

Bill Miller Commentary

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“In reality, those who repudiate a theory that they had once proposed, or a theory that they had accepted enthusiastically and with which they had identified themselves, are very rare. The great majority of them shut their ears so as not to hear the crying facts, and shut their eyes so as not to see the glaring facts, in order to remain faithful to their theories in spite of all and everything.”

—Maurice Arthus, *Philosophy of Scientific Investigation*, 1921

Mathematician Don Saari has noted the tendency for one or two variables to dominate complex systems with many more variables that need to be ordered, to the exclusion of the rest. In the complex adaptive system that is the stock market, that means there will be dominant narratives that most everyone agrees with and that seem to provide pat explanations for what has happened and predict what’s likely to happen.

Greedy bankers taking outsized risks caused the financial crisis, is an example. Another is that the large U.S. current account deficit, a result of chronic over consumption and under saving, means the U.S. dollar will continue to weaken. Still others are that China and the other emerging economies’ rapid growth will drive commodity prices higher, or that an over-leveraged consumer will lead to a “new normal” of subdued growth and lower-than-expected stock market returns. Finally, the only way out of the immense deficits of the government and the bloated balance sheet of the Fed is through inflation.

These narratives take highly complex, tightly coupled, interdependent systems and collapse them into a simple story that explains and influences behavior. Eyeing the deficits, Marc Faber in *Barron’s* this weekend concluded, “We are all doomed.” Well, maybe, but probably not this year, which ought to be a good one for stocks.

At LMCM we are no different from others in that we try to understand the environment and make investment decisions based on information, analysis, and judgment. Where we differ, though, is that we don’t make forecasts and conform portfolios to those forecasts, nor do we have theories which tell us what will be, or must be, as a result of what is or appears to be the case. We are data driven and try to observe and understand what the data seem to indicate, and leave the theories and predictions about what will or must happen to those with privileged access to the future. We do, of course, have beliefs that shape and influence how we interpret and weight the data, but those beliefs are in the form of provisional hypotheses, constantly subject to reformulation and change as the evidence warrants.

In our view, one thing the data support and the evidence warrants is the belief that the current consensus for economic growth for 2010 is too low, and that it’s likely expectations for profits growth are also too low. Both of these time series have been consistently revised higher since last year. Currently the Bloomberg contributor composite survey of 58 firms expects 2010 growth to be 2.7% in 2010 and 2.9% in 2011. Clearly the consensus has embraced the “new normal” popularized by our friends at PIMCO. (The old normal given

the depth and duration of this downturn would be for the real GDP rebound to be 6% or more the first year.) The Fed forecast is 3% for 2010 and 3.95% for 2011. Both of these forecasts are higher than they were in the previous survey, when the Fed was expecting growth of 2.7% while the consensus was at 1.8%.

Corporate profits growth is expected to be 25% in 2010, again a number that has been consistently revised higher, as more than two thirds of companies reporting in the second quarter beat expectations, and over 80% beat in the third quarter. The economic team at ISI reports that the incoming data are consistent with 35% profits growth in the first two quarters of 2010.

We of course don't know what GDP or profits growth will be in 2010. History and the data, though, support a view that GDP ought to be 7% to 10%, if corporate profits are going to grow 25% to 35%.

The jobs data is likewise consistent with a rosier outlook than consensus, which has unemployment averaging 10% in 2010 (consensus) or 9.5% (Fed). The improvement in the jobs numbers through last week is more consistent with the robust employment growth we saw coming out of the 1982 recession, rather than the more tepid job growth experienced following the 1990 and 2001 recessions, which are the blueprints for the current consensus.

Most forecasts of the fourth quarter's GDP now average 4%, but then drop back to 2.7% for the first quarter of 2010. Since inventories will still be in the process of being rebuilt (final demand never fell as much as production during the recession, leading to massive inventory liquidation), and the stimulus will still be going strong, and the economy is accelerating off the 2.2% third quarter, the sudden deceleration in the first quarter of 2010 seems more theory driven than data driven at this point.

What about the stock market? It's clear that economically things are getting better, not worse. In addition to GDP numbers, credit spreads have returned to some semblance of "normal," and the bond market has seen record refinancings. Yet stocks still sell below where they sold AFTER Lehman failed, when the world was falling apart. Even in the week after Lehman collapsed, the S&P 500 traded as high as 1255, over 10% higher than the market is today.

In the parlance of Jesse Livermore, the path of least resistance for the stock market is higher, yet investor resistance to stocks as evidenced by what people are actually doing with their money remains resolutely in favor of bonds, with money continuing to be redeemed from U.S.-oriented equity mutual funds, while flows into bond funds are running at record levels.

This affinity for bonds over stocks is understandable when looking at the last 10 years, but perverse, we believe, when looking at the likely course of the next 10. Bonds crushed stocks the past 10 years, with riskless Treasuries¹ returning over 6% per year, while stocks lost money on average each year of the past 10. Ten years ago stocks were expensive; now they are not.

In the next decade, the story is likely to be quite different. As the economy gradually (or quickly) recovers, the Fed will remove the extraordinary monetary accommodation it provided during the crisis, and shrink its balance sheet. A neutral fed funds rate would be in the 2.5% range or thereabouts, perhaps higher. Long term, the ten-year Treasury ought to yield about the nominal growth rate of GDP, so somewhere in the 4.5% to 5.5% range, leading to substantial losses in Treasuries and probably investment grade corporates as well. High-yield bonds ought to do better, but they had their big move last year, rising over 50% and providing the best returns relative to equities ever. All this, though, assumes benign inflation of 2% to 3%. If the inflation bears are right, bonds will be a disaster.

Stocks are quite a different story. After spending 10 years in the wilderness, high quality U.S. large capitalization stocks are cheap compared to bonds. Names such as Merck trade at 12x this year's earnings and yield more than 10-year Treasuries. IBM has record earnings, trades at 12x this year's expected results, buys back shares every year, and has grown its dividend 25% per year the past five years. Stocks have historically provided inflation protection that bonds cannot. Like Poe's purloined letter, these values are hidden in plain sight.

In addition to large cap stocks, so-called “low quality” recovery names are still quite attractive, with many of them trading below book value. Regional banks, for example, were among the worst stocks in an otherwise good year in 2009, but have begun 2010 strongly. Many of them have ample capital, will see loan and credit losses peak this year, yet trade below tangible book value and therefore with a negative deposit premium. This year should also see a merger boom, as corporate balance sheets are mostly flush with cash, and profits are again headed higher. Health care and tech are fertile hunting grounds, as well.

Broadly, I think the names that trade at low valuations on traditional accounting factors such as low price-to-earnings, low price-to-book, and low price-to-cash flow will be the winners this year. Companies whose stock prices already discount mid-cycle earnings, as many materials and industrial cyclicals do, may fare less well. Industrial metals prices have had very large moves, as has oil—both appear to be well ahead of fundamentals and are beneficiaries of the simple explanatory narratives noted above. If the Chinese continue their tightening cycle faster than the markets currently anticipate, those narratives could quickly unravel. It’s important to keep in mind that China is structurally short oil, and higher prices are not its friend.

The dollar remains a wild card that could underpin a strong stock market if its new-found strength against the euro continues, as investors in Europe appear to be substantially underweight U.S. equities. A euro at 1.25 to the dollar at the end of this year would not be a surprise, and it still would not be cheap.

I think 2010 will be a good year for stocks, and a challenging one for bonds. Low inflation, good economic growth, ample liquidity, rising corporate profits, attractive valuations, and continued investor skepticism should combine to move the market higher, perhaps substantially so. The current consensus appears to have the market up high single to low double digits. If the consensus is wrong, I think it will be because it is too low, not too high. At least that is what the facts, data, and evidence would lead one to believe, if one were unencumbered by a theory that says otherwise.

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S&P 500 1092

¹U.S. Treasuries are backed by the full faith and credit of the United States Government and offer return of principal value if held to maturity. Prior to maturity U.S. Treasuries will fluctuate with market conditions, inflation and interest rate changes.

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