Marble Harbor Investment Counsel, LLC
Excerpt from
First Quarter, 2009 Letter

Dear Client: April 2009

We all recall learning as children Benjamin Franklin's aphorism praising thrift, "A penny saved is a penny earned." And now, we have come to understand only too well the consequences of ignoring this wisdom. McMansions, colossal SUVs, and even more colossal credit card debt. Simply put: Too much money spent on too much *stuff*. With a financial crisis triggered by this profligacy, we are seeing something of a boomerang effect.

The savings rate in the United States had steadily dropped from about 10% in the early 1980s until it hovered between 0% and 2% for about three years leading up to mid-2008. We tend to believe that this orgy of consumption resulted from the nexus of a number of factors: an extraordinarily long, comfortable stretch of economic prosperity, the easy and plentiful credit this period of prosperity produced, and a drop in prices due to diminishing commodity costs and cheaper manufacturing and servicing costs driven by the growing ascendancy of India and China. Governments and companies alike indulged in the spending sprees. The federal government engaged in a level of deficit spending not seen since Lyndon B. Johnson's presidency. Companies invested in productive capital stock and new plants. And banks lent historically large amounts of money relative to their actual capital. This spending was funded, to paraphrase Blanche DuBois, "by the kindness of strangers."

The result was an economy on rocket fuel. Each of these factors is now being unwound. Banks have pulled back on lending because prior loans they injudiciously made have vaporized. Companies are curbing capital expenditures and laying off workers. And most impactful, consumers are no longer buying. Over recent decades, our economy has been comprised of approximately 70% consumer activity. In response to the rapid increase in home foreclosures, swelling unemployment numbers and rising energy costs, the United States has recently experienced the most dramatic change in the savings rate since data have been tracked. Since mid-2008, the savings rate has jumped from about 1-2% to approximately 6%. To put this in perspective, it took 13 years for the savings rate to fall *from* 6% to 1%. Multiplying this impact has been the slowing of income growth coupled with rising unemployment.

We can happily point to the positive effect of a higher savings rate *in the long term*. We will see household debts decrease, steady relief from our dependency on China to finance our deficits, and a much more sustainable rate of expansion. In the near term, these hard earned pennies contribute to the weak economy. When we speak to companies, they tell us of weak retail sales and a shift toward consumables from durables. The prolonged stretch of buying shiny new automobiles and appliances has ended. We can easily imagine a period of a year or two where sales of these sorts of durable, discretionary items remain light. After all, replacement could revert to *need* not fashion.

Toward the end of this period we can envision a nice rebound – pent-up demand from consumers who actually have the money to spend driving sustainable growth. But this will likely come only after a period of choppy economic activity. Clearly the government is in the early stages of trying to cushion this fall. The stimulus bill contemplates the greatest single-year escalation in domestic federal spending since the Second World War. It is a mixture of some relatively modest near-term spending programs to give the economy a quick, but small boost as well as hundreds of billions of longer-term social spending that is likely to recast the shape and nature of the economy for many decades. It implies a long period of rising taxes and an economy that has a much higher proportion of government involvement. We will live with this debt for a long time.

Why the recent rally? We have written to you over the past several quarters about the extreme fear and pessimism surrounding banks and the financial sector. We felt that the negativity was warranted to an extent, but on the whole, it was overdone. With recent pronouncements by most of the large banks that they expect to show strong profitability in the first quarter, the market has breathed a massive sigh of relief. And those companies that were most beaten down have rallied strongly. Contributing to this rally has been short covering as well as quarter-end window dressing by mutual funds and other institutional investors who wish to show their clients that they owned the best performing stocks. This has fed what we feel may be an artificially strong rally. As we look through the improving shape of the banks and insurance companies, we still see rising numbers of layoffs, including within the service sector. Commercial real estate loans remain fragile, and home mortgage defaults are still deteriorating. This doesn't imply a disaster scenario, but it does suggest that we are not out of the woods just yet. We expect a choppiness to the market akin to what we will see in the economy – Two steps forward and one step back.

How do we invest in this market? Well, we have rarely seen such compelling long-term values as those that are emerging today. High-quality companies that have strong balance sheets, nice dividend yields, and that are gaining market share are selling for modest multiples of earnings. This means that eventually they should be good investments; however, in the short term, they could certainly lose value. Yet, we are encouraged by how our companies are standing up to the recessionary assault while weaker competitors are showing signs of buckling under the strain. We think this bodes well for the future of your portfolio as business activity picks up and we make our way toward economic recovery.

We hope you are well. As always, please don't hesitate to call with questions or comments.

Marble Harbor Investment Counsel, LLC

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