CREEKSIDE INVESTMENT MANAGEMENT, INC

Cyclical Bull Market, not an Anomaly

The Standard & Poor's Index posted the best first quarter return (+12.6%) since 1998, led by bull market rallies in industrials, technology, consumer retail and financials. Low quality stocks outperformed high quality stocks as the Dow Industrials (high quality) posted and 8% return while the NASDAQ (lower quality) was up 19.5%, demonstrating the sheer breadth of the secular bull market.

This was not just a U.S. phenomenon. There was a positive rally around the globe as all regions posted gains for the quarter. The magnitude, breadth and duration of the rally across risk assets and the corresponding collapse of stock market volatility have taken many market participants by surprise, leading to fund managers to cover underweight/short positions as risks from Europe and global recession receded.

We have now witnessed two back to back quarter performances that began with the fourth quarter rally of last year. According to my diary, the market low occurred on September 4, 2011 with the S&P 500 Index at 1087, closing out the year at 1259 and with continued progress in the first quarter ending at 1404, a twenty-nine percent gain, not including returns from dividends. Real profit taking has not yet set in, which is to be expected after a run of this magnitude. But, barring an unforeseen event, a consolidation should be nothing like last year with 300 point swings in the averages. Unlike last year the volatility of the market as measured by the VIX (Volatility S&P 500 Index) is quite low and investors are willing to assume risk in the absence of liquidity issues in Europe.

What were (are) the key drivers of the rally and where are we now in terms of valuation and market dynamics?

Improving macro-economic data starting in late September fueled an abrupt covering of short positions from extremely low equity valuations.

The European Central Bank's infusion of liquidity into the banking system removed much of the financial systems risk that allowed investors to focus again on improving macro data.

U.S. economic performance during the first quarter provides strong support for the view that growth is broadening its base. Employment gains averaged 210,000 per month, led by private services and manufacturing. (The headline number continues to be impacted by a contraction in public sector jobs.) The improvement in the labor markets has led to faster than anticipated consumer spending.

Equity Market Outlook: Gradual grinding higher driven by continued inflows into U.S. equities. We view inflows into equities as the norm not the exception as a reasonable allocation of savings should be in the offing as investors are forced out on the risk curve by extraordinarily low real interest rates seeking not just income but growth in income from dividends.

Global growth is seen as bottoming in the first quarter although weakness in China remains a concern due to excesses in banking and property markets, yet domestic demand in China and the rest of Asia remains strong leaving intact the long standing strategy of participating through U.S. corporations with sizeable global business models.

We continue to believe that negative real bond yields will be the new norm over the next several years. We calculate that the 10 year real bond yields (coupon return minus inflation) of minus 1% to minus 2% are required to stabilize government debt in the U.S., U.K., Europe and Japan. We will elaborate more on this later.

Inflation has been rising of late, principally due to higher energy and food costs. Current year-over-year inflation in the U.S. is 2.3% which is not high enough to affect equity risk premiums. Not a worry unless inflation reaches 4% on a sustainable basis which is not in any serious economic forecast that we see.

U.S. Economic Recovery and Fiscal Budget Issues: The Federal Reserve Bank of Dallas (FRBD) is to thank for providing insight into the economic recovery both here and in Europe in the monologue, "*Deceivingly Similar, Strikingly Different*" and is worth mention because of the dimension it may add to our understanding behind the dynamics of the U.S. recovery. The parallel is made that both economic zones (U.S. and the Euro Zone) have experienced nascent, below trend line economic recoveries. Where the two zones are different is in the area of productivity, according to the FRBD, which happens to be a key determinant of the prosperity of nations…defined as "the efficiency with which labor and capital inputs is transformed into output." The productivity of the Euro Zone and the U.S. reveals a striking departure in the recovery process. Euro Zone labor productivity fell sharply during the Great Recession and never recovered, while U.S. productivity fell modestly and quickly recovered from its prerecession levels.

Why is this important in a macro sense and where is the relevance? The fact that productivity and output (growth) are not moving in sync seems to be an anomaly relative to past experience in the U.S. The fact that machines and workers seem to be more productive should induce firms to invest, hire more workers and expand production. The FRBD suggests the existence of "economic friction" stymies the transmission of productivity gains to output gains, i.e. economic growth. The challenge for U.S. policymakers (and voters) will be to figure out why, despite the gains in productivity, it has not lead to gains in prosperity.

U.S. Fiscal Sustainability and Further Stimulus from the FED: All in all, federal debt expanded by $9.5 trillion, from $5.7 trillion in 2000 to $15.2 trillion at the end of last year and is still growing over $1 trillion a year, or $5 billion every business day. And yet, interest expense did not go up because interest rates fell faster than debt went up and interest rates must be kept as low as possible to avoid explosive debt dynamics. Low interest rates are forcing investors out on the risk curve, seeking higher returns. This is good for equities and the probable duration of this low interest policy regime provides longevity. A notable aside is that the era of independent central banks is closing as those institutions revert from their foundational role to one of becoming fiscal agents of the state.

Outlook for Equities: The S&P 500 has reached our interim goal of 1400 that we have had in place since January, 2011. Earnings for the S&P are expected to reach $106 for the calendar year 2012 raising a new target for that index price of 1500-1550, which implies a multiple of 14.5X. What can go wrong? Bloomberg's compilations of analyst estimates for the S&P 500 companies are essentially flat compared to the first quarter of last year. We will be watching earnings releases that began this week very closely.

In Europe the financial system is still under heavy strain and the recovery is very fragile. Debt is still too high, both public and private, and unemployment is stubbornly high.

At home, the change in unit labor costs (productivity) may have reached a peak which is an ominous inflation signal.

Lastly, there are considerable concerns that the Fed will complete quantitative easing in June and that it should be extended. This has already impacted the equity markets.

The current low level of volatility is unsustainable and there are bound to be unpredictable events that will lead to an escalation but not to an extent seen last year. Like last year it will be important to maintain focus on the sustainability and flexibility inherent in free markets.

Tactically, we continue to favor U.S. industrials, financials principally banks and insurance, technology and consumer related companies. Energy is still a mainstay, but the dynamics of U.S. supply/demand are transitioning from its thirty year trend of declining supply with increasing demand to one of increasing supply and declining demand. This has already occurred in the case of natural gas resulting in low prices for that commodity and while oil is more fungible than gas, shale oil production in the U.S. lower forty eight and Canada is so prolific that it is mainly hampered more by the logistics of transmission to markets than lack of supply. The entire supply chain is geared toward importing oil and sending supply inland and that equation has been upset by domestic production. This is calling for more pipeline infrastructure. The Keystone pipeline is just one of many needed and present an abundance of visible and sustainable investment opportunities.

Bonds for the most part are fully priced. With the U.S. 10-year Treasury yielding 2.65% the upside is nil and the downside is considerable. The only space for fixed income investors in this low interest rate environment is high yield corporates with improving credits combined with short duration. The focus here is cash flow and total return to maturity and call features.

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