Marble Harbor Investment Counsel, LLC
Excerpt from
First Quarter, 2012 Letter

Dear Client:

The S&P 500 rose by 12.3% in the first quarter, registering its best results since 1998. This performance surprised many pundits who had tempered their expectations due to the slowing global economy. After all, Europe's southern tier of countries is in recession and the northern tier is slowing significantly. China's economy continues to slow, and the debate is how hard its landing will be. Macroeconomic concerns in the U.S. include a still weak housing market with a new wave of foreclosures expected by summer following the recent settlement between major mortgage-originating banks and states' attorneys general; rising gasoline prices; a stubbornly high unemployment level; and a growing Federal deficit along with troubling high U.S. debt to GDP ratios. How do these slowing conditions co-exist with the strong first quarter stock market? How will they resolve themselves?

Central bankers around the world have pumped an unprecedented amount of "liquidity" (i.e. cash) into the global economy over the past three years. Our own Federal Reserve has bought more than $2 trillion in bonds and troubled assets since the fall of 2008 as a way to clean up bank and insurance company balance sheets. China dramatically eased lending requirements in late 2008 to promote lending. The European Central Bank has provided massive amounts of cash to major European banks as a way to offset exposure to Italy's, Spain's, Portugal's and Greece's sovereign debt. Ordinarily, as the cash flows into the economy, it stimulates lending by banks. Within a few quarters, consumer consumption and finally jobs, rise.

Ordinarily, accommodative monetary policy is the lever for economic growth after a recession, and it is why central banks can usually help economies recover through increased lending and higher consumption. However, this time around, because of depressed house values and high consumer debt, the hoped-for growth has not taken place. Instead, the prices of riskier assets have risen.

This is in part why we saw inflationary pressures rise so dramatically in China over the past two years as their stimulus was effective in generating demand for scarce items such as food and housing. In the developed economies, easy-money policies have pushed yield-hungry and return-seeking investors into "risk-on" trades. This is essentially what we saw in the U.S. stock market in this last quarter. Over the last three months, the most volatile stocks with lower quality balance sheets and higher valuation ratios performed the best.

Have the economy's fundamental prospects changed over the past three or four months? It is true that jobless claims have fallen, but employment data are a lagging indicator, not a leading indicator. Furthermore, it is consumer consumption that drives employment, and consumption peaked a year ago. Seeing a lag of six to nine months in employment is not unusual. Consumption has deteriorated since a year ago, and it would not be surprising to see employment levels worsen as well over the next several quarters.

Part of the reason for apparently improved economic output numbers may be that they are reported on a seasonally-adjusted basis. The Great Recession generated such poor economic activity for the end of 2008 and beginning of 2009 that the methodology for making seasonal adjustments now “expects” to see unusually slow data generated at this time of the year. To compensate, it adjusts the data significantly upward. This distorts the seasonally adjusted figures we are seeing now for year-end 2011 and the first quarter of 2012. These data have been further distorted by the unusually mild winter this year. Looking at the raw data, the U.S. and European economies are slowing. This makes intuitive sense given slow job growth, rising gasoline prices, which act as a tax on consumer spending, and continued caution by both businesses and individuals.

This is precisely why our continued emphasis on high quality companies is central to how your assets are invested. It is often when stock markets are leaning toward greed that we look at our positions with more caution. Now is not the time to load up portfolios with aggressive investment strategies or complicated positions. Rather, now is the time to remember that conserving capital is sometimes the best way to build wealth.

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