



7 JULY 2009



William A. Harris, CFA  
Portfolio Manager

## Skirting the Volcano's Rim

Imagine we're on the slippery rim of some Antarctic volcano. Off to one steep side wait ice jags and subzero darkness, while off to the other, hot gases blast and magma glows. Rumor has it that if we can skirt round to the far edge, we'll find a path to a gentle plain where all will be safe and good. Till then, the footing will be treacherous, and the consequences of any misstep unforgiving.

Here I'm adapting a metaphor I used near the stock market top in my November 2007 letter, "Fire, Ice and Slogging Through," which contemplated the forces of Fire (rampant deficit-spending, inflation and U.S. dollar debasement) and Ice ("a deflationary spiral... the housing and credit manias having detonated, the economic equivalent of a nuclear winter sets in"). At the time I emphasized that these were not so much scenarios we'd have to choose between, but rather risk and opportunity factors to incorporate into our portfolio management decisions. I hazarded a single prediction: "In a newly volatile environment, adaptive rather than static strategies are going to serve best."

I still feel that way. Clearly the housing and credit manias have detonated, and much of the economy has iced up. The Fed and Treasury are heaping fuel into their furnaces down in the caldera, trying to drive the chill from that outer darkness, but whether they can get the temperature "just so" without blowing off the top like Krakatoa remains to be seen.

At present, we're more concerned about the remnants of nuclear winter as manifested in rising unemployment, continued housing market instability, and falling global trade; so long as these forces are still in play, they'll keep a lid on inflation. A de-levering world is a cold world, and we think there are still excesses which the markets have yet to unwind. When the mercury starts rising, it will be hard to control, but for now it's nowhere near to bursting the glass. That's our outlook in a nutshell, and the key to surviving the

Ice-Fire tandem lies foremost in its understanding its sequence rather than trying to guess at its timing. Altogether, we think the key response is NOT choosing one scenario over the other prematurely, but rather building portfolios which can adapt as either force exerts itself.

Truth be told, we're not completely agnostic on issues of timing. We judge the markets to be over-optimistic in their hopes that a durable recovery waits at the backend of 2009 – too many investors are underdressed for a longer spell of cold (i.e. they've jumped too quickly back into growth assets – mainly lower quality stocks, which have rallied the hardest since March – and too quickly away from intermediate and long-term bonds.) This base case is tempered by our conviction that asset valuations will start discounting future inflation before its arrival; so just because we think inflation won't manifest itself in resource or consumer prices any time soon, it may well do so in required returns on financial assets.

Accordingly, here are some of things we're looking to pocket as we skirt the rim of the volcano: Deeply discounted CPI-linked bonds of investment grade credits. Treasury Inflation Protected Securities (TIPS) at real yields of over 2%. Precious metals stocks as the gold/XAU ratio heads north of 7.0. Long-term tax-exempt municipal bonds (even if inflation raises required returns, this should be partly offset as the bonds' tax-exemption benefit gets more richly valued as higher future tax rates are imputed). And always in season: Stock in companies with pricing power and defensible competitive advantage which have the wherewithal to continue increasing their dividends at a rate greater than inflation (there's nothing unique to this macroeconomic environment about the appeal of such wonders).

What waits on that distant gentle plain? Sure footing, and maybe even a happy settlement where men tip their hats to ladies, banks are solvent and consumers cheery, and "Help Wanted" signs abound. For now, we've just got to pick our way round, propelled partly by optimism that prosperity waits unseen and partly by the knowledge we've got no other choice, and half-frostbit and half-singed keep from tilting too much to one side or the other.

*William A. Harris, CFA*