W O O D S T O C K

QUARTERLY NEWSLETTER

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'Til Debt Do Us Part

Lawrence S. Foster

Over the past twelve months the domestic equity market has recovered nicely from the steep and dramatic decline that began in September, 2008. However, the S&P 500 remains 8% below the pre-Lehman collapse price of 1,303 on September 1, 2008 and 25% below the all-time high of 1,576 reached on October 12, 2007. While we are pleased with the market's recent performance, our enthusiasm is restrained. This is not to imply that the current market is overvalued. Moreover, over the long term equity markets are fundamentally driven by corporate earnings growth which is likewise in part dependent upon a healthy economy. In our view, the market has climbed a "wall of worry". Corporate earnings have bounced off the bottom and beaten Wall Street analyst estimates for the last two quarters. In addition, Wall Street stock analysts continue to push earnings estimates higher, but concerns persist among investors as to whether the conditions exist for a ubiquitous, sustained economic recovery.

It is widely acknowledged that the onset of the current financial crisis was brought on by excessive mortgage debt and declining real estate values in the US and Europe. *Side bar: It is interesting to note that the financial press and many investors still refer to the current environment as a financial crisis. While the liquidity crisis is long over, the banking environment is far from normal. It also appears that the risk of systemic collapse is well passed though issues in Greece and other countries remind us that troubles remain.* It is unnecessary to recount all the factors, but the contagion in the mortgage and housing markets created cascading losses for many banks. The weakened state of many of the developed world's largest banks and the lack of liquidity in our financial system required the use of public funds to stabilize the banks' capital ratios and to lubricate the global financial machinery. As economies contracted, governments around the world also spent public funds to both stimulate economic activity and ease the pain of the disaffected. The process of patching our financial system and stimulating our economy has forced the U.S. government to borrow heavily, issuing $1.6 trillion in incremental debt over the past 12 months. Furthermore, reduced economic activity and higher unemployment has meant lower income tax receipts. State and local sales tax receipts have also suffered as consumers reigned in expenses. The combination of massive government spending programs and lower tax receipts has pushed our federal government debt to 84% of GDP and total government (fed, state & local) debt to 105% of GDP.

While government debt has surged over the past few years with larger deficits, it is interesting to track the growth in total debt (household, corporate and government) over the past six decades and compare it to the growth in GDP. As you can see in the table on the next page, in the 1950s, 1960s and 1970s, less than $2 of incremental debt was needed to create $1 of incremental GDP. However, the dynamics changed in the 1980s, when nearly $3 of incremental debt was required to create each dollar of new GDP. Today's ratio stands at over $5.5 dollars of debt per dollar of GDP growth. In each of the last three decades, we have increasingly used debt for purposes other than for promoting economic growth. Certainly the leveraged buyout ("LBO") industry which came to prominence in the 1980s can explain some of this. An LBO can be described as a way to use the untapped borrowing capability of a company to buy its stock. Alternatively, a company could borrow to expand product lines or build a new plant either of which would allow a company to grow revenue. What ultimately matters most in either scenario, is that the debt must be repaid. While asset values support debt, only cash flow repays it.

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Diminishing Returns from Debt-Financing by Decade

By Decade ($bns)	Δ Debt	Δ GDP	ΔDebt/ΔGDP
1950's	337.6	248.0	1.36
1960's	752.1	491.3	1.53
1970's	2,785.2	1,654.9	1.68
1980's	8,562.8	2,922.3	2.93
1990's	12,550.0	4,026.0	3.12
2000's	27,027.4	4,854.0	5.57

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Assessing the economic benefit of governmental borrowing is more problematic and fraught with political "land mines". However, we might be able to draw some conclusions from the chart below. From 1955-1982 as the ratio of government debt declined from 83% of GDP to 45%, GDP was growing faster than our government's appetite for debt. This was the case again from 1993-2001. While borrowing to the mid-80th percentile of GDP is high, our economy did show on two occasions that it can recover to grow faster. Now that GDP and government debt are of similar size, the growth rates will provide an easy comparison.

The Federal government debt grew by 15% last year while our economy grew an estimated 0.7%. This clearly is not a sustainable trajectory. Although many unusual one-time items contributed to last year's deficit, we can't be very encouraged by projections for an equally large deficit ($1.5 Tr) this year. In order to earn a surplus and begin paying down the debt, the Federal government needs to reduce spending and/or accelerate revenue by generating economic growth or raising taxes. Cutting government expenses will be politically difficult and will also negatively impact economic growth. Likewise, raising taxes or tax rates pose similar political and economic consequences. Recent attention to China's currency policy highlights yet another way to accelerate economic growth. The Chinese have not allowed the Yuan to float versus other currencies. Pegged to the dollar, the Yuan cannot appreciate versus the dollar to reflect China's growing economy. Therefore, US goods are unfairly valued relative to Chinese alternatives. China's currency combined with US consumer's enormous appetite for low cost goods has allowed China to generate a cumulative $1,745 Bn trade surplus with the U.S. since 2000 (data from U.S.

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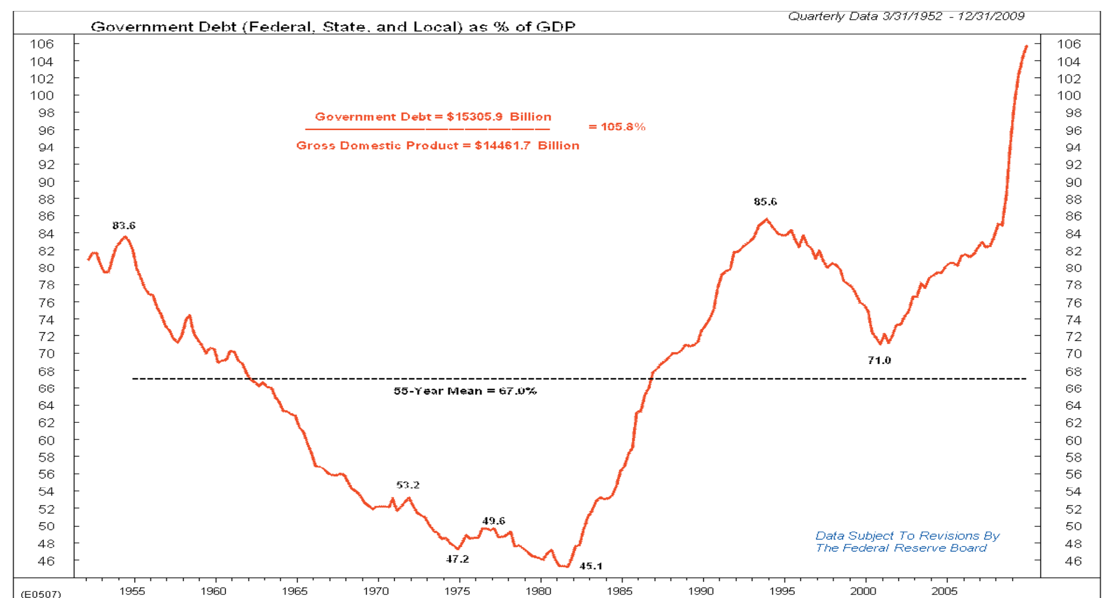

'Til Debt Do Us Part (continued)

Census Bureau: Foreign Trade Statistics). Certainly a reversal of this long standing policy would aid US GDP growth and accelerate tax revenue growth.

In the U.S. many states, cities and counties are struggling with how to balance budgets in a declining tax revenue environment. California's troubles have been well documented, but Illinois, New York and New Jersey are among a long list at critical junctures. State and local authorities have responded by raising fees and taxes as well as cutting payrolls and services. Some of the more public examples include higher tuition and fees at the public university system in California. Students there have recently lead public demonstrations to bring public attention to cutbacks in staff and services at the San Diego and Los Angeles campuses. Elsewhere, Kansas City recently closed one-half of its public schools. A year ago the auto industry dramatically altered labor contracts to salvage General Motors and Chrysler. While public employee unions still wield a lot of clout, taxpayer revolt, declining tax revenues and perhaps debt defaults may eventually force a restructuring of public sector wages and benefits ($39 per hour)* to more closely match private sector wages and benefits ($28 per hour).*

Just as the financial crisis revealed the nefarious investment activities of Bernard Madoff and other Ponzi schemers, poorly managed governments with inefficient economies have also been exposed in this global recession. Greece is perhaps the most relevant example now, but others are sure to join it. The financial press has attributed profligate government spending and underpayment/collection of taxes as the two main contributors to Greece's current problems. Although debt default is still a possibility, Greece is negotiating with various guarantors to provide some liquidity. Painful austerity measures from public employees are undoubtedly required as expenditures must be brought under control. It is widely acknowledged that Portugal, Spain, Italy and Ireland will follow Greece in having to make painful expense adjustments in order to refund existing debt or borrow incremental capital. We should monitor how these countries handle their fiscal challenges for clues as to what may confront the US if we don't get our finances in order.

At the risk of over simplifying things in what is a very complex global economic system, let's consider the following: the bull market in housing was not a natural event, but rather a number of initiatives conspired to create an environment where GDP, driven by tremendous growth in housing, grew faster than it otherwise should have. In fact, since this "growth" was purchased with debt, we were clearly borrowing this growth from the future. A colleague, Tom Stakem, wrote about this phenomenon in the December 2006 newsletter when he discussed the unsustainability of the negative savings rate. Therefore, the current economic correction and this slow to moderate growth phase is merely allowing the economy to regress to its normal trendline. Just how long it will take to get there is hard to predict and there are a number of variables (like exports to China) that can accelerate the recovery. However, there are also factors, such as our government's efforts to artificially prop up housing prices, which may prolong the process as well.

There are signs that some of this adjustment phase has occurred. Over the past year, households have reduced debt and increased savings reflecting a change in consumer spending habits. The corporate world reacted quickly beginning 12-18 months ago and instituted many cost saving programs. As a result profits have surprised analysts and investors to the upside for the last two quarters and now revenues are beginning to show year over year growth. Of course, not all sectors or companies will show immediate or dramatic improvement and we can't be sure that strong economic growth will resume. Clearly the adjustment phase in the public sector alluded to earlier in this newsletter is ongoing and is likely to moderate growth until we reach a "new normal". However, we do think well managed companies with solid balance sheets will provide a safe haven in this difficult environment and these stocks have good prospects for further appreciation should the economy surprise to the upside.◆

**Data from the Bureau of Labor Statistics*

Lawrie Foster is a Portfolio Manager at Woodstock Corporation. You may contact him at lfoster@woodstockcorp.com.

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Tax Update

Jeanne M. FitzGerald

The IRS has granted filing relief for certain counties in Massachusetts, New Jersey, Rhode Island, and West Virginia impacted by severe flooding. The President has declared Bristol, Essex, Middlesex, Norfolk, Plymouth, Suffolk and Worcester counties federal disaster areas qualifying for individual assistance. The IRS is postponing until May 11 certain deadlines for taxpayers who live or have a business in these disaster areas. This includes the April 15 deadline for filing 2009 individual, corporate, and estate and trust income tax returns; partnership returns, S corporation returns, and trust returns, estate, gift and generation-skipping transfer tax returns; and employment and certain excise tax returns. It also includes making tax payments and making the 2009 contribution to an individual retirement account.

Individuals may deduct personal property losses that are not covered by insurance or other reimbursements. Losses of personal use property attributable to federally declared disasters are subject to the 10% of adjusted gross income limit. These losses are also subject to the $100 per loss limit. Losses from fire, storm, shipwreck or other casualty, or theft are deductible as an itemized deduction on Schedule A of Form 1040. Any insurance proceeds that exceed the cost or other basis of the property may result in a gain.

President Obama signed the HealthCare and Education Reconciliation Act of 2010 on March 30, 2010. It provides the overall framework for health care reform. The small employer tax credit is effective for tax years after December 31, 2009. Many of the remaining major changes have delayed effective dates. We will be addressing these changes in future articles.

Jeanne FitzGerald is the Tax Administrator at Woodstock Services Company. You may contact her at jfitzgerald@woodstockservices.com.