

# Bill Miller Commentary



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The second quarter saw the market decisively break from the devastating collapse that began following the failure of Lehman Brothers last September and which appears to have ended on March 6<sup>th</sup> at an intraday low of 666 on the S&P 500<sup>1</sup>. The S&P rose 15.93% in the quarter, and ended the first half up 3.2%. We had an excellent quarter, as our fund rose 29.04%, bringing our year-to-date returns to 13.98% (excluding sales charges). This was due largely to our staying the course with names that hurt us last year, which were very cheap and got deeply oversold, and which began to rebound as it became clear that financial Armageddon had been avoided.

The market has begun to recover, although the economy has not (yet). It seems to have ended the second quarter somewhere between a much slower, milder slide and stabilization. This is better than many economists had expected, and we are beginning to see forecasts being raised for the first time in a long while. The consensus now appears to be for modest growth this quarter, picking up in the fourth quarter and then continuing to gain traction into 2010.

Of course, no one is vouchsafed any unique insight into the economy. Most observers use a modified Bayesian approach of having a baseline view, anchoring on it, and then making adjustments as the data arrive each week. Still, the preponderance of the evidence supports the view that the worst has passed in the market and the economy.

Clearly the extreme risk aversion that characterized the period from early October to early March is over, and absent some exogenous event or dramatic policy error, it is very unlikely to return. That has allowed almost all asset prices along the risk spectrum to rise, except Treasuries, a trend I

expect to continue, since I think bargains abound in the U.S. stock market.

Many worry that this rally is just a cyclical bounce in an ongoing bear market and they remain quite cautious in committing capital to risk assets. Assets in money market funds recently exceeded those in general equity funds for the first time in over 15 years. In contrast, at the market peak in October 2007, assets in equity funds were more than 3x greater than the assets in money market funds. The return on this mountain of cash rounds to zero, which is good when stocks and bonds are falling, but far from optimal when they are rising. Although I expect credit spreads<sup>2</sup> and risk aversion to remain well above the averages of the past decade, there is plenty of room for them to narrow and for equities to move higher as this cash gradually moves out the curve in search of better returns.

Those looking for the economic numbers to validate the market's move higher or for corporate executives to express optimism about the outlook are likely to continue to be disappointed. Economic numbers report the past, and corporations observe the present, while the market lives in the future. Corporations always express the most optimism about the outlook at the top, and the most pessimism at the bottom. Markets are about expectations, and expectations about the future are improving, on balance, and so are the markets.

Our friends at GaveKal Research<sup>3</sup> have reminded us there is a certain rhythm to the remarks surrounding recessions and recovery. The psychological cycle goes something like this: first it is said the fiscal and monetary stimuli are not sufficient and won't work. When the markets start up and the economic forecasts begin to be revised up — where we are now — the refrain is that it is only an inventory restocking and once it is over the economy will stall or we may even have a double dip. Once the economy begins to improve, the worry is that profits will not recover enough to justify stock prices. When profits recover, it is said that the recovery will be jobless; and when the jobs start being created, the fear is that this will not be sustained.

The data from the recent ISM<sup>4</sup> reports on employment and production are consistent with an economy that has stabilized and should turn higher this quarter. The very dramatic inventory liquidation of the past nine months could set the stage for a considerably stronger set of GDP<sup>5</sup> numbers than currently forecast as inventories are rebuilt. This should in turn lead to better payroll numbers and underpin a stock market that appears poised to move higher.

The market got a good lift this week from some early reporters of second-quarter numbers, including Intel and IBM. The tech sector has been a bright spot in this market, with many prominent names significantly outperforming the S&P 500. IBM's operating performance has been particularly impressive: In the worst recession in 50 years and the worst financial crisis since the 1930s, IBM has continued to post record earnings, more than doubling operating earnings per share in the past five years, more than doubling the dividend, and shrinking shares outstanding by 18%, yet it still trades at around 11x next years earnings estimates. If this economy can't hurt it, it's hard to see what can. The tech sector, on average, has a great balance sheet, is flush with cash, and trades at a large discount to the market on a free cash flow yield basis. It should continue to perform well.

Financials have been leaders off the bottom, just as they were off the bottom of the last banking crisis in the late 1980s and early 1990s. Banks still face mounting credit losses for the next year or so, but that should not impede their performance in the market, as it did not in 1991 when the same thing occurred. Pre-tax, pre-provision earnings at banks continue to rise, setting a new record last quarter, which means that banks are likewise set to report record results as the economy improves. They are a candidate for being among the leadership groups as they are under-owned, widely disliked, very inexpensive on price-to-book<sup>6</sup> value or to normalized earnings, and the system has seen massive capacity withdrawn due to the disappearance of Bear Stearns, Lehman, Washington Mutual, and Wachovia. The powerful results of Goldman Sachs this quarter may be a preview of things to come in that sector in the next few years as the economy recovers.

Although the market is up sharply from the lows and the economy appears on the brink of recovery, both can reverse if things don't continue on the present path. I think there are three endogenous risks to watch for: rising interest rates, a sharp rise in commodity prices (especially oil), and policy errors.

I expect medium- and long-term interest rates on government debt to gradually move higher. Treasury yields got ridiculously low during the height of the panic as everyone sought safety. They have now begun to normalize, and a 10-year with a yield of 4% or so would not be surprising in six months, nor do I think it would be problematic for the stock market. A sharp rise beyond that, though, could jeopardize a nascent housing stabilization and undermine the budding recovery. Housing remains the key to consumer confidence and spending (along with jobs). If housing prices stabilize, as they look to later this year or early next, that will help underpin consumer confidence and the recovery. That seems likely, but rates have to cooperate.

Oil prices are less than half from last summer's peak, but they are still up sharply this year and until the last few weeks had more than doubled off the lows of last fall. The rebound seems to be due more to people returning to the old leadership of the last market than to any improvement in fundamentals, because there hasn't been any. The last time oil prices were at this level, in 2007, the global economy was growing, oil demand was around 85 million barrels a day, inventories were low, and OPEC spare production capacity was about half of its historic average. Now inventories are as high as they were in 1998 (when oil was \$10 per barrel), demand is under 84 million barrels per day, the world is overproducing by about 1.5 million barrels per day, and OPEC is flush with spare production capacity. The market is clearly optimistic about the outlook for oil prices. Oil price increases are deflationary in this kind of economy, taking money directly from consumers and users at a time when incomes and profits are not rising. If oil prices mount a sustained advance from here into the high \$70s or low \$80s, that could threaten the recovery as well.

Finally there is the matter of policy errors. The much and wrongly maligned TARP money injected directly into banks marked a turning point in policy, from being punitive to capital invested in financial institutions, to being supportive of it. No major financial institution has failed since, and investors have shown a willingness to put new capital into banks that would have been unthinkable last fall. The government's decision not to support CIT, a major middle market lender, marks another turning point. Regulatory officials believe, correctly, that a CIT failure does not pose a systemic risk and that if it collapses, that will not undermine confidence in other financials. The market's non-reaction supports that view. I think the economic

policy troika of Summers, Geithner and Bernanke has, on balance, done an outstanding job under extraordinarily trying circumstances. Former Treasury Secretary Paulson also deserves credit for courageously reversing course last fall and certainly does not deserve the bashing he recently got from Congress about the Bank of America/Merrill Lynch deal. The chances of a major policy error from here seem to have lessened, with the major risk being a removal of policy accommodation too soon, as was done in the late 1930s. There seems to be no impetus to do this, and the statements of Fed officials indicate they are alert to this risk.

The administration could help the economy, the markets, and its own reputation for good decision-making by announcing immediately its intention to nominate Chairman Bernanke for an additional term leading the Fed. He has done a superb job under the most difficult circumstances. No Fed in history has been more innovative and creative in dealing with unprecedented financial turmoil and global economic challenges. He deserves the nation's gratitude.

Where does that leave us? The exogenous risks — geopolitical upheaval, terrorism, pandemics — are always with us. The others, rapidly rising interest rates or commodity prices, or serious policy errors, look to have fairly low probabilities attached to them and do not presently pose a threat to the economy or to a continued rise in the market.

I have not said anything about the risk of inflation, in part because it is remote over the next few years. But it is a common worry, and a constant topic of discussion. The issue arises because of the massive deficits being run now and for the next couple of years, and the inexorable growth of entitlements programs, which will drive debt-to-GDP ratios north of 100%, from the current level of around 65%, for the first time since World War II. Many believe we will have no choice but to inflate our way out of those obligations.

I disagree and think the major threat remains deflation, not inflation. The U.S. government ran large deficits in the 1930s and even larger ones during World War II reaching nearly 40% of GDP. Yet except for a one-time rise in prices after wage and price controls were lifted when the war ended, there was almost no inflation for 30 years. Japan's debt-to-GDP ratio is 170% now, and its problem is deflation, not inflation. Inflation can only arise if labor or business, or both, have pricing power. Labor is still around 70% of the cost of doing business, and there won't be any inflation there with unemployment at 9.5%

and rising. Capacity utilization is 68%, among the lowest in the postwar period. Businesses will have no pricing power until that number is at least over 80%, a long way away. If the so-called new normal is growth of between 1 and 2%, there will be no inflation.

What about the idea that politically we will be unable to do anything but inflate our way out of our debts? To believe that is going to happen, one has to believe the Federal Reserve will collectively repudiate its objective of price stability. Since the Fed that allowed inflation to devastate the economy in the 1970s is seen as having failed in its mission, while Paul Volcker, who sent the economy into what was until now the worst recession in postwar history by raising rates dramatically to kill inflation, is seen as a hero, it seems at best a stretch to think a future Fed will deliberately pursue inflationary policies. Could it happen? Sure. Do we need to be watchful for any signs of an incipient inflation? Absolutely. But the prospect of any kind of inflationary risk to the stock market over the next couple of years is vanishingly small.

Bull markets typically begin when the following four conditions are present: the economy is bottoming, profits are bottoming, the Fed is stimulating, and valuations are low. That's where we are now. The path of least resistance, as Jesse Livermore used to call it, is higher.

Bill Miller

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<sup>1</sup>The S&P 500 Index is an unmanaged index of 500 stocks that is generally representative of the performance of larger companies in the U.S. Please note an investor cannot invest directly in an index.

<sup>2</sup>Credit spread is the difference between the yield of a particular corporate security and a benchmark security that has the same maturity as that particular corporate security.

<sup>3</sup>Source: Gavekal Research 7/14/09

<sup>4</sup>Formerly known as the National Association for Purchasing Management, the Institute for Supply Management is an association that links with more than 48,000 purchasing and supply management professionals. As one of its goals, it surveys purchasing and supply managers to determine industry trends

<sup>5</sup>Gross Domestic Product ("GDP") is the market value of all final goods and services produced within a country in a given period of time.

“The price-to-book ratio (P/B) is a stock's price divided by the stock's per share book value.

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