QUARTERLY COMMENTARY
Fourth Quarter 2010

At the beginning of every year investors want clear forecasts. Will stocks go up? By how much? What about bonds, gold, commodities? There is little tolerance for equivocation. I recently listened to an anchor on one of the popular business TV stations rail against a pair of analysts for their moderate stock market forecasts for the year ahead. He wanted them to go out on a limb, as though that would be more valuable to his listeners.

Huge Spectrum of Possible Outcomes

Never has it been more important for investors to recognize that investment is a probability business, not a certainty business. The spectrum of possible market outcomes in the years ahead is immense. Stocks could soar, at least in nominal terms, if government-sponsored financial rescue programs succeed in the United States and around the world. Stocks could plummet if the rescues fail and excess debt brings down households, businesses, even governments. Bond returns could be strong if the economy slows and/or government bond purchase programs push interest rates lower. Bonds could be battered if investors-- especially foreign governments--fear defaults or runaway inflation flowing from excessive money creation.

I urge you to take the time to read this longer-than-usual report. It will not definitively forecast what will happen in the year ahead. It will, however, identify several factors that could lead to dramatic market moves. No one knows what will ultimately unfold this year. Final outcomes will depend on critical variables that cannot be predicted in advance with any high degree of certainty. But not recognizing the potential for extreme outcomes could have a huge impact on portfolio performance.

Experts Have a Bad Record

Increasing numbers of people have become devotees of financial television. Almost 24 hours a day they can hear “experts” tell them what to buy. Notwithstanding the constant flow of information, relatively few investors have done well since the dawn of the new century. The excellent researchers at Ned Davis Research, Inc. released studies last week that testified to just how poorly the experts have performed in recent years. They revealed that equity strategists “have predicted, on average, a gain in the S&P 500 of 11.3% per annum the last ten years.…They have never forecasted a down year….Yet, the actual return is, on average, a gain of only 1.7%, which includes three years of double-digit losses.” Professional economists, as a group, have been similarly overoptimistic, having failed to forecast even one of the seven domestic recessions over the past forty years. Investors will accept the advice of the professional investment community at their own peril.

Obviously there are some investment managers that have done very well, at least intermittently. The successful ones are few and far between, however, when one examines their overall track records since the end of the twentieth century. Few take seriously the stock market’s potential to remain weak for a decade or more. Accordingly, some of the most successful bull market managers have been punished severely in the two catastrophic bear markets century-to-date. While Marathon has certainly not been consistently right in that time period, we did accurately forecast a coming long weak cycle at the end of the 1990s. That has resulted in our clients, for whom we control asset allocation, seeing each $1 million of their assets grow to more than $1.6 million before fees, which vary based on portfolio size, in the first eleven years of the new century. We have had a few years, including 2010, in which we lagged strong markets because we were unwilling to accept the risks necessary to benefit from a more aggressive asset allocation. We outperformed the vast majority of managers over that full period because we avoided major losses. In fact, our clients experienced only one negative return year over that entire span. In 2008 our average portfolio lost just under one percent in a year in which the S&P 500 fell by 37%. We readily admit that we cannot foretell what will unfold in 2011. We believe, however, in the probability that the long weak cycle begun in 2000 has not breathed its last. This belief bolsters our caution about buying heavily into almost unanimous investor optimism.

Many Conditions Like 2000 and 2007

Interestingly, investors are wrestling with many of the same issues today as they did before the stock market peaks in 2000 and 2007. Stocks have been rising strongly for almost two years. The government and the Federal Reserve have been extremely accommodative. Bond returns, until recently, have been relatively strong. Business conditions have been improving, and analysts are almost unanimously bullish. Investor sentiment surveys show extreme optimism. Perhaps that optimism will be rewarded, but there are significant concerns for the prudent investor to evaluate carefully. Following are a number of critical conditions that could have huge effects on portfolio values.

Liquidity Boosts Stock Prices

The U.S. stock market, down for the year through late-August, bounded to life when Fed Chairman Ben Bernanke promised a second round of quantitative easing (QE2) at a speech in Jackson Hole, Wyoming. The major stock market averages then sprinted through the finish line at year end, turning a down year into a winner. While ongoing Fed largesse has indeed benefitted banks and non-financial businesses, the primary beneficiary has been the stock market. As Chairman Bernanke has made clear, boosting stock prices has been a primary objective of the Fed's expansionary policy. And it has worked over its first several months. Similar expansionary policies have been employed worldwide, and have floated world equity prices higher on a rising sea of liquidity. Easy money has led to increased industrial production, capital expenditures and corporate profits here and abroad, but the primary beneficiaries have been the world's stock markets. So strong have been the short-term results that investors and analysts are setting aside any reservations about the ultimate success of the policy in spite of its prior failures in recent years.

Critical Questions Remain

Reeling from the recession in the early years of the new century, the Fed slashed interest rates, which rekindled enthusiasm for investment assets, particularly real estate. As we know in distressing retrospect, the investments made with that easy money ultimately fared badly as the housing bubble burst and stock prices plummeted in the 2007 to 2009 crash. Many commentators shared my concern about the irony of trying to solve economic problems precipitated by excessive debt by the creation of more debt. Not dissuaded by earlier failure, from 2008 to present the Fed, in conjunction with the Treasury department, has determined once again to rescue the banking system and boost the economy with essentially free money. As was the case with government's earlier rescue efforts, initial results have been positive. Free money is an enormous short-term stimulant. The open question is whether or not the long-term results will end up on the positive side of the ledger. Will new bubbles burst, as did dot.coms and real estate? Will inflation become a major problem in this country, as it is becoming in many emerging countries? To date few are expressing concern with the long-term consequences of massive debt creation. Negative consequences are inevitable, however; otherwise governments and central banks would engage in the stimulative practice constantly. When will such consequences emerge or at least enter investors' focus?

Not Business As Usual

I encourage investors to recognize that we are not in a "business as usual" environment. Less than two years ago governments around the world feared that the financial system as we know it was on the verge of collapse. Unprecedented rescue efforts kept the system afloat. Despite economic growth from seriously depressed levels, huge problems remain, any one of which could precipitate another crisis. Let me highlight a few.

Over 800 U.S. banks remain on the FDIC's list of troubled banks. Many of the toxic assets that necessitated the Fed's rescue efforts remain on bank books. As we know, few that are real estate-related have risen in value. Will those assets ever be dollar good, or will they have to be written off?

So far banks' practice of "extend and pretend" relative to a significant number of loans has kept commercial real estate from compounding the housing problems, as many had expected. As each month's dismal housing statistics testify, however, we are not close to the end of our country's real estate problem. And surprisingly weak numbers from England demonstrate that falling prices are not restricted to our country. Just last week Reuters reported: "In the month of November, home prices fell for the 53rd consecutive month, taking the decline past that of the Great Depression for the first time in the prolonged house slump. Home prices have fallen 26% since the peak in 2006, exceeding the drop off registered in the five years of 1928 and 1933." Is there any realistic potential that we can sustain even moderate economic growth with large numbers of foreclosures a fact of life and a huge overhang of houses for sale?

As with housing, U.S. unemployment is scarcely off its worst reading since the Great Depression. The most recent headline number of 9.4% unemployed is slightly better than similar readings in the early 1980s, but conditions today are actually far worse. Whereas in the past many unemployed were merely laid off, more than half of today's unemployed have had their jobs eliminated. And more than 40% of the 9.4% figure represents workers who have been out of work for more than 27 weeks, an unprecedented percentage in modern times. The Federal Reserve itself admits that it will take years to get unemployment back to levels considered normal. Can we logically expect a sustained economic recovery with almost one in ten of us unemployed and nearly one in six either unemployed or unintentionally underemployed?

In Europe we are seeing the consequences of excessive debt in stark detail. But for government rescue, Iceland, Greece and Ireland are already bankrupt. Belgium, Portugal, Hungary, Italy and Spain are tottering on the edge. For many of these peripheral European countries, the problem is solvency, not merely liquidity. A few recent sovereign bond issues have been reasonably successful because of heavy buying from foreign governments eager to forestall defaults. Nonetheless, yields on foreign bonds continue to rise. And the prices of credit default swaps are rising, indicating a growing fear of sovereign defaults.

Default potential extends beyond the countries in question. The bonds of these entities are owned around the world. Especially endangered by any sovereign default would be European banks, which own the bulk of these assets. German taxpayers are vociferously opposed to bailing out some of their Southern European neighbors. If they let those countries default, however, they would likely be faced with rescuing their own country's banks, which hold the vulnerable sovereign debt. At a March election, Irish voters will effectively face the choice of either defaulting on sovereign debt or adopting an austerity budget that economists predict will consign them to depressionary conditions for a decade or more. It is impossible to predict their choice with certainty or to forecast the regional and world effects, should they permit default.

In our own country there is growing concern about the solvency of many states and municipalities. Scores of municipal bond prices have fallen by almost 10% in less than five months. Left to their own financial devices, many of these entities could default. There is widespread expectation, however, that the U.S. Government would never let one of its states default. Warren Buffett, among others, has pointed to the superior quality of that municipal debt if backstopped by the Government. He has warned, however, of its far less pristine quality should those entities have to rely on their own resources. The composition of the new Congress, many of whose members come to their seats with a pledge to implement fiscal integrity, introduces legitimate questions about how that body would respond to a rescue plea from one or more states.

While not all threats to investment markets stem from debt, excessive debt underlies all of the problems that have necessitated government bailouts here and abroad. Domestically, businesses and individuals have reduced their debt loads. Unfortunately much of that reduction has come from foreclosures and other defaults. Government balance sheets, however, are an entirely different matter. Both at home and abroad government debt levels have exploded both on an absolute basis and relative to the size of their respective economies. Leverage from debt can obviously magnify success when times are good. As the past decade has painfully demonstrated, however, leverage cuts both ways. Investors should recognize that an unprecedented debt level raises the negative potential, should any of the acknowledged dangers lead to another economic unraveling. At the very least, the risk level remains high.

All countries stand to benefit if the world can stay calm and allow the global business recovery to continue. When individual countries are struggling with their own recoveries, however, there is a tendency to safeguard domestic industries. That protectionism often weakens the home currency, a beggar-thy-neighbor approach, which we are seeing vividly in the United States. Other countries are responding by taking actions to weaken their own currencies. Brazilian Finance Minister Guido Mantega has warned recently that both trade wars and currency wars are on the horizon, either of which could derail the worldwide recovery. Mantega is hardly an alarmist compared with former Japanese finance official Eisuke Sakakibara, who sees the United States following similar policies to those that led Japan into its lost decade. Sakakibara warns that such actions will contribute to a coming global recession that will last seven to eight years. Investors must hope he’s way off base.

The Bullish Case

While many long-term fundamentals are precarious at best, world stock markets are rising and world economies are growing. Analysts almost unanimously are forecasting continued growth, albeit moderate in all but emerging economies. The rationale for a continuation of the global recovery is two-fold: 1) the recovery cycle has been successfully initiated by government stimulus, and normal growth cycles extend over longer time periods than this one so far; and 2) the emerging market economies are growing far faster than developed economies and will continue to fuel worldwide growth. Both beliefs could prove correct, but there are strong counterarguments to each.

Direction Positive, Levels Negative

Supplementing the argument that the growth cycle logically has farther to go is the fact that there is considerable room to grow, given the severity of the preceding recession. The flip side of that same argument, however, is that despite the government-fueled recovery off the depressed lows, many economic data remain at normal recession levels. We are measuring recovery by rate of improvement rather than level of activity or level of business confidence. Despite the rapid bounce in many measures, the Federal Reserve was sufficiently worried about economic conditions that it implemented QE2 at a time when it was originally scheduled to be withdrawing the effects of QE1.

There has been significant concern among economists that the rescue efforts have still been insufficient to move the economy beyond "stall speed," at which growth can be self-sustaining. If government stimulus continues to promote growth, the path of least resistance for stocks remains up. Investors choosing caution will regret their decision. On the other hand, should expansionary government policies fail once more, as they ultimately did in the last cycle, stocks could again collapse in spectacular fashion as they did from 2007 to 2009.

Can Emerging Countries Sustain Recovery?

The second major rationale for a continuing worldwide recovery is the impressive strength and growth in the emerging nations, which now represent more than half of world demand. Almost certainly these countries will exert a much greater force on future world economic conditions. Mere size and potential, however, are no guarantee that the effect will always be positive. Several factors warrant less than uncritical enthusiasm. First, these countries have never before led a world recovery. Second, we can't know that their banking systems will remain strong and capable of supporting growing domestic needs. Within the past few years we have seen the most allegedly sophisticated banks in the world requiring bailouts to survive. We must not assume that these far less-seasoned bankers will necessarily have the same levels of professionalism. Perhaps, in retrospect, that's a positive. When Japan's banks grew to be among the world's largest two decades ago, they proved to be laden with bad loans, some of which remain today. That episode ushered in two decades of economic stagnation. Many suspect that China's banks today are similarly encumbered with loans that will never be fully repaid.

China's monetary authorities have flooded their economy with new money, and the money supply is still growing by more than 20% per year. China watchers fear that bubbles have been inflated in real estate and other areas, which could cause great distress if they collapse, as such bubbles did in this country. We are also starting to see serious inflation in many emerging countries, the logical consequence of excessive money creation. Food riots are becoming all too frequent. It's sobering to reflect back on a previous Chinese inflationary episode, which may not have led to, but was at least coincident with, the tragic Tiananmen Square protest. Political stability is not guaranteed in all emerging nations.

The tremendous growth in emerging nations is impressive. Most observers would assume that the stock markets of these countries must all be rising strongly, mirroring the economic growth. Surprisingly, China, the largest of them all, is floundering at levels more than 50% below where that market was just over three years ago. Growth is no guarantee of rising stock prices. Perhaps investors are concerned that government-fueled growth is not sustainable.

Will Government Win Its Bet?

This collection of uncertainties raises what is ultimately the most important question facing today's investors. Will government win its bet that it can solve the problems brought on by excessive debt by creating unprecedented amounts of new debt? Or rather, will unstable underlying monetary and economic fundamentals overwhelm the best inflationary efforts of governments and central banks?

Rescue efforts to date have kept countries and major banks from default. Although the favorable initial results from QE1 began to fade last April when the Fed stopped expanding its balance sheet, the implementation of QE2 has rekindled the fire under economic growth. The jury is still out, however, on several issues with respect to the government's rescue efforts. While handing out essentially free money is almost certain to create a positive initial surge, there is no assurance that the longer-term benefits will outweigh the eventual repercussions. Many current Federal Reserve members, including Chairman Bernanke, notoriously underestimated the severity of the housing crisis and ultimately inflated the housing balloon that burst with disastrous financial consequences across the full spectrum of the American economy. Our monetary decision-makers can hardly point with pride to a record of past success. Why should investors trust that they will be more successful this time?

Even if immense monetary stimulus is a successful prescription, its immediate effect will soon come to an end. There is no way to know whether or not the economy will have developed sufficient strength and momentum to survive the end of stimulus, much less the withdrawal of that money. As analyst Doug Cliggott has recently pointed out, it's hard to consider our economy capable of standing on its own when the federal government feels it necessary to spend $1.60 for each $1.00 it collects.

Some have speculated that QE2 will eventually be followed by QE3 and QE4 if the economy begins to weaken again. With the election of a new Congress pledging financial sobriety, it will become politically more and more difficult to bail out the economy with money borrowed from future generations.

Investor Confidence High

At least for the moment, positive business and stock market momentum has investor confidence high. While consumer and small business confidence is far less strong, the professional investment community is not dissuaded from pushing equity prices higher. But confidence can be an ephemeral thing. With the litany of highly uncertain conditions listed earlier, there are any number of sources nationally or internationally that could transform confidence into fear. And continued economic growth depends on confidence.

Having a list of ambiguous conditions and unanswered questions is hardly unique to our present environment. Allegedly intelligent market analysts and commentators continuously chant the meaningless mantra that the market hates uncertainty. Of course it does, but when is there ever certainty? Stocks have experienced a powerful advance for almost two years in an environment of monumental uncertainty. Was there absolute confidence that world governments and central banks would simply not allow strategically-large financial and government entities to fail, even if they had more current liabilities than current assets? The remaining ambiguities are such that negative outcomes could throw economies and markets into serious disarray, as we saw all too vividly before governments pledged rescues with money from future generations.

Value Promotes Profit Potential

That there are uncertainties, even large ones, is not by itself a reason to avoid equities. At attractive prices, risks may be worth taking. History has taught us clearly that no one consistently foresees the outcome to unclear conditions. If one buys at sufficiently attractive prices, however, even failed forecasting may leave portfolio values relatively intact. On the other hand, if one buys at above-average prices, forecasting errors can be destructive to portfolio values.

Stocks Not Cheap

History can be very instructive when it comes to determining whether or not current prices are attractive. We have nearly a century of detailed data showing how well investors have done when purchasing stocks at various levels of such valuation measures as price-to-earnings, to-dividends, to-book value, to-sales and to-cash flow. The data argue unassailably that returns are typically greater when purchases are made at below-average valuations. Conversely, returns are below normal when purchases are made at high valuations. Contrary to what one hears listening to financial commentators, stocks are now historically expensive, not cheap. Using Standard & Poors' preferred method of analyzing these measures with trailing twelve month data, all but the price-to-earnings ratio are at or near the historic highs of the decades prior to the late-1990s. We know in retrospect that the valuation levels reached since the late-1990s ushered in two massive bear markets, and in the aggregate provided virtually no positive returns for more than a decade. To compare current valuations to those bubble levels makes no sense. Even the price-to-earnings ratio, the least overvalued of the indicators, is above its long-term average. That stocks are selling at above-average valuations does not mean they cannot go higher. Stocks can go from overvalued to even more overvalued, and they can stay overvalued for a long time, as we saw leading up to major market peaks in 2000 and 2007. Investors must recognize, however, that at such levels there is below-average potential for longer-term success.

Risk/Reward Analysis

Another major component of a sound risk/reward analysis is an evaluation of the potential or probable return if one's investment approach proves right or wrong. The most bullish analysts are anticipating equity return percentages in the teens for the year ahead. The last two bear market declines took away 50% or more of equity values. Would you choose to invest in a style in which you had an 80% probability of earning a 15% return with a 20% possibility of losing 50%? For many, especially those who cannot replace lost assets, that might be an unacceptable investment.

Significant uncertainties are not limited to the equity markets. There are powerful opposing forces in the interest rate arena as well. A fuller discussion of the many layers of possibilities will have to await another day. A brief summary of the current environment follows.

Fixed Income Uncertainty

Despite the best efforts of the Federal Reserve and its "Ponzi like" (Bill Gross's words) direct purchases of longer-dated treasury bonds in the open market, interest rates have risen over the past few months. The conditions that provoked this quantitative easing effort are deflationary. Combined with the Fed's direct buying in response, both would logically lead to lower rates and higher bond prices. The past few months' unexpected rise in rates could stem from a growing confidence in the business recovery's sustainability. On the other hand, it could also be a result of growing fear of future inflation due to massive increases in the money supply, bank reserves and debt commitments. One could make a reasonable argument for either rising or falling rates based on whichever forces one believes will dominate.

Notwithstanding the recent rate rise, current yields are not far above multi-decade lows. There is clearly far more room for rates to rise than fall. In an environment in which the penalty for being wrong is far greater than the reward for being right, there is little incentive to maintain a permanent position in bonds. We did acquire a strategic position in long U.S. Treasury bonds in the fourth quarter at a yield which offered a potential for both yield and profit if deflationary or disinflationary conditions should become more prominent. When opposite indications began to push yields higher in the first few weeks of this new year, however, we closed the position at a small profit. We will continue to seek strategic opportunities to own bonds. To avoid potentially severe price declines, which could occur should investors begin to fear runaway inflation, we will emphasize safe, short maturities unless strategic opportunities in longer bonds appear very compelling.

Several clients have asked if we could increase portfolio yield. The answer is always "yes." We have chosen not to do that, however, for reasons related to the tremendous uncertainties described earlier. In the municipal bond area, for example, price declines in the past five months have erased more than two years of yield. And now we hear discussions about how Congress might deal with potential state bankruptcies. We currently prefer to seek most of our portfolio income in relatively short-term government-guaranteed securities. There will be opportunities ahead for greater yield--possibly much greater yield--but the key is to avoid losing capital in the dangerous periods and to keep it fully available to earn that higher yield when it is available from good quality securities.

Confusing Environment

In my 43rd year in this business, I've never before experienced such a confusing environment. Many of the world's largest banks are alive solely because of governmental rescue. Countries are in danger of default. The central bank overseeing the world's reserve currency has more than tripled its balance sheet in just two years. Huge amounts of money have been injected into the banking system at virtually no cost. The world economy has bounced off near-depression lows and is advancing nicely. Business profits are growing strongly. Emerging countries have risen to comprise more than half the world's economy. At the same time employment and housing remains seriously depressed in most of the developed world. Deflation is still a concern in the debt-laden developed world. Inflation is becoming worrisome in the emerging world.

Because of unprecedented and growing amounts of debt, even the most bullish analysts admit that we will inevitably see big problems in the future. Because current economic conditions are still so fragile, however, they say that beginning to tackle them today would be imprudent. We should continue to stimulate the economy and bail out government mortgage agencies and most homeowners who can't pay their mortgages. We should just ignore potential debt problems until they become more immediately pressing or until other countries become unwilling to loan us any more money.

In the meantime, investors are enjoying the liquidity surge and the resultant asset inflation. We simply cannot know when investor confidence will wane, and investors need to evaluate their own willingness and ability to withstand the risks of the out-year problems moving into investors' current consciousness. The investment community has assumed the approach famously voiced by Scarlett O'Hara in Gone with the Wind: "I can't think about that right now. If I do, I'll go crazy. I'll think about that tomorrow." So far it's working. We have to hope that no geo-political event nor recalcitrant debtor or creditor country forces us to deal with it today.

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January 21, 2011

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