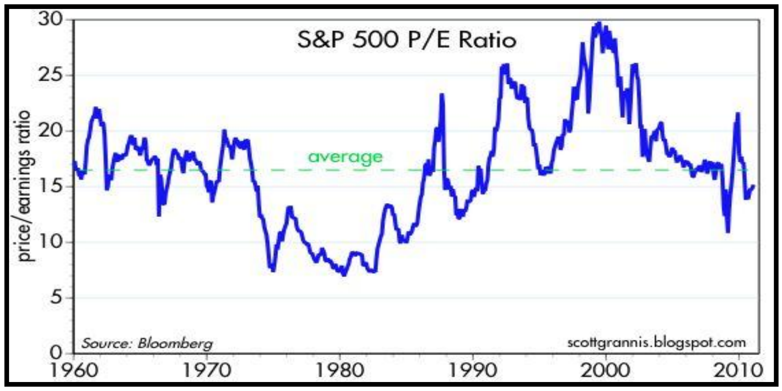
Economic confidence remains rock bottom low



- Overall stock valuations are not pumped up with optimism. Although stock prices ("P") have advanced sharply since two years ago, corporate earnings ("E"), cash flow, and productivity growth have all surged as well. As a result, overall stock valuations—as captured by the market's P/E (price/earnings) ratio—are not flashing caution signals (Chart 3 on next page).

- Further, the incidence of short selling remains very elevated (Chart 4). Short sales, of course, represent investors betting on price declines.

Chart 3
Modest valuation of stocks does not appear consistent with late-bull market optimism

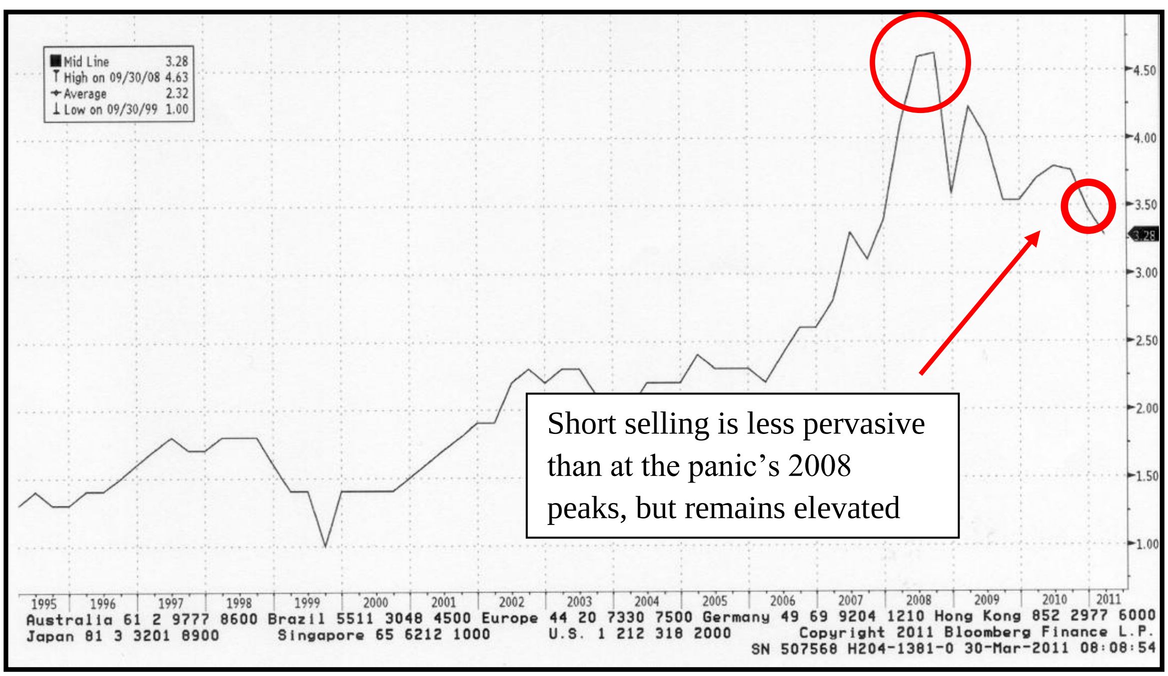


Templeton's three stages fit well within the *great escape from FUD (fear, uncertainty, and doubt)* thesis that we posited several quarters ago. The key underlying point of both is that as reality proves better than generally anticipated, investors slowly adjust their expectations upward. And as the conversion to "believers" occurs, money moves from the "bomb shelter" of low return, perceived "safe" assets (cash, money funds, bonds), into stocks which offer the potential for significantly higher returns.

Remember, the economy doesn't have to be free from troubles if many are underestimating an expansion's resiliency. It simply needs to be better than generally anticipated for upgrades in expectations to occur.

As far as the stock market advance, still fragile general investor confidence probably renders the market vulnerable to periodic bouts of FUD. This will likely continue to make for considerable volatility along the way. But the underlying fundamentals (earnings, cash flow, etc.) should continue to support a *great escape* and move "bomb shelter" money towards stocks.

Chart 4
Short Interest as a % of total shares outstanding on New York Stock Exchange (Source: Bloomberg, LP)



One other investment implication of note: just as the bull market advances through psychological stages, as an economic expansion matures the *rate of change* in corporate earnings growth also progresses through stages.

Much as *apples* are plentiful in the autumn, strong earnings growth is abundant in the early stages of a stock bull market as earnings recover from a cyclically depressed base. But as cyclical earnings dynamics wane along with the progression of an economic expansion, strong earnings growth becomes more like *diamonds*—relatively scarce.

In the current situation, as the rate of corporate earning growth slows—and it appears to be doing so—the investment attractiveness increases for companies that are tethered to growth trends beyond the economy's cyclical movements. Just such businesses remain the focus of our growth stock research efforts.

Bonds: a market over- reaching for yield?

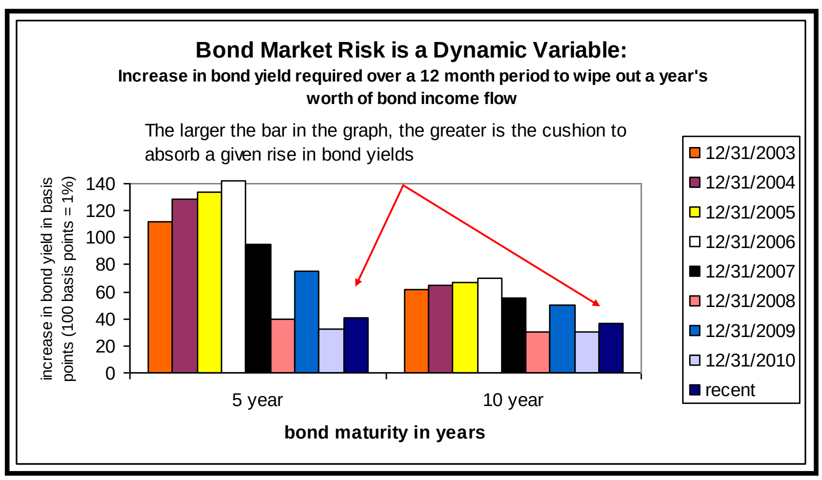
Ultra-low bond yields also reflect skepticism about the economic expansion. Over time, the yield on Treasury securities should hover around the (annualized) growth rate in the economy itself.

With short-term Treasury yields near 0% even as the economy is growing at a rate north of 4%, things appear out of whack. Yields can only persist at these levels if economic growth significantly falters.

Besides low economic confidence by general investors, the behavior of another very important bond market participant is significantly helping depress bond yields. The Federal Reserve's ("Fed") $600 billion bond buying program[1] initiated last summer, is playing a big role in preventing yields from "normalizing" at (higher) levels that are more consistent with the economy's fundamental run-rate.

Too-low yields are not confined to short-term Treasury securities. Money has poured into the bond market since the financial panic in 2008. These money flows have been searching for "safety" and yield, impacting (infecting?) yields across not just the maturity spectrum in Treasury securities but across most segments of the bond market. (Exceptions to this trend include opportunities within the municipal bond market and some bank preferred stock issues, by the way).

Chart 5: Little margin of safety in bonds



With most bonds over-valued, there remains little protection to shield investors from bond price declines that would be triggered by rising bond yields. The DeVoe quote earlier, *more money has been lost reaching for yield than at the point of a gun,* cautions against what could be in store for many investors as yields normalize.

Chart 5 gauges the risk/reward profile within the bond market.

[1] The program is often called "QE2", shorthand for quantitative easing round 2. "QE" refers to the Fed buying bonds when short-term interest rates under their control are at 0%. "QE1" was the first round of such buying actions by the Fed in the wake of the 2008 financial panic.

The chart does indicate that the rise in yields that's occurred so far this year has reduced bond market risk a bit from year-end 2010 levels. However, risk remains uncomfortably high for what is intended to be a low risk asset group that is supposed to lower—not increase—overall portfolio risk!

The Fed: Fool in the shower risk?

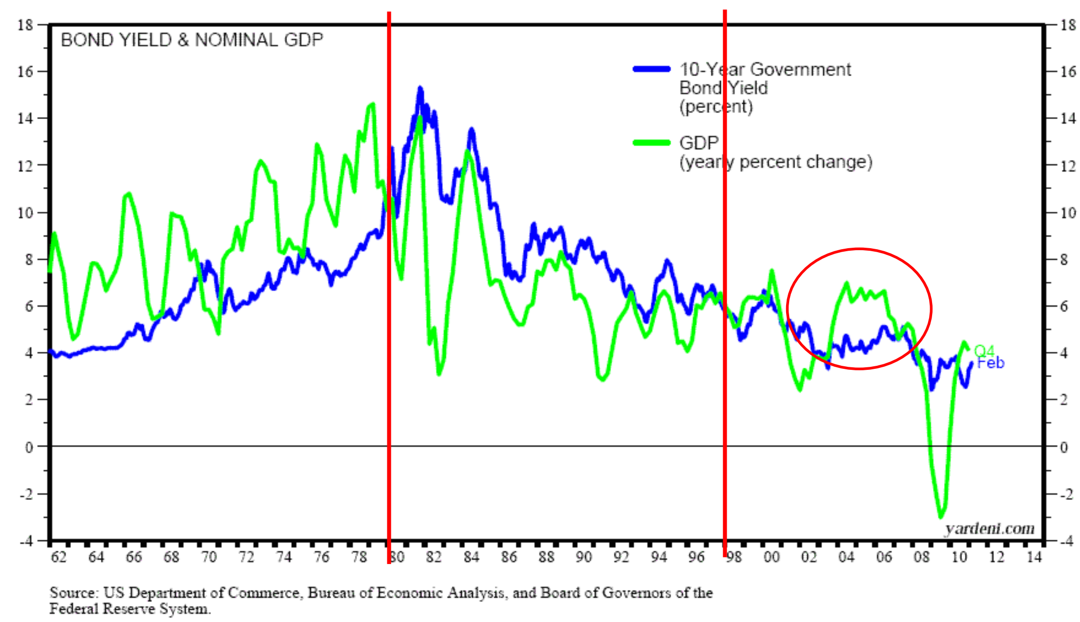
We have noted—and lauded—on previous occasions the Fed's actions in the heat of the financial panic in late 2008 and early 2009. Learning lessons from the disastrous mistakes of their 1930s counterparts, the modern Fed prevented a Great Depression rerun this time around.

While the ultra-easy monetary policy adopted in the panic was necessary to stabilize the economy, it remains of concern that this same policy left in place too long could *destabilize* the economy. Economist Milton Friedman's "fool in the shower" analogy comes to mind as a policy risk.

Friedman noted central banks' historical tendency to act like the showering fool that turns the water too far in the cold water direction. And then, because it takes the hot water a while to arrive, the fool turns the water so far in the opposite direction that he ends up getting scalded.

Chart 6 attempts to put some perspective on Fed policy stances, bond yields, and economic growth over time. The chart segments the history depicted into three periods.

Chart 6: Phases of Fed policy on display



- Persistent "easy money" from a growth-focused Fed and too low bond yields were trouble in the 1960s-1970s and inflation roared. Fool in the shower behavior was evident with frequent booms and busts, with each bust (recession) becoming deeper.

  Finally, the Paul Volcker-led Fed in the late 1970s and early 1980s changed tack and made inflation fighting its focus.

- The middle period (1980s-1990s) was marked by a "tight money" Fed and bond yields typically above the economic growth rate. The Alan Greenspan Fed picked up where Volcker's left off in 1984 and dis-inflation continued. This policy backdrop contributed to two of the longest economic expansions in U.S. history and massive stock and bond bull markets.

- The third period which brings us to the present represents a source of ongoing debate among many economy watchers. Worried about deflation in the wake of the tech bust and 9/11/01, an easy money Fed of 2002-2005 (which contributed to bond yields below economic run-rate—circled area in chart) likely helped grease the skids of accelerating oil and commodity prices leading up to the 2008 financial panic.

  In addition, the easy Fed and the associated low mortgage rates, likely aided and abetted the housing market bubble. And, that too-low yield environment created another one of DeVoe's yield chasing episodes that ended very badly for many investors.

More recently, the Fed adopted its accelerated bond buying program to make sure deflationary expectations didn't take hold. Mission accomplished.

Instead of deflation, we're likely to get modest inflation (2-3%) this expansion, but nothing close to that which plagued the 1970s. Why not? In today's global economy with supply chains that almost instantly move to lowest cost sources, strong productivity growth, and the continuing technology revolution, the economy is not likely as inflation-prone as was the case in past decades.

This doesn't mean that monetary policy doesn't matter. But it does suggest that fundamental changes in the basic economic structure have likely reduced the "hot" and "cold" extremes in the fool's shower.

Also, just as the Fed learned lessons from the mistakes of their 1930s counterparts, they also profess (see Bernanke quote nearby) to have learned lessons from their counterpart's 1970s inflation mistakes. The recently announced and unprecedented adoption of Fed press conferences immediately after their multi-day meetings, hopefully was done to help prepare market participants for upcoming changes in Fed policy.

We expect bond yields to continue to "normalize" by moving higher—in anticipation of actual Fed moves. The risks of a fool in the shower may be diminished, but the sooner the Fed can recreate the 1980s-1990s policy posture, the better.

> *"Central bankers have learned the lessons of the 1970s.*
> *We will not allow inflation to get above low and stable levels."*
>
> Fed Chair Ben Bernanke 3/2/11

A new economics needed?

In the shadow of the financial panic of 2008, some economists appear to have gone wobbly in the knees. Many statistically elegant economic models—representing common “tools of the trade” such as *neoclassical synthesis*, *general equilibrium,* and *Keynesian spending multipliers* have come up short in terms of depicting the real world.

This has led some to wonder if the world needs a revolution in economics. It is not the first episode of such questioning, only the latest. In the 1970s, many economists were perplexed by the economic troubles of that era. Those issues, by the way, were no less daunting than those facing us today.

Speedbump

For example, in the 1960s and early 1970s the condition of stagflation wasn’t viewed as even possible. The popular view was that a tradeoff existed between the rates of unemployment and inflation. The so-called Phillips Curve depicted the tradeoff relationship and suggested the Fed (and politicians) could turn-the-policy-dial and get less unemployment at the cost of a little more inflation. Instead, the “impossible” happened as the 1970s wore on and the U.S. got (much) more of both!

Wobbly economic knees back then created a void that was filled with many doom and gloom peddlers predicting the permanent decline of economic prospects.[2] The popular 1980 book, _The Zero Sum Society_ by economist Lester Thurow of MIT argued (persuasively) that the only solution to stagflation would entail dramatically lower living standards.

The subsequent reality proved much different than many warned, however. Sound monetary policy by Volcker’s Fed coupled with tax cuts and de-regulation across many industries rejuvenated the private sector and stagflation was replaced over the next two decades with long economic expansions and a steep rise in the prevailing standard of living.

The field of economics seems to suffer from what some have called “history trying to be physics”. Much of the formal training in economics treats the field as if, like physics and the hard sciences, it can be quantified and boiled down to physical laws and relationships that can be described accurately by statistical models.

But, as one observer recently noted:

> *There are no control studies in economics, no way to hold everything else constant to determine the impact of one variable, no way to falsify conclusions that models spit out.*[3]

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[2] Other popular figures and books of the times included frequent *Tonight Show* guest Paul Ehrlich and his _*Population Bomb*_ (1968) that warned of upcoming mass starvation, and the Club Of Rome’s _*Limits to Growth*_ (1972) that forecasted impending resource shortages and the trend towards a permanent decline in post-war prosperity.

[3] Caroline Baum, _*Macroeconomics really is stuck in the Dark Ages*_, Bloomberg, March 3, 2011

Instead of a *new* economics, it seems a return to the ideas of some of the giants in economic thought over the ages is needed. It is the work of one such giant whose insights has important relevancy to the current situation that we now turn.

Dynamism and creative destruction are the economic models we need

We have discussed in previous *Perspectives* the ideas of Austrian economist Joseph Schumpeter (1883-1950). However, we thought a deeper look was in order.

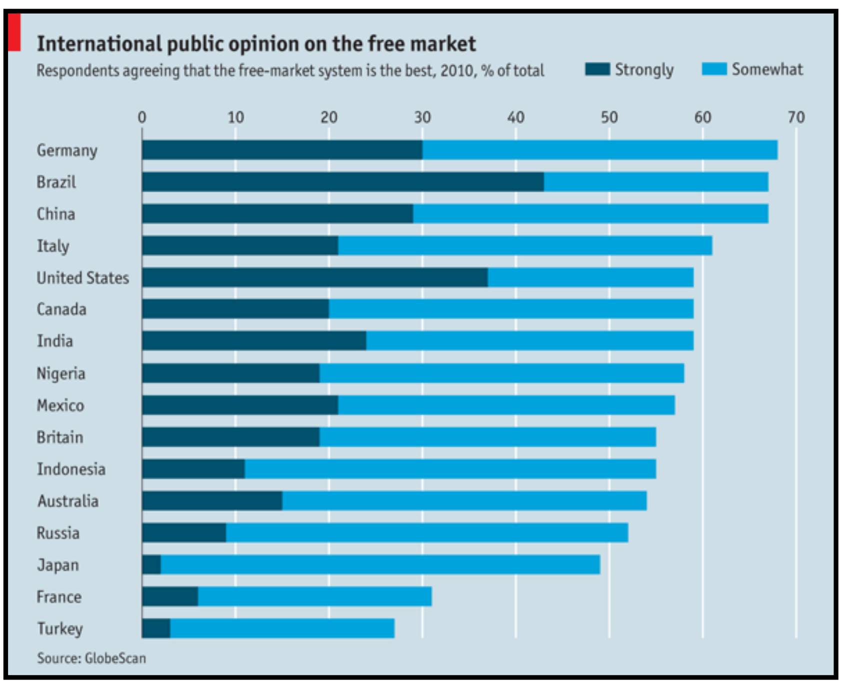
Schumpeter mostly toiled in the background while his contemporary, economist John Maynard Keynes became wildly popular. Unlike Keynes, whose rock-star status largely resulted from his politically popular prescriptions for the considerable economic issues of the day (i.e. the Great Depression), Schumpeter focused more on trying to understand what made a capitalist economy "tick" in the longer-run sense.

Schumpeter was one of the first to emphasize the *dynamism* that underlies market-based economies. Though he tried throughout his career, he couldn't come up with a mathematical model for the economy simply because it's a perpetual motion machine of constantly changing relationships. Not only is there "no way to hold everything else constant to determine the impact of one variable" as the quote above implies, Schumpeter recognized that even the *one variable* being studied may well be in a state of flux.

His qualitative model rests on the observation that capitalism is a *process* that he called *creative destruction*. At the heart of creative destruction is innovation. While most models of the economy (to this day) focus on the laws of supply and demand, Schumpeter noted that often overlooked is the fact that innovations come along that radically transform both supply and demand.

Help we've fallen (to fifth on the list) and we can't get up?

(Source: *The Economist* April, 7, 2010)



Creative destruction recognizes that entirely new products and services as well as new ways of making or delivering existing products and services are a way of life. Economic advancement and rising standards of living occur as a result of the creative part of his creative destruction model. However, creation also destroys the status quo—often leaving people, towns, and industries displaced in the process.

Classic examples of creative destruction involve the industrial revolution that transformed the economy from its agriculture basis to one based on industry. Whereas in the early 1900s the vast majority of the population was involved in farming, today less than 2% of the population is involved. Millions of people migrated from farms to industry, yet because of booming ag-productivity (tractors, fertilizers, etc.); food production has exploded—with obesity rather than starvation becoming an issue.

"So we're in agreement that the recovery isn't as robust as others in the past. . ."

The advent of auto transportation is another common creative destruction example. Many farmers (it's estimated one-third to one-half of the grain crops went to feed horses used for transportation), blacksmiths, and the proverbial buggy whip makers were displaced by the new modes of transportation.

In the present day, we see creative destruction examples like Blockbuster going bankrupt as its movie renting service is displaced by Netflix and others using new video streaming techniques. Or, the declines of the newspaper industry as their previous monopoly/oligopoly market positions have been eroded as eyeballs have migrated to the internet. Ditto for the three network channels as cable brought many more choices, and cable in turn may be threatened by the emerging wedding between the internet and TV. Or, we also see the music industry upended by iTunes, and Kodak's film franchise ceded away to digital photography.

The biggie of modern examples however, is the globalization of the economy itself. It's brought (and bringing still more) new production zones, new consumers, new minds to work on every conceivable problem. Yet it's also scary as it destroys commercial life as we know it.

Eroding foundations?

Schumpeter was not naïve about the fears and social implications of creative destruction. He recognized that the benefits of creation are often only appreciated with the passage of time. But he also noted that the destruction side of dynamism is typically immediately observable by all and for some, recovery from the destruction element of the process may never come.

Interestingly, he worried about the long-term viability of capitalism—not because the creation side fails to lift the standard of living for the masses, but because it means downward mobility for some and envy from others.

As historian Jerry Muller notes:

> *Schumpeter believed Marxism had such great appeal because it addressed what he called 'that feeling of being thwarted and ill-treated which is the auto-therapeutic attitude of the unsuccessful.' Marxists were right to point out the significance of social class, but they downplayed or ignored the reality that in a capitalistic society, there's a great deal of movement between income classes.*[4]

Schumpeter feared that malcontents and professional critics could ultimately erode the institutional foundations (government agencies, universities) on which capitalism rests. He also noted that in the downturns that occur within business cycles, the critics of capitalism will find many listening ears.

> *The accuracy of an economic vision is not always commensurate with the analytical ability of those who hold it. Pessimistic visions about almost anything always strike the public as more erudite than optimistic ones.* Joseph Schumpeter

[4] The Mind and the Market—Capitalism in Western Thought, by Jerry Muller, Anchor Books
Worthwhile analysis of Schumpeter can also be found in Muller's Thinking About Capitalism, *Great Course Lecture Series*, 2008, and *Profit of Innovation* by Thomas McCraw, 2007 Harvard University

Investment conclusion

Despite Schumpeter's "end game" fear for capitalism, lower standards of living anytime soon are by no means a foregone conclusion. It seems to us that the current environment remains ripe for significant transformative innovation that creates wealth and lifts the well being of most people.

The tech revolution continues to gain additional speed and globalization is bringing within reach new markets with billions of potential consumers. The ability to share information has never been greater or easier. If one believes that human achievement is based on collective intelligence—as our read of history suggests is the case—the flow of information across more minds than ever before is a wonderfully power tool for economic advancement.

Yes, things can and will go wrong in economics and world events. Are the current Middle East uprisings like Iran's in 1979 or the Fall of the Wall in 1989? The answer is probably somewhere in between. But the ability of despots to repress their populations is growing harder by the moment as it becomes increasingly difficult to restrict access to information from the "outside" world.

Will governments get a handle on their debts and deficits? In the U. S., at least, there is still time, and while the process is messy and aggravating, a process appears underway none the less.

What's needed is not a new economics, but a return to the tried and true economic ideas articulated by the many great minds in history. Chief among these ideas are sound monetary policy, restraint on intervention into the economy by the visible hand of government, property rights and courts to uphold the rules of law, incentives to innovate, create, and educate, and perhaps most important of all, faith in the ultimate resource—human ingenuity.

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