



The Song Remains the Same

John Gustafson – 26 May 2011

Originally, when I began compiling my notes to write this report, I was going to title the piece “Game Change?” because of the successful operation against Osama Bin Laden and the couple of other items that went very well for President Obama within the short span of a week. (The other two were: verbally *crushing* Trump about being a “birther” at the correspondent’s dinner, and deciding not to release the OBL death pictures – for those of you scoring at home.) I will get into the politics later in this note, but first I need to point something out – the markets are crying about the exact same debt issues in Europe I wrote about almost exactly a year ago. And we even have another volcanic eruption in Iceland. Just as Yogi said, “It’s déjà vu all over again.”

When last we left our friends in the EU, they were making grand claims of “austerity” and “change” (politicians the world over really seem to like that one) and how everything was going to be all right with a few minor tweaks and a little belt-tightening. Well, reality has intervened in the form of protests by the populace who are fine with change – on paper, and as long as it doesn’t affect them and their benefits from the government they have “earned.” Perhaps this time around folks are realizing that an aging nanny-state with less than half the citizenry actually participating in the carrying of the water for the rest cannot survive in its current form. (Sound familiar?)

Also this time around there seems to be a real sense that the Euro will be broken apart or at least somehow tiered – the Greeks have been making noise of late regarding a turn back to back to the Drachma – which I’m sure will be fully supported by the Germans and the French. The specific talk I’m hearing is that the Euro may remain, but only amongst the strongest “Old Europe” participants, and many of the smaller members will revert back to their native currencies with a weak political affiliation, but no longer a financial one.

For commercial purposes the Euro has been a great tool for those countries, but it’s simply too difficult to coordinate all of the disparate economies of the continent, especially as the union has continued to expand beyond the original members. Think of it this way – if our government implements a fiscal policy to help the northeast corridor – from D.C. to Boston for example – those policies would likely have no effect on the rest of the country west of Pittsburgh. (Other than lots of political grousing about footing the bill, favoritism, etc.) And we are all “Americans” more or less – the hatred the Tea Party has for the elitist-left, led by our current President, pales in comparison to some of the bad blood between the Greeks and the Cypriots or the Czechs and the Slovaks. The appropriate analogy may be “herding cats” – and it is probably even worse than that in practice.

My feeling is that as we look at investments in our allocation, the non-EU, European countries will probably still be able to thrive, as they have for the past couple of years coming out of the abyss, but there is simply too many debt problems to keep the rest of the union moving smoothly forward in its current format. The market and commerce participants around the globe right now dislike the Euro almost as much as they dislike the Dollar. (Until something terrible happens in the world, of course, and they all come running home to Uncle Sam.)

On this side of the pond, the correction we’ve experienced recently has so far been quite broad and orderly – a healthy pause in what was beginning to be a bit of a frothy rise. It has also produced the appropriate gnashing of teeth and proclamations of the death of the bull by those so inclined. The sign that everyone in the bearish majority seems to gloss over or completely ignore is that every time we’ve had a big downdraft buyers have once again

shown up looking for value. That tells me that even if people are cautious in their speech, they are still interested in deploying their investment dollars into something other than a 0% bank account or Treasury bond – the same pattern playing out again today as I sit and edit this piece. A trend worth keeping an eye on for sure...

The bottom line: corporate earnings are up and continuing to rise, consumer spending is up 7%+ YOY for the past 6 – 9 months and the credit markets are healthy. Basically everything except real estate (please don't let me slip into a tirade about that industry and how badly it remains broken) is on the upswing – so what's the problem?? I know, I know... Growth in the economy and in employment remains sluggish, but please realize, it is growing and not contracting. It may not “feel” great, and the media continues to harp on these items along with housing, but it is getting better, not worse. As they say, “A house not on fire is not news.”

As promised at the beginning of this missive, we must now slip into the filthy pit of politics, because like it or not, that is still what is in emotional control of our economy and will certainly not relent the closer we get to the 2012 Presidential election.

My first thought this spring was that it's clearly obvious the best course of action for the GOP would be to focus on taking the Senate, solidifying the House majority and if something happened to weaken the President, make a charge up that hill later. (This may be what Romney, Christie and some of the other presumed front-runners, who are relatively young, are thinking??) However, what I've seen and heard coming out of the extreme right worries me quite a bit. I generally sit on the right side of the aisle as most of you know, but I am far closer to the middle on most issues outside of tax policy.

President Obama currently appears to be in good stead to be re-elected, unless something truly bad happens between now and next fall. Though, as golfers would say on a long putt, “there's a lot of grass left in that one” - a la Bush-41 in the early 1990's. The Senate is clearly winnable: 33 Senators up for reelection in 2012, 23 of them are Democrats – and something like five of those folks have decided to retire rather than run again and potentially be beaten. If you remember the JP Morgan chart I relayed from a previous note, the true “gridlock” scenario that is best for our country historically is a GOP-controlled Congress with a Democratic President. Remember that they are never really sitting idle and doing nothing, we just need to make sure that ridiculous wastefulness on both sides is weeded out.

A big concern to me currently is that the extremists on the right - who, in my opinion, are equally as crazy as their counterparts on the left in terms of their dogmatic view of the country and their economic beliefs - will cut off their noses to spite their faces. In other words, they may become completely obstructionist and anti-American in order to try and blame the President for the continuing unemployment and housing problems. If that's the case, they risk being dragged into the sphere of blame themselves and may actually significantly weaken the party and blow the greater Congressional opportunities.

And just so we're clear, by “Anti-American” I mean thinking so short term that they refuse to budge on critical items like the debt ceiling, thereby further eroding foreign confidence in the American economy – which is far more damaging long term as other nations rise in the world. Is making your point, doing what's necessary, and waiting for the next Congressional cycle for true fundamental change to become legislative reality too radical a position to take? I hope not...

We can all agree that the biggest weakness in Obama's political armor was national security – whatever happens now along those lines he can appropriately check that box - whether you believe we're actually

safer or not. The continuing softness in the economy would be the other major item on his kryptonite list, but I fail to see how obstructionist policies on the right would fail to be shoved up their backsides during a campaign. It seems as though you wouldn't need the wizardry of James Carville to make that message stick. In my opinion, the worst thing the Republicans can do over the next few months is to allow the far right make the President look like the only reasonable moderate in the room. The incumbent coattails will be quite effective if that's the scenario and we will head further into the economically damaging, one-party rule, political abyss.

The polling numbers that media people recently love to quote always seem to mention that Obama would lose to a "generic GOP opponent." Unfortunately, they actually have to put a name on that ballot, not an amalgam of everyone's ideal candidate that comes to mind when asked the voting question. In that variation of the poll the President cruises to a win. Also, this polling that I've seen was done long before "Geronimo" was eliminated.

Finally, I learned a new term this week which seems to apply to the markets and people discussing / opining about them in the media, "cognitive capture." If you're unfamiliar with the term, as I was, it basically means that you focus too intently on one item and ignore the rest of the environment based on your biases. ("Can't see the forest for the trees") Something quite evident in my business – we all get paid for our theories as to why and how things will play out and sometimes focus only on those items that support the thesis. I'm sure I'm guilty of it at times, but it is also why I try to focus on general attitude and emotions of the environment, rather than strictly on the data.

People who are looking at data-only to confirm a recovery – or lack thereof – that appears exactly like one in the past will almost always be disappointed and miss wildly. At many inflection points, perception is more important than reality. That is why I continue to harp on the current political wrangling which can be more damaging than many people, including the politicians, seem to appreciate. We face a real risk falling back to the emotional "malaise" I discussed last summer.

Right now we are in a position of rational caution with fund flows in our favor and extremely favorable credit markets – also with the business community seemingly adapting well to the "new normal." (Remember, we invest in companies and their actual success, not beliefs or attitudes.) We now have to see if the politicians move the cheese too far or too often and muck it up again. If we get consistency and rationality from Washington – actual policy, not rhetoric - we should continue to grind higher. If the politics stray to the extremes either way, we are in a precarious enough position to possibly derail the train. It is why many of the position tweaks I've made to portfolios recently have been hedges around the core allocation – I'm comfortable, but prefer a little political defense.

As always, I thank you for your business and I welcome any questions or further discussion.

A handwritten signature in black ink, appearing to read "J. M. Gustaf". The signature is fluid and cursive, with a large initial "J" and "M".