September 2012

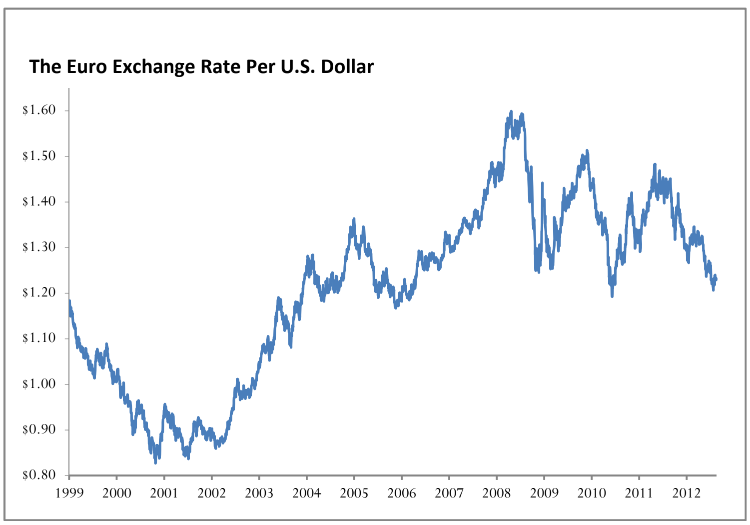
As Time Goes By

Last week, my three kids started school. As I walked them to their new classrooms, I couldn't believe the new school year had started. Time Flew. I then realized it has been some time since my last investment letter. Time really flew!

It is particularly easy to lose track and "watch time go by" when you feel stuck in the same place. Thus, my lapse may be due to the never ending European saga that continues to dominate the news. This year we have gone through new elections in Greece, new elections in France, economic struggles in Spain and a host of initiatives to save the euro and stimulate the eurozone economy. In that regard, some innovative solutions reportedly being considered by the European Central Bank (ECB) include outright purchases of sovereign debt and capping sovereign debt interest rates.

The ECB President Mario Draghi has recently said he will "do whatever it takes to preserve the euro." I certainly believe him. Just like I equally believe that our Federal Reserve (Fed) will do whatever it takes to keep us out of another "Great Recession."

The market anxiety seems to escalate at every bit of news. For example, the media watches every $0.01 decline in the euro as if it's the harbinger of the next terrible world event. People forget that the euro is much stronger now at $1.25 than its inception exchange rate of $1.17 back in 1999. Looking at the $/€ exchange rate history graphed below, the euro is incredibly stronger than the $0.83 lows reached in late 2000. Besides, if the world is so worried about Europe, a weaker euro may be the perfect medicine to keep their exports strong and to prevent a total economic collapse of the region.



Source: Bloomberg

In addition to national pride and historical motivations, I believe the Germans will support initiatives to do whatever it takes to preserve the euro because, to put it simply, THEY HAVE TO! Let's remember that a primary driver of the eurozone and single currency creation was to facilitate trade in the region. And it has worked. German exports now make up over half of their total economy. With the bulk of German exports (39%) going to the eurozone, total regional trade represents just over 20% of their total economy. As a comparison, US exports make up 14% of our economy. With almost a third of our exports going to Mexico and Canada, regional trade represents less than 5% of our total economy. Clearly, one can see that Germany is incredibly vulnerable and dependent on the economies of the region.

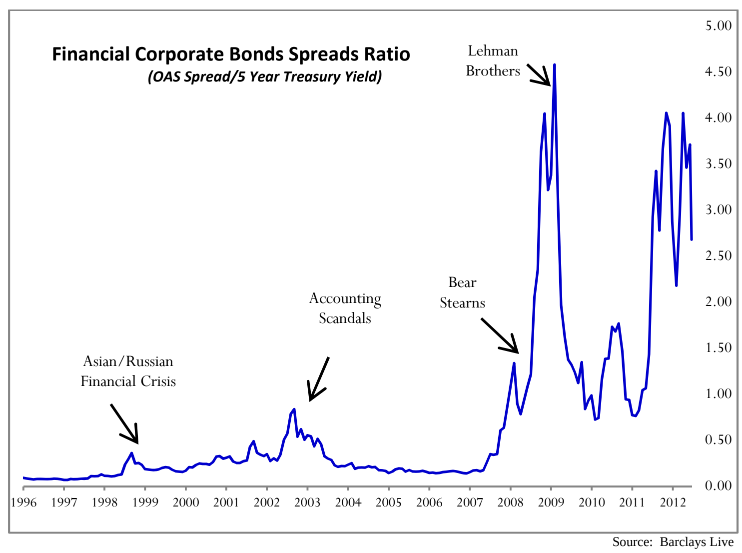
Draghi gets it. Germany has no choice but to do what's necessary to stave off a eurozone depression. Ultimately, Germany will agree to bold initiatives in furtherance of this goal and the ECB will "do whatever it takes."

While the market frets about Europe, the domestic economy is improving. We see that in the stabilizing housing market and a continuing decline in jobless claims. The result has been a quiet but steady rally in stocks with most equity indices near 5-year highs.

In the bond market, the big story continues to be the overvaluation of government securities. Another major story developing is the healthy rally in corporate bonds, especially financials.

Over the last few years, we have been strong advocates for financials. Since the fall of Lehman Brothers in 2008, financial institutions have written down assets, reduced leverage and built up capital. And with the Fed committed to maintaining the federal funds rate at basically zero through late 2014, they have set the stage for banks to earn their way back to health.

Despite the recent rally in financials, there is more relative alpha to come. Below is a chart previously discussed in my October 2011 letter. It is a graph of financial spreads as a ratio of the yield of an approximate equal duration treasury. Despite the recent rally, the sector offers significant relative value at levels near the crisis peak immediately after Lehman.



Source: Barclays Live

Nothing can prevent interest rates from rising. But if they do, financials should provide an income cushion to minimize the damage. While some may be "watching time go by," we remain aggressively positioned for an economic recovery with a meaningful overweight in financials.

I often think of my kids when I hear the wonderful Herman Hupfeld tune, "As Time Goes By." I certainly won't let time go by before my next letter. Please enjoy:

"You must remember this, A kiss is still a kiss, A sigh is still a sigh, The fundamental things apply, As time goes by."

Gilbert A. Garcia, CFA
Managing Partner

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