Savour the Moment

Sometimes you feel as if you'd like the world to stop right where it is. For most investors, arriving at work and checking their portfolios over coffee this morning should be one of the most pleasant beverages they've consumed in many months. After the misery of the third quarter culminating in September's testing of every reasonable investment thesis, sanity is finally returning. The Europeans have avoided disaster; the Germans have crammed voluntary losses on the banks (who have only themselves to blame for owning so much Greek debt in the first place). The banks say they will recapitalize through retained earnings rather than dilutive secondary offerings. The EFSF will be stretched as needed (although details are still sketchy). Life as we knew it can resume, and risk assets are cheap. Enjoy the view, like gazing across a beautiful vista on a sunny day. Touch the moment and savour it. Of course there are problems, and the moment won't last. But for now, just look and let September's nightmare recede.

So having done that, what's next? Well, having engineered a voluntary loss of 50% on holders of Greek debt and thereby avoiding an actual default, the market for sovereign credit default swaps (CDS) appears superfluous. Cautious buyers of Greek debt (were there ever any?) who bought credit insurance (i.e. CDS) have found it a waste of money. Sovereign defaults are at the end of the day as much political as credit events. Rating agency assessments of countries are political judgments, and maybe we're witnessing the end of one corner of the CDS market. Bankers have warned that reduced hedging opportunities will reduce the appetite of banks to extend credit – that may not be a wholly bad outcome given the amount of poorly conceived credit they've extended in the past. But reduced credit in the near term combined with Europe-wide fiscal retrenchment will stifle growth.

For our part, the main challenge to investors remains finding a fair alternative to the paltry yields offered in fixed income. Senior loans continue to be an attractive sector. The ING Prime Rate Fund (PPR) yields close to 6% and closed at a 7% discount to its NAV. When I spoke to one of the co-PMs a couple of weeks ago he felt fairly sanguine about defaults barring a European disaster which, at that time couldn't be ruled out. Meanwhile, high-grade corporate bonds at around 4% with no growth require conditions close to but just short of deflation to turn out well. The gap between the 8% earnings yield on the S&P500 and 2.25% ten-year treasury bonds is somewhat narrower than a month ago but still historically wide. Today is probably not the day to jump into equities, but at a calmer moment they still look like a more attractive long-term investment than bonds. The after-tax return on $100 in ten year treasuries can be beaten by a combination of $80 in 0% cash and only $20 in 2.2% dividend yielding stocks assuming as little as 4% dividend growth. Bonds are at yields that only a QE emboldened government could love.

In equities we remain fully invested. Natural gas E&P names continue to represent the more volatile sector of our Deep Value Equity portfolio. Devon Energy (DVN) is barely above the value of its proved reserves. We continue to believe Gannett (GCI) is very cheap at 6X earnings or less than five times free cashflow. And Microsoft (MSFT) remains attractive at less than 7X earnings net of cash (less debt) on balance sheet. MSFT has been cheap for many, many months. It's not exciting to be an investor – far from it. But it continues to be reliably profitable.

Disclosure: Author is Long PPR, DVN, GCI, MSFT