

## TFC Market Update

February 7, 2011

### Summary of Portfolio Strategy Meeting

During the past week, we met with the firm's economic and global investment strategy advisors, culminating in a full morning's Portfolio Strategy Committee reassessment. These periodic sessions each begin a few weeks prior with assigned in-depth research inquiries (internally carried out, or prepared and presented by outside consultants), all aimed at developing a sense of the investment environment present and future. The objective of the exercise is, of course, the development of appropriate portfolio asset class structure and weightings for client accounts. Our investment horizon is this year and into the next few years.

We still think of our approach as one for *investors*, not as players in today's high-frequency trading, computerized, rapid turnover, speculative stock market culture. In the end, domestically and worldwide, the absolute level and trends in corporate earnings remain the primary driving force behind stock market relative values, but asset class weightings form the basis for a portfolio's intended risk profile and correlation with a client's investment objectives. Our challenge has been, and still is, to distinguish the fundamental outline of what might lie ahead from the emotions of the moment and media noise which makes rational investing so problematic today.

### Macroeconomic View (Fragile, But Improving)

Last Thursday's strategy meeting began with input from Decision Economics via conference call. We covered their translation of the macroeconomic outlook into suggested U.S. and international asset class portfolio over- and under-weightings. Our conclusions from this discussion:

- 1) The U.S. economy is moving from recovery into an expansion phase of GDP growth, and as this develops and consumers and investors transition from doubt to acceptance, U.S. economic activity will accelerate later this year at rates not incorporated into the current expert consensus;
- 2) If 1) (above) materializes, then as 2012 begins, the unemployment rate may be improving faster than anticipated, productive slack may have been absorbed more quickly, monetary policy will be tightening a bit, interest rates moving toward a "normalized" range, and all against a moderate inflation backdrop;
- 3) Near term, U.S. corporate quarterly earnings reports will continue to positively surprise on the upside, labor productivity improvement will persist, due in part to an expected increase in capital equipment expenditures (i.e., technology replaces labor), and
- 4) U.S. stock market valuations (today at 12-13X 2012 earnings prospects), particularly for larger core and value companies, appear under-priced and poised for continued better relative market performance.

## **Global Asset Class Sector Portfolio Strategy**

For many years, we have also worked with BCA Research (Bank Credit Analyst), an independent investment research firm founded in Montreal some 50 years ago. Their refinement of the macro outlook, reflecting as well our expectations would be:

- 1) The U.S. economic expansion is ahead of the Eurozone, but lags anticipated GDP growth in Asia and the emerging markets. The probabilities favor continued expansion and improvement worldwide;
- 2) China's extraordinary growth "heat wave" (particularly in the coastal regions where annual GDP growth rates approximate 15%) persists, but inflation expectations are becoming a serious policy issue. A soft landing is expected, but not without some pain in the process;
- 3) The Eurozone debt crisis is solvable when one considers that 98% of the Greek, Irish and Portuguese sovereign debt is Euro-denominated and could be monetized overnight. The Germans will step up and back any bailout;
- 4) Globally, overweighting equities (emphasis on large value companies) seems warranted. Fixed income securities, broadly speaking, appear to offer the prospect of little more than coupon yield, and
- 5) For U.S. dollar investors, the currency overlay for international equity positions should reflect an Asian tilt. BCA expects the Chinese RMB to appreciate 15-18% against the U.S. dollar this year. Other Asian currencies will be caught in the updraft and follow suit.

## **Challenging the Conventional Wisdom (What Could Derail the Cautiously Optimistic Scenario?)**

All of the above, you might say, reflects the developing current consensus. And the recent reversal in direction of individual investor cash flows out of bond funds into equity funds would seem to indicate a shift in sentiment signaling a greater willingness to take more investment market risk. One could also argue that today's U.S. equity market valuations already discount the improving outlook discussed above. So perhaps considering what could undermine the positive forecast might be useful, if only to prepare for the inevitable need to regroup at some time in the not too distant future. Some potential "Black Swan" events, although by definition never predictable, might be:

- 1) Ironically, the most probable negative could be that the U.S. economic expansion unfolds in a more robust fashion than expected; unemployment contracts faster than projected, and labor-cost inflation rears its ugly head, forcing the Fed to raise rates sooner and more aggressively than today's expert opinion assumes;
- 2) China's economic juggernaut is consumed by uncontrolled rising inflation expectations. Asia's economic engine is moving from primarily an export-driven model toward a more consumer-oriented emphasis. In the process, authorities will need to tighten lending standards, expand employment opportunities, allow its currency to float to more realistic relationships with its trading partners, and rein in corruption. As China's central planners attempt to reconcile all these competing issues, avoiding a hard landing would seem a herculean task;

- 3) The Tunisian-Egyptian upheavals become a broader Middle East crisis in which other of the entrenched dictators topple like dominoes, Israel is under siege and the price of oil further escalates. BCA estimates that if petroleum once again reaches the 2008 high of \$145/barrel, the U.S. GDP growth rate this year would decline 1 percentage point (i.e., from 3½% down to 2½%, and/or
- 4) Having belatedly discovered and begun to invest in the international and more recently emerging country markets during the past few years, professional and individual investors have diverted massive amounts of cash to these “non-conventional” asset class sectors. Most of the latter country economies are commodity-based, today benefiting from China’s and India’s insatiable demand. If the emerging stock markets appear to be peaking, disappointing the recent new money entrants, the psychological shift could result in a quick reversal in investor behavior. In fact, during the past few weeks, investors have begun to pull money out of the emerging market sector, a change which bears watching.

The counter to all these potentially devastating events, and to any of the other unexpected events which could occur, would be that current global equity market valuations have retreated over the last decade to today’s historically very reasonable levels. One might posit that this provides a cushion should a geopolitical shock materialize. Conversely, if the reasonably positive global economic scenario we expect unfolds, today’s very conservative stock price levels provide a solid platform from which further equity market gains could be the outcome. Going forward, we anticipate some minor rebalancing changes in the structure of client equity holdings, with an optimistic view in mind of how events will unfold.

Let us know if you have any comments or questions.

Best,



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Chairman, CEO & CCO

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