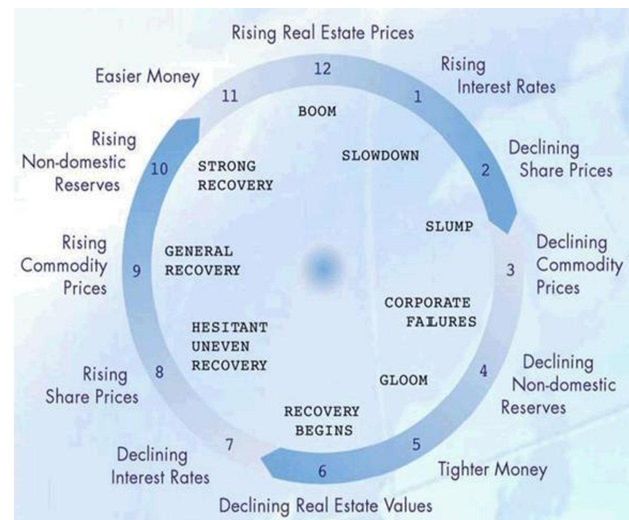
July 2011

INVESTMENT PERSPECTIVES

<u>This Time is *Not* Different</u>

Economic cycles repeat continuously. They go from a period of boom to slowdown to slump, then to gloom. Eventually a hesitant recovery begins, then a more sustained recovery, and back to boom.

Throughout history the cycle continues to repeat itself. It is not exactly the same each time, but quite similar. It is often amplified, by fear and greed. People want to feel good and want to be involved in the good times – consumers tend to spend more in good times, people invest in the stock markets, factories produce more products, etc. Conversely, people don't want to be involved in bad times – they pull back on spending, they sell stocks as prices go down, factories produce less, employers lay off people, etc. Unfortunately, good times tend to create good times until asset prices are too high, and then the bubble bursts and over-corrects as the economy swings into a recession (or sometimes a depression).



What is quite interesting, in our opinion, is the number of recessions (or panics as they were often called in the 18th and 19th centuries) in the United Sates since the country was founded. [1] The number is <u>forty-seven</u> since 1790! Downturns are caused primarily by various types of financial crises, the health of the banking industry, as well as cycles in agriculture, consumption, and business investment.

The National Bureau of Economic Research dates recessions on a monthly basis back to 1854; according to their chronology, from 1854 to 1919, there were 16 cycles. The average recession lasted 22 months, and the average expansion 27 months. From 1919 to 1945, there were 6 cycles; recessions lasted an average of 18 months and expansions for 35 months. From 1945 to 2001, there were 10 cycles - recessions lasted an average of 10 months and expansions an average of 57 months. The fact that recessions have lasted for shorter periods and that expansions for longer periods since 1945 has prompted some economists to declare that the business cycle has become less severe.

Most economic cycles are driven by the expansion and contraction of credit; too much credit gets extended in the good times and too little in the bad times. Most credit is extended by banks, so it would make sense that at the heart of every economic crisis, there is a banking crisis. There have been 16 banking crises in the United States since the early 1800's.[2] The earliest identified was in 1814 when state

banks suspended payments due to the War of 1812, paralyzing the treasury's operations. Other noteworthy failures were as follows:

- August 1857 – The discovery of gold fields in Australia and California led to massive speculation and then collapse paralyzing finances throughout the world. Most banks suspended operations.
- July 1914 – The New York Stock Exchange closed from July through December 1914 in response to the war; a banking crisis was avoided by flooding the country with emergency currency to prevent hasty withdrawals.
- 1929 to 1933 – During the Great Depression, thousands of banks closed. The bank of the USA failed in December 1930.
- 1984 to 1991 – There were 1400 savings and loan and 1300 bank failures.

One conclusion we may draw from the ups and downs of our economic cycle and bank failures throughout our country's history is that we always find a solution to our problems – we are a resilient nation. One of the key reasons for our success is the strength of our institutions (please refer to our Investment Perspectives from last quarter, America the Beautiful.)

The Great Recession

The most recent economic downturn has been appropriately called the "Great Recession" because it undisputedly is the most severe downturn in the post-World War II period. Conventional economic thinking suggests that deep recessions are subsequently followed by strong recoveries. This leads us to the following question: "Shouldn't the current recovery be among the fastest in the post-war period since the Great Recession was the deepest?" This line of reasoning has contributed to seemingly widespread disappointment in the strength of the current recovery. In reality, however, a close examination of the eleven economic recoveries in the post-war period indicates that there is very little relationship or correlation between the depth of a recession and the subsequent recovery[3]. The two most recent recessions provide evidence to support this assertion: while 2009 had the deepest recession and 2001 the mildest one, the magnitude of the recoveries has been about the same. We disagree with the widely held assumption that the current economic recovery is fundamentally "broken."

Any discussion of the general economy quickly leads to an assessment of the U.S. consumer, which represents about two-thirds of U.S. economic activity. There is certainly no denying that excessive debt (mortgage, consumer, etc.) was a primary factor in the 2008-2009 crisis and that many U.S. households remain under significant pressure. While "deleveraging" will likely be a multi-year process, we view the shoring up of household balance sheets as a good thing. Indeed, the U.S. personal savings rate is currently near a 20 year high. Consumers saving more and spending less may translate into a barrier to more robust economic growth than would otherwise be the case, at least in the near term. Perhaps what many are overlooking, however, is the potential for an extended duration of the current recovery and for the impact of "pent-up" consumer spending looking a few years out.

In stark contrast to the consumer sector, corporations and businesses in general have emerged from the most recent downturn in a much healthier financial position. Balance sheets remain solid, with the Standard and Poor's 500 companies holding $1.1 trillion of cash and short-term investment at the end of the first quarter (Wall Street Journal, June 2, 2011). While corporations have exercised caution in using cash for hiring and capital spending purposes, this has translated into one of the strongest recoveries in corporate profits on record. As such, despite the run-up in stock prices since the lows of March 2009, based upon current consensus earnings estimates the S & P 500 trades at a price-to-earnings ratio of 13.9. Based on the historical average of 15 times earnings, the current ratio is not excessive.

Psychological Influences

It is human nature to be most influenced by significant events that have occurred in the past two to four years and as a result many people tend to make monetary decisions that reflect the recent past. The magnitude of the recent recession resulted in most investors or their friends and associates having experienced either personal financial setbacks such as a significant drop in the value of their homes, their retirement plans, or individual portfolios; a job loss; or a reduction in pay. These situations, which started near the end of 2007, were well publicized by the media. For many, the fear of additional negative financial events seems quite possible and it still seems to be the dominant message delivered by the media all over the world. Additionally, many young professionals who are just now starting their families and had just bought their first home are particularly sensitive to the recent economic downturn.

At the moment, most people are quite reluctant to make major new investments, to borrow more money and most certainly are not looking seriously and enthusiastically at the incredible opportunities for investing in housing, commercial properties, new business opportunities, and the stock market. They do not realize that major financial downturns will pass to be followed by normal recoveries, and that now is a great time to invest!

Deleveraging

McKinsey Global Institute reported in a study published in January of 2010, that virtually every major financial crisis after World War II has been followed by a prolonged period in which the ratio of total debt (government, corporate and individual) to Gross Domestic Product (GDP) declined significantly − as is happening now. On July 1, 2011, James Paulsen pointed out that the financial obligations ratio (the ratio of outstanding mortgage and consumer debt to disposable income) had declined from its all-time record high in late 2007 by almost 3.0% to its current total of 16.3%. The current ratio is more than 1% below its average since 1980 and no higher today than it was in 1985. He also points out that household net worth has risen nicely during the last several quarters and consumers have amassed a record $8 trillion in cash assets.

The natural process of reducing debt by the consumer, by financial institutions, and by all levels of government has been underway for almost 3 years now − it is not just starting.

Political Situation

An article in the Wall Street Journal on June 28 entitled 'Debt Talks Impasse Masks Real Progress', the author points out three interesting points:

1. President Obama and Republican Congressman Paul Ryan have released budget plans that broadly agree that cutting projected deficits by about $4 trillion over the next decade is the right thing to do.

2. Serious spending discipline is starting to 'set in'– President Obama is proposing a budget that would reduce spending over the next decade on discretionary domestic programs and Republican leaders say their members are far more willing to cut defense programs than ever before. The entire federal subsidies for huge ethanol programs are being seriously challenged by both parties.

3. And finally, the most sacred of cows, entitlement programs for the elderly, are on the table for consideration by both political parties.

We believe that our elected officials are starting to listen to voters and are seriously starting to address the excessive levels of debt that have built up. All of these events would never have had this type of universal support four or more years ago. We are convinced that this is not just a passing thing; we believe that curtailment of excessive debt is starting to occur in all sectors of our economy.

The Future

We believe that we are in the midst of a recovering stock market, real estate market, and economic upturn for at least the next four years. Many will point to the weakness in employment, lower GDP than in previous recoveries, and an overburdened consumer as reasons that we cannot be in a recovery. However, many people are too focused on weekly economic data and do not see that the economic recovery is real. General confidence in the future is lower than it has been in sometime, but is this because investors have extraordinary insight, or simply because it reflects the events we have recently experienced?

Deleveraging is in full swing, corporate balance sheets are healthy, and government is considering serious change for the first time in years. As *confidence* returns, we will see the benefits of the pent-up demand in employment as well as business and consumer spending.

Regardless of our current view of the economy it will not affect our investment philosophy at Hutchinson Capital Management. We continue to look for high quality companies that are depressed based on fundamental valuations. Your portfolio includes companies that will benefit from an economic recovery as consumers spend again and unleash pent-up demand. Many of these stocks became depressed recently as talk of a double-dip in the economy surfaced. Most importantly we will not chase new fads that profess to have unending growth or upside potential. Such aggressive growth stocks tend to flame out far before they ever reach their theoretical potential.

While we can never know what the future holds, we can be certain of one thing: there will continue to be economic cycles, driven by credit cycles that at the core are amplified by society's changing attitude toward risk.

A veteran investor described three stages of a bull market:

- Stage 1: When a few forward looking people begin to believe things will get better.
- Stage 2: When most investors realize improvement is actually taking place.
- Stage 3: When everyone concludes that things will get better forever.

It is in this final stage, similar to technology stocks in 1999 and housing in 2006, that you must be very careful. At Hutchinson Capital Management we are diligently aware of these cycles and aim to never fall prey to the idea that cyclicality has miraculously ended and "this time is different". Our goal is to be aware of cycles to better protect your capital and help you sleep at night.

[1] *Business Cycles: Theory, History, Indicators, and Forecasting* (Victor Zarnowitz, University of Chicago Press, 1996)
[2] *This Time is Different* (Carmen M. Reinhart & Kenneth S. Rogoff, Princeton University Press, 2009)
[3] *Economic and Market Perspectives, July 1, 2011* (James Paulsen, Chief Economist at Wells Fargo Capital Management)

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