Ashdon Investment Management

Q1 2013 ECONOMIC COMMENTARY

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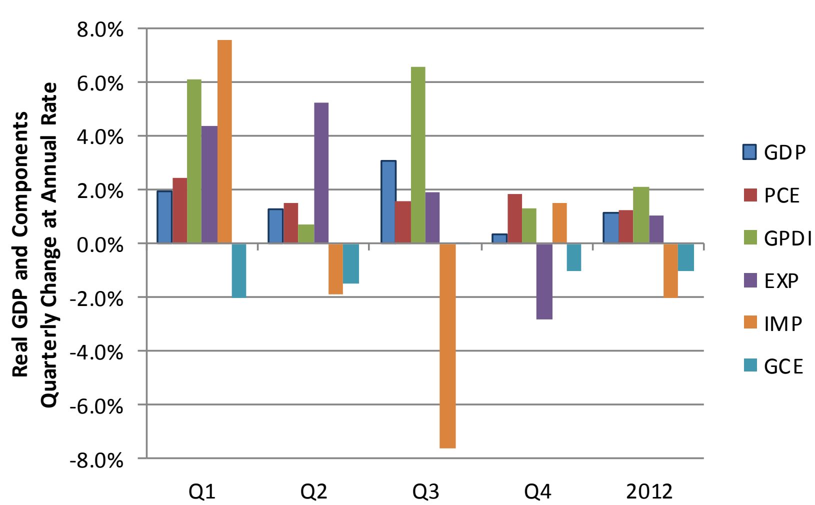
ASHDON
Investment Management

First Quarter 2013 Economic Commentary

Economists and investors greeted the disappointing Q4 2012 GDP release (2/13) with barely a passing glance and the modest recovery of the economy continued in the first quarter. Final data release indicated that US economic growth was flat (0.4% in real terms) for the last quarter of 2012. A close look at the weak data did nothing to change our expectations for the US economy over the next 12 to 24 months. We have stated on several occasions since 2010 that the modest recovery shows no imminent sign of being derailed, so the market's reaction to the release was much more interesting than the GDP data itself. In particular, we were intrigued that investors seemed to shrug off this sluggish data after four years of violent market reactions at every "disappointing" data release. We thought this change bore further examination and we discuss that examination in this edition of our commentary.

Before proceeding, it is best to present the GDP data to provide consistent context. GDP data are very high level aggregations of complex chains of economic activity and so it is difficult to use the data to make *precise statements* about the state of the economy. However, we can use the data to gather *a sense of the broad themes* in the economy. The chart below shows GDP and it's components for 2012. The real productive performance of the US economy is best represented by PCE (Personal Consumption Expenditures –goods and services consumed by citizens) and GPDI (Gross Private Domestic Investment –investment in buildings, equipment, and inventories). As seen in the chart, these two measures were positive and stable through 2012, and have been similarly stable through the recovery since 2009.



However GDP is a measure of all economic activity including the influence of Government activity. It was changes in US foreign policy and US fiscal policy (i.e. sequestration) that were responsible for this deceleration, not private sector economic activity.

The primary source of weakness for Q4, and for the trailing year, was GCE (Government Consumption Expenses). Declines in defense spending subtracted 0.6% from GDP. Other government spending categories subtracted 0.2%. A portion of this decline was related to the winding down of US deployments in Iraq and Afghanistan.

Looking more broadly, we see that the economic picture brightened at the slow pace to which we've all become accustom. The continually improving employment picture shows that a great deal of damage has been repaired. Unemployment is at 7.7% and the job creation rate has reaccelerated after a slowdown in 2012. Stabilization of the employment picture improves the economy, but further improvement is needed. The recovery of the housing market is just beginning and, at the very least, this segment of the economy has stopped detracting from growth. At best, it can become a substantial addition over the coming years. All of these outcomes are small parts of the virtuous cycle that the FOMC ignited with its innovative monetary policy measures from 2008 through today.

These objective data suggest that the real US economy – companies and productive citizens - continues on a self-powered path to recovery. For private sector companies, recovery has been driven by sophisticated corporate efficiency measures and entrepreneurial spirit.

At the same time, the US consumer has taken advantage of what is possibly a once-in-a-lifetime opportunity to repair and strengthen family balance sheets with the aid of ultra-low interest rates – debt carrying costs have been reduced and principal payments accelerated. This hypothesis is supported by a diverse range of economic and corporate data. In our view, the very strong – if volatile – equity market advance since 2009 is perfectly consistent with the picture painted by the economic data since the recovery commenced. The market's ability to shrug off the "disappointing" Q4 release seems to us to be a late, but broadening recognition of the objective data.

We see that the highly contentious political climate that we've lived with for the last four years has caused investors to confound political views with investing views. Many investors have been "out of the market" (though we must confess this kind of thinking is foreign to our view of what "investing" really means) on the basis of political leanings. Given the depth, breadth and severity of the "Great Recession", strong emotions are understandable. Unfortunately these emotions have had opportunity costs.

As broad perceptions have turned the corner, we have been struck by the numerous ways the broader investing population has begun to come to terms with the reality. We believe we are witnessing a significant change in investor mindset. We are seeing signs of this shift in very diverse segments of the investing landscape. On one end of the spectrum, we see the marketing efforts of very large banks and brokerage firms eagerly pushing clients into equity positions "before it's too late". At the other end, we have seen energetic academic debates concerning the inconsequential technical errors in the gloomy, highly influential (and substantially correct) academic analysis by Rienhart and Rogoff.   Just like the overly negative voices that held sway during the early days of the recovery – costing investors opportunity. There are overly optimistic voices that we believe are likely to lead investors to a disappointment.

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