Ashdon Investment Management

Q2 2012 ECONOMIC COMMENTARY

July 2012

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Second Quarter 2012 Economic Commentary

- **A wealth of data contradicted popular headlines that indicated evidence of a slowing or recession-headed economy.**
- **Our view is that recent economic data is consistent with a growing economy, but with a pace of growth at the low end of the moderate-growth range.**
- **Even painting a positive picture of the economy for the second quarter, we still acknowledge that a "recession" in the U.S. economy is possible over the next several quarters.**
- **As in all types of economic environments, each recessionary period creates a wealth of inherently valuable yet underpriced investment opportunities.**

Incoming data during the second quarter was quickly interpreted as evidence of an economy that was at least slowing down and possibly tipping into recession. Yet there was also a wealth of data that indicated otherwise, contradicting the sentiment of popular headline data.

One the one side, certain headline data seemed to indicate we're headed in a negative direction. Two key examples were the advance reading of Q2 GDP(+1.5% compared to +2.2% for Q1) and three consecutive months of declining jobs creation data. While these two particular readings were consistent with the soft economic growth experienced during the recovery from the recession, many worried that the declining data trend was a worrisome measurement. Similar indications of data weakness were captured in several aggregating data measures (e.g. ISM PMI, Aruoba-Diebold-Scotti Business Condition Index).

Our view is that the recent economic data is consistent with a growing economy, but with a pace of growth at the low end of the moderate-growth range experienced over the last few years. We note that unusually warm weather in the first quarter caused seasonal adjustments that biased data toward higher growth rates. While we cannot quantify this bias, we do believe that second quarter data would naturally have corrected itself if weather patterns had been more normal.

At the same time, other data measures do not yet indicate an economic slowdown, but rather robust growth among some segments of the economy. Perhaps contrary to investors' headline-driven expectations, consumption in the U.S. economy remains robust. Core retail sales (i.e. retail sales excluding auto, gas and building materials) have increased in each month of 2012. Yet, lower gas prices and lower seasonally adjusted sales of building materials dragged on headline retail sales in recent months.

Importantly, this correlates well with income data. Nominal wages and salaries continued to grow in a range of about 4% per annum. Wages and salaries are at an all-time high, 3.3% above the previous high, even though payrolls remain 3.6% below the January 2008 peak. Stabilization of the employment situation over the last several years has seemingly provided a degree of confidence to consumers, in spite of what survey data indicates. As long as consumers have growing wages, consumption is likely to

grow. As one analyst recently noted: it is more important to observe what people do than what they say.

Finally, these less obvious and more positive data trends are well correlated with corporate profit data. Corporate profits rebounded to a new high during the period as the U.S. economy slowly recovered from the recession. Despite moderating pace of growth in recent quarters, profit growth remains solid. After-tax corporate profits grew 6.5% in Q1 2012 compared to a year ago.

If the economic picture is weighted toward the positive side, why has headline data indicated such weakness? We addressed one possible cause of weakness in GDP data – seasonal adjustments during an unusually warm winter. Similarly, employment data can be tricky to interpret. After a period of increasing strength, the so-called "Establishment Survey," the most widely quoted employment metric, indicated declining jobs growth for several months. However, the U.S. government produces another, equally valid measure of the employment situation known as the "Household Survey," which showed increasing jobs growth through the second quarter, contradicting the Establishment Survey. Neither metric is perfect nor superior to the other, yet for no apparent reason The Household Survey is often under observed. Over time, the two measures are highly correlated, yet there have been short-term divergent time periods. We believe that 2012 has been one such period and that overweighting the importance of the Establishment Survey trend is misleading.

Even painting a positive picture of the economy for the second quarter, we still acknowledge that a "recession" in the U.S. economy is possible over the next several quarters. What we know about recessions is that they are officially and by definition obvious only in hindsight. You cannot know you are in a recession until it is already begun. We also know that all recessions are not created equal -- their effects differ. The most recent recession was a unique event, powerfully focused on the global financial system, making it painful and long lasting. By comparison, the impact of the recession of 2000-2002 on the U.S. economy was modest.

Outlook

The short-term nature of recessions and recession forecasts has contributed to our value investment style and focus on investing on a fundamental basis. As always, we believe that investing in asset classes that are inherently valuable but currently underpriced creates significant opportunity in any economic environment. Each recessionary period creates a wealth of underpriced investment opportunities.

In the current environment, we've uncovered significant opportunities in consumption- and technology-related equities, as well as commercial and residential real estate securities, while keeping portfolios exposed to hedged strategies to stabilize portfolio value.

Consumption-related equities. Popular opinion of the current economic environment is that with inflation and the fiscal cliff approaching, consumers will soon cut back significantly on spending. We disagree. Rather, we maintain that consumption is consistently dominated by the top 25%, a demographic that rarely alters their spending habits, and likely won't stop now. This belief, combined with a profitable

corporate environment, has resulted in our investment in consumption-related equities, which are currently out of favor by the broader market but we believe are underpriced and positioned to offer significant returns.

Technology. On par with our contrarian approach to investing, we view technology slightly differently than the broader market, as we look outside the obvious dominant players, such as Apple, in the sector. We believe that while technology is continuing to improve, corporations that now have cash on hand yet are still reticent to hire will invest in non-human infrastructure to enhance productivity and efficiency. Companies we believe are poised to gain from the current state of the economy and technology specifically include large-scale information management and infrastructure companies.

Real estate. While commercial and residential housing construction over the past several years has showed little to no signs of growth, the population has continued to grow and the demand for housing has followed suit. Real estate prices have already begun to correct with this increased demand. In this environment, we've found significant opportunities for investment in distressed residential and commercial real estate assets.