MV Capital Management Thought Content Series: Markets in Transition

View from the Kayak: More "Starts" than "Fits"

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We're in the kayaks again, navigating the twists and bends that comprise the economic landscape of the first quarter 2010. As the quarter draws to a close we are reminded of the language we used to describe the year in our Market Outlook back in January: Fits and Starts. That signified an economy trying to get its feet steady and back on a growth trajectory. The image still applies, but on balance we are seeing more "starts" than "fits". Retail sales are holding steady, inflation remains modest and while that sticky unemployment number is still hovering just under double digits, new jobless claims have been subsiding and payroll additions have been showing some signs of life. Despite much handwringing to the contrary, the Fed is not making explicit any sense of urgency to raise the Fed funds target off the zero-percent level where it has languished for the past 15 months. In our view these are all "starts", and indicators that the market recovery that just passed its one-year anniversary may have some more legs.

Moreover the "fits", such as they are, have not made much of a dent on world equity markets. The wobbles of Greece and other second-level European economies (including Portugal, Spain and Ireland) probably are not going to go away any time in the near future, but fears of another global pandemic appear to be muted – a reasonable reaction in our opinion. Policymakers in Berlin or Paris may joke about the need for Athens to put a couple of the country's choicer Aegean islands up for auction as part of a debt reduction plan – but the EU's handling of the crisis to date by and large has been reassuring.

None of this should be taken to mean that we have put our structural problems behind us and are ready to embark on another multi-year growth run. As we noted in our last *Markets in Transition* installment "The Price of (Illusory) Growth", the business model that powered the Great Growth Market of 1982-2000 has run its course and another one has not emerged in its place as the obvious answer to the question "where is the sustainable going to come from?" But that is a longer-term discussion framed around performance possibilities for the next 3-7 years. Any secular period of that length is comprised in turn of a series of cycles, each driven by its own particular influences. In 2009 the cyclical keyword was 'stimulus' – massive government intervention brought the economy back from the edge of the abyss. But the stimulus cycle has quietly transitioned to the stabilization cycle, where economic indicators show an economy re-learning the art of standing on its own two feet. The Purchasing Managers' Index, an indicator of manufacturing activity, has been above the 50-level indicating expansion for the past handful of months. Retail sales for February were up modestly despite the impact of back-to-back blizzards throughout much of the population-dense Eastern Seaboard.

Signs of stability show themselves in other ways as well. In the DC metro area where we are based, one useful indicator is the return of the lunchtime wait. For a number of months after the 2008 market crash and well into last year, restaurant tables at the middle- or middle/upper-end watering holes around town were nearly always available even during the peak lunch and dinner hours. No more – venues ranging from the family-popular Houston's in Bethesda to Kellari's, a trending-upwards Greek *taverna* for K Street swells, require some planning ahead if one is to avoid milling around the maître d's station waiting for an opening. And our anecdotal data points do not appear to be outliers: in the latest batch of retail sales information the nationwide food away from home (FAFH) numbers showed broad-based growth.

We think sectors like FAFH are important because they straddle that line between purely discretionary spending and basic staples that people will buy no matter what the economic climate. Think of a spectrum of purchases where you have basic bath soap on one end and imported Tuscan patio tiles on the

other end. Those end points are fairly predictable: bath soap is a staple commodity for good times and bad (people don't stop washing their hands during economic recessions), while big-ticket whimsies like expensive patio tiles are going to tend to do better when times are really, really good. In between those endpoints we have the Houston's and the Abercrombie & Fitches of the world – stuff that we can cross off our monthly budgets in times of duress but that otherwise occupy a desirable component of our total wallet-share. The economy's overall direction owes quite a bit to how the dollars are flowing in this quasi-discretionary middle ground.

All well and good – but how does this translate to portfolio decisions? The thing about being in the kayak is that you never know exactly what awaits you two or three bends in the river ahead. You have to make the best sense of the landscape you see, anticipate what is to come and be prepared to act nimbly if conditions change (as they are always bound to do). In constructing portfolios we designate a portion of assets for tactical allocation decisions that can be deployed periodically to take advantage of opportunities we see in cyclical markets while maintaining most of our exposure in alignment with our longer term strategic outlook. For tactical purposes we think some additional exposure to equities is warranted in present circumstances, primarily in high-quality US stocks. We don't think this is the right time to add to our emerging market exposure levels, and non-US developed markets have a currency overhang working against them both in Euroland (e.g. the ongoing Greek drama) and Japan (we expect the Bank of Japan's quantitative easing program to continue to ease the yen against both the dollar and regional Asian currencies).

We don't necessarily expect to see another gangbuster year in equity markets like 2009 – nor do we think we are in the near term necessarily headed towards returns reminiscent of the last macro bull market. But taking into account the various forces at work in equities, fixed income and alternative asset classes we think a reasonable case exists for decent performance in stock markets this year, and our portfolios intend to reflect this.

With warm regards,

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