Fiscal Cliff – Alternatives to Conventional Wisdom

While various ideas are floated and journalists report on the state of negotiations, the market consensus seems to be settling on the idea that Congress and the White House will do enough to avoid the automatic tax hikes and sequestration that will follow if they fail to agree. The bounce in the S&P500 (SPY) over the past couple of weeks presumably reflects this conclusion. As well it should, for both sides will struggle to show any political gain out of imposing enough fiscal drag to cause a recession early next year. The negotiations will probably not be easy and key concessions ought to be expected at the end rather than the beginning. But an agreement of some sort is probably what we'll get – some tax hikes on the wealthy, a few spending cuts and a solemn promise to do more next year.

This got me thinking about alternative scenarios. Most obviously, there could be no agreement. The talks could break up in acrimony as one or both sides conclude that shared responsibility for a recession is preferable to making big concessions on core parts of their platform. For Republicans this is Taxes, and for Democrats it's Entitlements. It's not made easier by opinion polls that show quite clearly what people want – fiscal discipline without cuts in Entitlements or broad tax increases. The fiscal discipline that would therefore be imposed automatically through a failure to agree could cause a GDP contraction of 3% or more and is unlikely to be greeted warmly by stocks.

Another possibility is negotiators go farther than expected. Somehow they reach a grand compromise, embracing part of Simpson-Bowles and reining in entitlements while simultaneously raising taxes. It's of course not likely, but if it did happen this "good news" would likely cause greater

fiscal drag than a more modest negotiated agreement. Indeed, it's hard to see how you can reduce the ongoing fiscal stimulus that profligacy creates without some fiscal drag as a result. But in this case interest rates, which in the past have softened the blow of such events by falling, wouldn't be much help. Bond yields scarcely reflect any concern about the long term budget outlook – or if they do such concern has been effectively silenced by the Fed's QE (1,2,3 etc). So the economy would endure the pain of newfound fiscal discipline without the salve of lower bond yields. This is also unlikely to be a good outcome for the market, in spite of the hand-wringing over business as usual.

So the more a modest negotiated settlement is expected by market participants, the less attractive the alternative outcomes appear.

We are holding around 10% cash in our Deep Value Equity Strategy, and currently think we have less than 90% of the short term volatility of the market since many of the names we own are fairly stable businesses. Many companies are issuing cautious guidance and so the bottom-up view has started to reflect some of the macro concerns many investors have felt for a long time. Among the names we do own Berkshire Hathaway (BRK-B) is one of our bigger holdings. It's trading close to 10% above book value, the upper boundary at which the company has indicated it will buy back shares. We recently added to McDonalds (MCD) on weakness since high single digits EPS growth and a P/E of 16 are a reasonable level at which to invest.

We've also added to Master Limited Partnership which had sold off along with other income generating sectors such as high dividend stocks and utilities. MLPs after tax returns may be even more attractive compared with traditional income generating sectors of the equity market depending on what Congress does to taxes on investment income.

Managing Downside Risk With The Fiscal Cliff

Having been pushed into the background in recent weeks by the election, the Fiscal Cliff is now at the forefront of investors concerns. Basic game theory dictates that a resolution should not occur until late in December. Negotiators won’t know if they have extracted the maximum concessions from the other side if they agree too soon. In addition, since America returned approximately the same set of leaders to power that engineered the Debt Ceiling mess in the Summer of 2011, there’s little reason for high expectations. Ultimately, one would think the Democrats are more inclined to compromise to get a deal, since it is “their” economy. However, for Republicans so opposed to taxes, a failure to agree will result in automatic tax hikes and just what they don’t want.

The one caveat to all this is that, living in the North East U.S. and having just endured the disruption of Hurricane Sandy, the economy is a little more vulnerable than a month ago. Losing power for days on end can really mess with your productivity. On balance we expect a compromise that will avoid the more dire forecasts, but it won’t be an easy road to get there. In our Deep Value Equity Strategy we’ve raised from more cyclical names. Yesterday we invested a small amount in McDonalds (MCD) which remains under pressure because of disappointing sales, and today we added to Kraft Foods Group (KRFT) which reported earnings yesterday and now sports a dividend yield of 4.55%. Yesterday’s earnings report was good and although their payout ratio is high at 77% based on 2013 EPS guidance of $2.60 supporting the $2 dividend, we think it’s well covered and an attractive investment here.

But we continue to hold back some cash because of the increasing likelihood that the market will respond poorly to the undoubtedly messy negotiations.

The reflation theme remains compelling, with developed country central banks fully committed to keeping interest rates below inflation. Owning gold bullion through the Gold Miners ETF (GDX) remains one of our larger positions. Corrections Corp (CXW) also held their earnings call this morning and are still working towards restructuring themselves as a REIT which we think provides further compelling upside. The Fiscal Cliff represents a potential source of uncertainty for them since the Federal government is such an important client of theirs, but while that may cause some short-term uncertainty we don't belive it materially alters the value of the company.

Investing on the Edge of the Fiscal Cliff

For investors, 2012 has been a year so far of disasters that did not occur. The Euro did not implode; Greece was not unceremoniously dumped out; Israel has not attacked Iran; and other perhaps even less likely mishaps did not occur. Consequently, it's been a good year for equity investors if you had the long term view or short term intestinal fortitude to remain invested.

But it seems to me that the next looming disaster, the "fiscal cliff" may not be so easily avoided. Corporations are increasingly voicing concern about slowing demand. Anecdotal evidence is that uncertainty related to the election and its immediate aftermath are causing many spending

decisions to be put on hold. And it seems 3Q corporate profits, whether they were surprisingly good or not have included downward revisions to guidance more often than in the past.

Meanwhile, conventional wisdom is that after the election legislators in Washington will arrive at a compromise that avoids the worst of the immediate drag on the economy from higher taxes and spending cuts that current law dictates. The idea behind this structure was that it would force Congress to address the issue rather than submit to the blunt instrument of sequestration. Although many people seem optimistic that a solution will be found, I don't think it's so simple.

First of all, the election is intended to clarify popular opinion with respect to each party's preferred solution (i.e. will we solve the problem with more cuts and less tax hikes or vice versa). And yet, the most likely electoral result is that Obama wins, the House remains Republican and the Senate is controlled by neither party (where a 60-vote filibuster-proof majority is required to push through contentious legislation). Don't be confused by the various national polls – Intrade (where people bet money on the outcome) shows Obama with a 62% probability of winning (versus 38% for Romney). It may well come down to Ohio, and Romney's improvement in national opinion polls isn't nearly as important as what the people of Ohio think. Romney is not ahead in Ohio.

So there's a reasonable chance that the Lame Duck session of Congress that will meet following the election (for only 12 scheduled days until January) will be approximately the same group to be sworn in to power early next year. This is the same group of legislators who almost took us over the precipice in the Summer of 2011 with the debt ceiling mess. The notion that the losing party will respect the popular mandate and make more of the concessions necessary to avoid the cliff seems fanciful. More likely is that the Republicans will claim that a weak Presidential candidate not truly loved

by the rank and file failed to capitalize on the widespread unhappiness with Obama. Moreover, they’ll have little incentive to compromise because it’s not their economy. A 2013 recession might be the best way to start the fight for 2014 mid-term elections, from the Republicans point of view.

But whether you accept that analysis or not, consider that neither side will want to settle things until the last possible minute, for fear of foregoing the best available deal usually obtained through brinkmanship. Two or three extra weeks of bargaining in hope of a better political outcome will seem worth the possible short term economic damage.

They’ll work something out in the end. There’s little choice. But my bet is that between now and December 31 there will be moments when there’s reason to doubt that optimistic outcome, and in any event the economic damage caused by uncertainty is being inflicted every day.

How to invest through that period? We continue to own equities we like, but have trimmed positions in names that we believe are highly cyclical and hold some cash in case we are able to invest in one or two businesses at better prices than are available today. In our Deep Value Equity strategy one of our biggest positions is Berkshire Hathaway (BRK-A) which is attractively priced and not likely to cause too much concern even in the dark days of late December. We also have a big position in Microsoft (MSFT) – the release of Windows 8 looks underwhelming but its valuation and monopoly-like positions limit the downside in our opinion. The Gold Miners ETF (GDX) is a bet on central bank reflation and it’s been handily outperforming the S&P500 of late. And Corrections Corp (CXW) should reveal more about their REIT conversion in a couple of weeks.

Why Kraft Still Looks Cheap Before It Recrafts Itself

On Monday Kraft (KFT) begins its new life as two new companies: Kraft Foods Group (KRFT) and Mondelez International (MDLZ). In fact, both stocks trade on a when issued basis already. The purpose of the split is to highlight the value in the company. The old Kraft consisted of a North American grocery business with low single digit revenue growth prospects and the possibility of modestly expanding operating margins, and a global snacks business with emerging markets exposure and higher growth potential. Kraft felt that operating both businesses under one corporate entity made the company less attractive than as two separate entities, since as two separate companies they could appeal to investors seeking stable income (who could invest in the grocery business) while investors seeking faster growing but more volatile earnings could choose the snack business. In effect they were suffering from the "conglomerate discount" such that investors looking for more specific exposure didn't find the company attractive. The upcoming split results in two separate companies that can appeal to two different types of investor.

Although KFT has been a great investment over the past couple of years and especially since the split was first announced, now that the two new components of Kraft can be examined it reveals the purpose of the split. For every 30 KFT shares held, KFT owners will receive 30 shares of MDLZ and ten shares of KRFT. Recently the two new companies' management teams made presentations and KFT responded poorly because the earnings guidance of the new bits of KFT added up to less than the prior guidance for the whole.

But when you look at each company, the figures aren't that bad. KRFT, the North American grocery business, will pay a $2 dividend and based on the when-issued price yields 4.4%. Although that represents a heft 77% payout ratio, low single digit revenue growth with modest operating leverage should leave this dividend comfortably covered since they sell into less economically sensitive sectors. The 4.4% dividend yield compares favorably with its likely peers, such as General Mills (GIS) yielding 3.3% or Kellogg (K) yielding 3.4%.

Meanwhile MDLZ is more appropriately compared with global snack companies with decent emerging markets growth. MDLZ is guiding to $1.55 EPS which gives it a P/E of just over 17,and is no more expensive than, say Coke (KO) with a forward P/E of 17.3.

This illustrates the point of the split, because finding true comparables to the old KFT was difficult given its diversified business mix with very different margins and outlook.

Recently, the management teams for both new companies (KRFT and MDLZ) gave investor presentations. The reaction was cool, not least because together, the two companies' 2013 earnings guidance added up to the equivalent of $2.30-2.40 for the old KFT, whereas KFT itself had previously been guiding to $2.60-2.80. It was this disappointment, that the sum of the parts was less than the whole, that pushed the stock down.

But here there's probably a little gamesmanship going on. Neither management team of the new companies "owns" the prior guidance in the same way that old KFT's CEO Irene Rosenfeld did (she'll be running MDLZ). The leadership teams of the two new companies are most likely motivated to be cautious, both because of the transition to independence but also because stock options that will be part of executive compensation will be priced shortly after the two new companies' stocks start trading. But it's still the same set of businesses, with the same strong brands and growth prospects. So we think the two

pieces of the old KFT remain reasonably attractive as an investment.

We think it’s also interesting to be long KFT hedged with a short position in the Consumer Staples ETF (XLP). When KFT splits into KRFT and MDLZ we think the two components of old KFT will appreciate relative to what the old KFT was worth, and against the basket of consumer staples stocks which is the most correlated hedge.

Disclosure: Author is Long KFT, Short XLP

The Tragedy of Coeur d'Alene

Coeur d’Alene (CDE) is a silver and gold mining company that we have owned in the past but do not at present. Like many bullion miners, they seem to be cheap relative to the NAV of the assets they own. CDE was down quite sharply during the Summer before rallying strongly starting in August when central bank reflation started driving up bullion prices. And yet, spare a thought for CEO Mitch Krebs, because the poor fellow has barely participated in the recent stock rally. Mitch Krebs owns 74,812 shares according to the 2012 proxy statement, a mere 0.083% of the company. He’s a bystander, barely connected to the daily swings in the company’s value. In fact his 2011 compensation of $2.4 million was more than the entire value of his stockholding. How frustrating this must be for Mr. Krebs to show up for work every day helping to make his owners rich which working for a (not trivial) salary and bonus.

But Mr. Krebs is actually far smarter than he at first appears. The proxy statement describes a performance-driven compensation process which sounds reasonable enough. But

rather than being based on increasing debt-adjusted per share earnings, which is what shareholders care about, the relevant metrics are production. His interests are to make CDE bigger, not necessarily to increase EPS. So in fact, the common equity is there to be used to make acquisitions, even though surely one of the best investments CDE could make would be to repurchase its own stock.

Mitch Krebs has made this clear. He recently said they expect to make an acquisition within the next 12 months. This will undoubtedly help him achieve some of the production metrics that drive his compensation, but may not make his shareholders richer. Perhaps that's why former CEO Denis Wheeler owns no shares at all. He's seen this movie before – in fact, he had a starring role in it for many years. The best way to make money out of CDE is to own what they'd like to buy. For our part, we are long the Gold Miners ETF (GDX), although it's admittedly a little too big for CDE to buy.

Bernanke Makes the Case for Gold

There's a thoughtful op-ed by Gavyn Davies in the FT today (Why did Bernanke change his mind). The Fed has a dual mandate of targetting maximum employment consistent with stable prices (which they take to mean inflation no greater than 2%). What's become clear following last week's announcement is that the priority the Fed attaches to each of these goals is likely to subtly shift in favor of tolerating higher inflation in the interests of achieving greater employment. Bernanke himself went to great pains to argue that no such change was contemplated, and traditionally Fed chairman have always

argued that low inflation is the best way to support job growth.

But the Fed has little choice but to shift its emphasis, if for no other reason than one of its two mandates has been missing its target for several years now. Bernanke talked about skills atrophying as the long term unemployed become unemployable, and therefore move from cyclically unemployed to structurally so (a miserably dry way to describe a sad loss of many people's ability to earn a decent living). Republicans have jumped all over this as being pro-Obama politics, which it is although almost certainly that's coincidental. The Fed would be far too aware of the political season to do anything overtly political and risk being seen as less than independent.

The politics though are for others to contemplate. What does seem plain is that an open-ended and potentially long-lived QE 3 is probably negative for the US$ – especially so now that the ECB has enough firepower to support bond markets far longer than speculators can bet on a crisis. It's probably positive for equities, although here it's important to own names you'd like regardless of the near term direction of the economy. And the Fiscal Cliff isn't receiving the attention it most likely will after the election when the focus shifts to whether Congress will avert a 2013 recession or not.

Our biggest position remains the gold miners ETF (GDX) which we like both because many miners are cheap to NAV but also for the QE 3 reasons described above. Both the Fed and the ECB are focused on reflation as their number one goal. Fiscal policy is likely to be at least modestly restrictive, but it seems that we'll get QE (4,5…57) until employment improves. The Fed's response to weaker growth is quite plain. When eventually growth does pick up expect those familiar "Fed behind the curve" headlines to last longer than usual. In fact, the most bearish case for gold is if the Fed fails. It's not an attractive outcome to contemplate, and not one that's

likely in our opinion. So we like GDX as the most efficient way to align ourselves with government policy.

We also continue to own Corrections Corp (CXW) while we wait for further developments as the company finally decides to convert to partial REIT status, a change likely in early 2013.

Most recently we invested in Energizer Holdings Inc. (ENR) which, at under 11 times next year's earnings and with strong market share in both batteries and razors is attractively priced. The stock has been weak recently, and there are some questions about the long term outlook for disposable batteries. But management is still guiding to $6-6.20 per share for FY 2012 earnings (their fiscal year ends this month). They also continue to buy back stock, having repurchase $268 million in FY 2011 and $211 million in the first 9 months of FY 2012 through June. It's likely they'll dedicate substantial portions of their free cashflow to buying stock over the next couple of years, and so we've been accumulating a small position at current levels.

Trading Inflation for Growth

In yesterday's press conference, Steve Liesman from CNBC asked a highly pertinent question of Chairman Bernanke. Steve asked whether the explicit focus on employment meant that the Fed was now willing to tolerate a higher inflation rate than would otherwise be the case. Bernanke answered predictably by noting that the Fed by law has a dual mandate (maximum employment consistent with stable prices). But in thinking about his comments afterwards and the way they've positioned themselves,

it seems to be unlikely the Fed will spend any time worrying about inflation until the employment picture improves. Of course there isn’t much evidence of inflation anyway, but we are virtually assured, based on his comments, that if or when things do ultimately pick up the Fed will be a long way behind the curve in terms of raising rates. Negative real returns are here to stay for bond investors. Bernanke made the case for real assets yesterday, including gold which we own through our investment in the gold miners ETF (GDX).

No Surprises Except the Rally

Over the past few days a few not very surprising things have happened. From Der Spiegel (as reported in the FT) German Chancellor Merkel has concluded that Greece must stay in the Euro and is now focused on ensuring this happens. Although many people (including apparently a majority of German voters) believe Greece should be kicked out (a satisfying and totally justified result of their profligacy) policymakers no doubt recognize that shoring up Spain and Italy (whose bond markets would undoubtedly be under enormous pressure in the event of a “Grexit”) would require sums beyond their current resources (perhaps 1 Trillion Euros). There really is no other choice.

Meanwhile the ECB announced its own version of QE last week over the objections of the Bundesbank. And another month of weak U.S. employment data on Friday made QE3 ever more likely. So Greece is staying in, and government buying of bonds is being broadened. None of this was much of a surprise, but equities have been rallying nevertheless, driven in part by the ever-decreasing attractiveness of fixed income. Mitt Romney even noted on Meet the Press yesterday that equities were higher because where else can you earn a decent return.

Interestingly though, GDP forecasts are not being revised higher. JPMorgan for example notes that consensus forecasts for GDP continue to be subject to modest downward revisions, and many corporations reporting earnings in recent weeks have provided cautious guidance on the near term outlook. It’s also interesting to note the divergence between stable, dividend yielding stocks and the S&P 500. On Friday they actually moved in opposite directions – the iShares Dow Jones Select Dividend Index (DVY) was -0.3% while the S&P 500 was +0.40%. In aggregate this all looks rather as if active equity managers are scrambling to keep up with their benchmarks while the market’s rising – higher beta names are performing well and the market is climbing its wall of worry.

For our part, our largest overall exposure in Deep Value Equities remains the Gold Miners ETF (GDX) since real assets have central bank support through reflation if they fail to improve through stronger economic activity. Our next largest is Corrections Corp (CXW) as we await further developments on their conversion to a REIT. Hedged Dividend Capture has lost around 2% over the past few weeks consistent with its proclivity to underperform a strong equity market. MLPs remain attractive – it’s interesting to note the growing number of unconventional MLP IPOs in recent weeks. A number of private equity firms have been taking public as MLPs businesses that have far more volatile earnings than is normal for the sector. An example is Petrologistics lp (PDH), whose S-1 registration statement includes the warning that, “We may not have sufficient cash available to pay any quarterly distribution on our common units.” Their units offer an 8% distribution yield but that yield could move violently in response to the profitability of polypropylene production rom their single facility. It’s not a name we would own, but developments such as these may begin to alter the make-up of the Alerian MLP Index.

Why Gold Miners Can Outperform the S&P500

Towards the end of last year we felt there was an interesting opportunity to be long equities hedged with a short position in the Euro. Our thinking was that equities were attractively priced as long as a crisis was averted, and most of the bad things we could imagine would either begin in Europe (i.e. Euro collapse) or affect it more than the U.S. (such as an Israeli strike on Iran given the EU's greater reliance of Middle East imports than the U.S.). We employed this bias in Fixed Income where long positions in bank debt were combined with short Euro positions.

That trade is no longer interesting, because a short Euro is a less effective hedge now that it's weakened. But a similar concept exists with gold miners and equities.

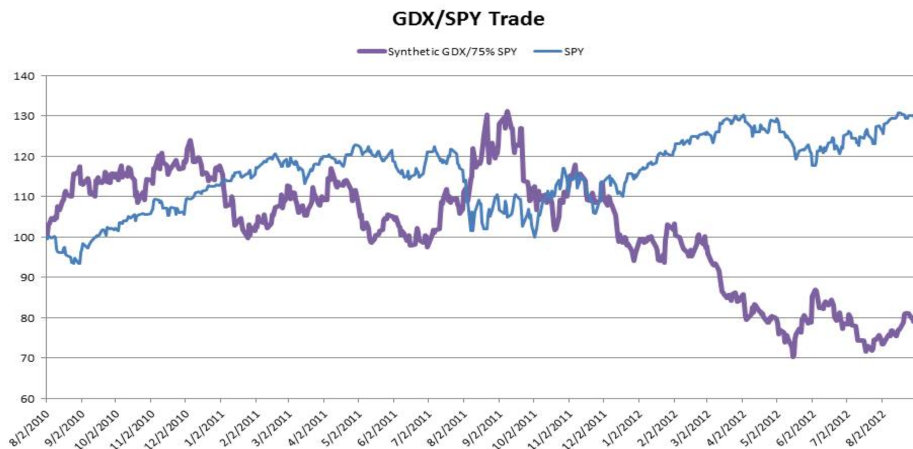
Gold and Silver miners have for many months been trading at a healthy discount to the NAV of their reserves. Although the optionality provided by a long position in a miner should be worth something (since a rising gold price ought to create a disproportionate increase in the stock through operating leverage while if gold falls to unprofitable levels they can simply stop digging) the market continues to price the sector at a discount. One obvious move is to buy the Gold Miners ETF (GDX) and short gold itself (GLD). However, this means simply betting on a reversion to the mean of the relationship, and there's no knowing when that might happen.

Instead, long GDX and short S&P 500 is an interesting trade. Gold is out of favor and a short position isn't likely to provide much protection from here. If gold does sink, along

with GDX, it’s likely to be in response to slower growth so the short equity hedge should provide some protection. But in that scenario the odds of QE increase, so reflation ought to provide some support for the yellow metal. Conversely, if the world avoids all the various disasters that may afflict it, rising markets are likely to lift commodities with them, and the weaker US$ that would result in that scenario would also provide support for GDX.

The correct hedge ratio is less than 1:1 – we prefer something closer to $1 of GDX versus short $0.75 of SPY. And the correlation between GDX and SPY is not as strong at with GLD, but we think this combinaton of exposures makes more sense. In the long run (i.e. years) we don’t think gold will perform as well as equities. Warren Buffett and others have articulated most eloquently the problems with an asset that does nothing, pays no dividend and costs money to store. But we’re entering a period where developed world central banks will be redoubling their efforts at reflating, with the ECB likely to adopt their own form of QE in the next several weeks. Long GDX allows one to invest in mining stocks at a current discount to their reserves without direct exposure to the relationship continuing to deteriorate. This is why we are currently invested in GDX in our Deep Value Equity Strategy, since we think it offers an attractive risk/return profile compared with the broader equity markets.

The chart below shows the last two years of a position long GDX/short 75% SPY, and also the S&P500 itself, both rebased to 100 on August 2, 2010.



Disclosure: Author is Long GDX

Greece Borrows from Prof. Shiller

A little known element of the Greek bond restructuring of several months back was the granting of warrants whose coupons were linked to Greece's GDP. Maybe this was inspired by Professor Shiller's suggestion (most recently in his book, "Finance and the Good Society") in which he proposed that the U.S. issue "Trills", securities whose coupons would pay one trillionth of GDP annually. Such an approach is pro-cyclical, in that it links a government's cost of financing to economic growth. While there's no chance of the U.S. adopting anything so radical, the problem facing southern European Euro members is that slow GDP growth impedes their ability to finance their existing debt, perversely driving up its cost as the risk of default overwhelms the subdued inflation expectations that would normally drive rates down.

The Greek warrants were an attempt to share some of that risk with their creditors, and as noted in the FT today these originally unloved instruments have performed quite well of late.

It illustrates the many unconventional tools and limitless ingenuity of the Europeans to maintain the Euro and keep the European project alive.

We have been invested in gold miners through GDX for some time. Gold has been a mediocre performer but a form of quantitative easing is looking increasingly likely in Europe. The London Daily Telegraph today also believes that Germany will endorse “capping” the spreads between the bonds of weaker Euro members and Germany. If implemented, this really would represent the a blank check for the ECB to finance Italy and Spain and thus prevent high borrowing costs from offsetting their budget discipline. While controversial in Germany, it makes financial assets (such as bonds) marginally less attractive and we think improves the case for investments in real assets including gold. We are invested in GDX in our Deep Value Equity Strategy.