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"Please, sir, I want some more." – Oliver Twist

When asked about the world economic situation, one of our mentors offered a plainspoken agricultural analogy by suggesting that global markets were due for a much needed "hard frost." This phenomenon ensures nature's vitality by occasionally eliminating all but the heartiest of vegetation. We find the frost analogy spot on regarding the financial world—especially if one looks over decades of "boom and bust." In this Newsletter we attempt to put today's conundrum of the simultaneous occurrence of a bull stock market and ongoing government imbalances in perspective. We look back at two historic cases where markets got a bit out of whack, concluding that healthy economic frosts do occur from time to time, but government intervention can skew the results.

Trusting Market Forces

Probably the best recent example of markets working in normal fashion was the rise and fall of the internet bubble in 2001. It was then that the bubble's poster-child **Cisco** had annual net income of $2.7 billion but traded at over a $500 billion corporate valuation, or around 200x earnings. Markets, which generally get it right when left to their own devices, took a while to get through the "irrational exuberance" phase, but once the freeze set in, rapidly turned from lava-hot to ice cold until the correction was complete. Some eleven years later, Cisco now earns over $7 billion annually and trades at a reasonable $80 billion value. Although the popping of the internet bubble may have been disturbing to those caught up in the mania or to index/benchmark oriented investors, it was a clear victory for the free market.

Turning another page of history we find that our government occasionally tinkers with the natural cycle of business and, at times, creates more problems than they solve. Although historians may differ as to exactly when our country got "hooked" on bailing out failed financial institutions, one good case study is that of Continental Illinois Bank in May 1984. This reckless bank took gobs of national market share by making aggressive long-term loans that were funded with short-term borrowings (so-called hot money). As some readers may remember, Continental crashed when bad loans surfaced and the "hot money" exited in a matter of days. Rather than send the banking industry a hard lesson, our Government bailed out *all* of Continental Illinois' bondholders and guaranteed all C.D.'s—even if above the $100,000 then-promised level.

Spinning our frost analogy a tad further, we believe that bailing out banks is a little bit like when farmers in Florida employ gas heaters for their orchards when expecting frost or, alternatively, when Augusta National covers precious azalea roots with tons of ice to time their peak flowering for the Masters event. Gas heaters and ice may work temporarily but these heroics offer neither a permanent nor inexpensive solution to the problem at hand. In the case of Continental Bank, our country had a choice to make and we decided then that our seventh largest bank was "too big to fail"—and we have been bailing out larger and larger banks ever since. Had we stood firm in 1984 it would have cost bond investors and large C.D. hold-

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ers as much as $10 billion in today's dollars as compared to the one hundred times more we recently had to pay with the collapse of our financial system in 2008. Well, as Mother Nature might say, that water is so far over the dam it has since evaporated and circulated back more times than can be remembered.

What the Frost Happened in 2008?

Now let's try to put markets since 2008 in perspective. As we know, real estate was in a classic "bubble" building up to the crash. We believe the real estate problem incubated with the events of 9/11, after which the Federal Reserve wisely jammed interest rates lower to assist the much shaken world markets. Unfortunately, Mr. Greenspan did not think to tighten mortgage standards to insulate against the formation of a real estate bubble due to such low financing costs. Worse yet, other Government initiatives actually *relaxed* lending standards which, coupled with Greenspan's low interest rates, encouraged a massive misallocation of investment in real estate. Moreover, bank lobbyists successfully watered down the Glass Steagall Act, allowing bankers to leverage balance sheets more than ever. All told, in the 2002-2007 timeframe Americans borrowed $5.2 trillion in new mortgages, effectively doubling the amount of mortgage debt outstanding in just six years. Meanwhile, the domestic financial sector borrowed $7.1 trillion over the same time period, a 77% increase over the 2001 level[1]. The end result was a super-leveraged housing market and financial system that could not handle even a small frosty correction in housing prices—let alone the large drop we suffered.

Falling real estate prices in 2008 ultimately caused "runs" on all manner of financial institutions that, unlike Continental Bank in 1984, had become *way* too big to fail—something they all promptly did one Fall weekend in 2008 (until they were bailed out that following Monday). As Mr. Bernanke said in January 2009, "It is unacceptable that the large firms the government is now compelled to support to preserve financial stability were among the greatest risk takers during the boom period." Unlike the popping of the internet bubble when markets were allowed to deliver discipline, few argue that we could have let things run their course in 2008 as we risked sending the country (and world) into deep depression. Quite to the contrary, the Federal Reserve executed extraordinary measures to keep interest rates at or near zero and bought over $2 trillion of debt to stimulate the economy. Meanwhile, stimulus spending and tax reductions have produced deficits that have averaged over $1.3 trillion a year—*each* of the past four years—thereby adding some $5.3 trillion to our federal government's debt (and growing). As a side note, we now use the word trillion in this country like it is insignificant, but let's not forget that each $1 trillion is $1,000 billion or ~$8,750 per household in this country. To continue our agricultural story, what our government has done since 2008 would be akin to covering the entire Augusta National golf course under a ten mile high pile of ice—on a very hot day.

The bull market, in our view, is real and results from the fact that many of the "economic sucker punches" delivered since 2008 were ultimately taken in the stomach of the Government—shielding or relieving individuals, banks, local governments, corporations and nonprofits from much of the pain by effectively shifting their debts (and then some) to the government's balance sheet. The extraordinarily low interest rate environment has helped private borrowers greatly reduce both their interest costs and absolute debt levels. Banks are now so flush with cash that they are asking their government "keepers" if it is okay to increase their dividends (think Oliver Twist). Highly coordinated global stimulus has meant that growth has continued, albeit slowing some recently, which drives high corporate cash flows used to increase dividends, buy back stock, and/ or make acquisitions. The self-fulfilling part of it all is that the "wealth-effect" created by high stock prices provides positive feedback to consumer confidence, spending and growth.

How Many Punches Can Uncle Sam Take?

So what, if anything, is there to worry about? Isn't that how government intervention is supposed to work? Much like the Continental Illinois case or Greenspan's post 9/11 actions, initial results can be deceiving, and in our view, the enormous scale of what has transpired over the last few years, especially as compared to these latter two examples, is worrisome. We must remain mindful of unintended consequences and an eventual disconnect between how much our government borrows and the rate of interest paid on that money. In normal circumstances, a borrower—even a government—must pay higher interest rates when they continually increase their rate of borrowing. However, in our country's case we have added huge amounts of debt but have actually *reduced* the rate we pay on that money from 3-4% to less than 2% now. Our officials have worked this magic in part because global inves-

[1]Federal Reserve Flow of Funds Summary, Fourth Quarter 2011

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tors are generally afraid and therefore willing to park money in the USA at next to a zero interest rate. Since "flight-to-safety" is not enough by itself to explain our borrowing rate, we must look to some rather unorthodox tools our government has used to manage our finances—and these are not without risk. For example, our government has increased its issuance of both short term and Treasury Inflation Protected Bonds, both of which carry exceptionally low current interest rates but could balloon quickly if inflation rages and/or interest rates rise. Finally, by twice exercising "quantitative easing" the Fed has defied market forces by buying new government bonds to force interest rates low.

We have no idea when, or for sure if, a hard frost in the form of higher interest rates will come or exactly what will trigger it. Perhaps it will be recession in China that causes them to sell our debt in order to invest more at home. Could the situation in Europe, which has similarly tried to solve a massive debt problem with a liquidity infusion to this point (not a reduction of the debt), trigger another banking crisis and/or global growth stagnation, thereby further inhibiting the flexibility of developed countries (including the U.S.) to manage their debts? Asset inflation in commodities or otherwise could put pressure on policy-makers, not wanting to repeat Greenspan's mistakes, to increase rates faster than they would like to. At current debt levels, just a 3% increase in the average interest rate the federal government pays would increase net interest expense by over $325 billion annually, only worsening the fiscal health of the country. To us that sounds a lot like the adjustable rate mortgages taken on just a few short years ago by consumers with no flexibility to absorb a financial "shock" or higher interest payments.

Be Prepared To Bring the Hibiscus Indoors

For our part at Hamilton Point, while performance can never be guaranteed, we are confident that our portfolios are positioned to avoid those areas of the markets most susceptible to a hard frost like financial and other low-quality stocks and long-term bonds. (We wonder if some bond investors realize that only a 1% increase in interest rates causes a 20 year bond to decline by 15% in value.) Certain money market funds with European bank exposure, exotic ETFs and municipal bonds from overleveraged states and municipalities with massive public sector liabilities are other categories that could suffer that we remain wary of.

Finally, in bringing the analogy full circle, it is impossible to know when a hard frost will come until it is upon us. Governments and monetary policy makers simply have too many options for fighting the frost and that is part of the equation when investing in the markets. We do know, however, that certain vegetation is made to survive and then even thrive as the true warming season kicks in (as opposed to the gas-powered generator) and we think the same is true for investing.

For long-term investors, we are confident in the health of many companies that now have a whole globe of consumers to sell to and the ability to produce cash-on-cash returns regardless of short-term market movements. We continue to emphasize high-quality global and dividend paying companies as well as shorter-term, high-quality bonds. While not immune to market disruptions, we believe these companies with the financial flexibility to weather storms and, indeed, to take advantage of them when they inevitably arrive should remain the bedrock of portfolios built for preservation of capital and long-term growth.

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