Martin Capital Partners

Quarterly Point of View

April 15, 2011

Last quarter I started our commentary by stating that "government balance sheets in this country and across the world are not in good condition, but the same cannot be said for corporate America." Illustrating today's very strong financial position of U.S. corporate balance sheets is not difficult. Non-financial corporations held almost $2 trillion of cash and other liquid assets toward the end of 2010. According to a Standard and Poor's study of what they termed the 'old' industrials, 36% had more cash than long term debt and almost 50% of these companies had boosted cash reserves by more than 20%, over just the previous 12 months. This clear strength is an underpinning of our belief that a segment of the U.S. market, notably large, high quality multinational companies with durable dividends, offers compelling reward for risk characteristics.

Conversely, and very unfortunately, illustrating the weak financial position of global government balance sheets is also not difficult. The concept of a debt 'super-cycle' has been discussed for many years. In its simplest form it is the decades' long growth of debt from a relatively small and manageable phase to oppressive and unmanageable levels. Last year the Bank for International Settlements (BIS), based in Switzerland and sometimes referred to as the central banker to central banks, issued a paper titled "The Future of Public Debt: Prospects and Implications." They discuss their baseline scenarios and project debt to GDP ratios in a dozen major industrial economies. Even taking a conservative approach – assuming government spending remains a constant percentage of GDP and the real interest rate to determine the cost of funding stays constant at the 1998-2007 average - the numbers become staggering. The BIS argues that unless age-related (entitlement) spending is cut and the stance of fiscal policy changes, debt will continue to rise rapidly over the coming decade, exceeding 300% of GDP in Japan; 200% in the United Kingdom; and 150% in Belgium, France, Ireland, Greece, Italy and the United States. They further illustrate the potential crisis by projecting that interest payments to service the debt, which alone stand near 5% of GDP currently, will rise to 10% in all of the above countries by decade's end, and for the United Kingdom and the United States – a completely staggering 20-30% of GDP in the next 30 years…just to make the interest payments! The report concludes, "the path pursued by fiscal authorities in a number of industrialized countries is unsustainable" and that "drastic measures are necessary."

Though it is clear they desperately need to, it will be very challenging for these 'authorities' to take enough action to make a dent in the numbers. On April 12, the Wall Street Journal reported that the United States Congress was detailing almost $39 billion in spending cuts to keep the government funded for the remainder of fiscal 2011. Despite all the gnashing of teeth between the parties over the size of the projected cuts, given the $1.5 trillion projected budget deficit our nation faces this year, $39 billion appears almost immaterial. It is analogous to a family facing financial woes and a $10,000 debt burden that has to be immediately addressed. After much debate the family decides to take 'radical' measures and reduce its expenditures by $260.

When armed with a printing press, there are three paths countries can take to deal with their debt outside of outright default:

1) They can impose austerity measures.
2) They can inflate it away.
3) They can devalue their currency hurting foreign holders of the debt (U.S. debt is 57% foreign owned) - another form of inflating it away called currency debasement.

Although a heavy dose of path one is what many nations will absolutely need to undergo, it is emotionally the hardest, politically the toughest, and therefore likely to be the authorities' last choice to be carried out in any meaningful fashion. This leaves us with the very real scenario that inflation and debasement, though not publicly endorsed, will be allowed to continue to take root. There will likely be an unofficial monetization of deficits and attempts to reduce the future value of liabilities through inflation. This exercise will be fraught with danger, as inflation will be hard to control once it accelerates. As discussed above, many nations face the same difficult debt scenario, so whenever one country debases, its neighbor won't be far behind. Clearly not everyone can win with this strategy, but it is likely to be a part of many nations' approach.

The only fundamental fix for any economy plagued by over indebtedness is austerity and time; there is no quick or easy fix. Abraham Lincoln once said "I am a firm believer in the people. If given the truth, they can be depended upon to meet any national crisis. The great point is to bring them the real facts." The 'real' facts will need to be confronted and serious austerity measures undertaken by those in power. It may take some time to come to this realization, but the issue is too big to be ignored. In the meantime it will be accompanied by the covert attempt to inflate away liabilities.

How this relates to the investment outlook is clearly of importance to us. If we do in fact see inflation manifest itself, how will we want to be positioned? As it relates to bond investors, during periods of inflationary pressure the prices of bonds (which move inversely to bond yields) may decline as yields rise to offset the increase in expected inflation. In such an environment, bond owners may suffer a degree of price depreciation that detracts from interest received and may result in negative total returns. In our opinion, the need to keep maturities on the shorter end of the yield curve will be critical, allowing for the reinvestment of maturing instruments at higher rates.

The last decade investors experienced significant inflation, the 1970's, may offer some clues as to what will be important for equity investors in a similar cycle. Inflation measured by the Consumer Price Index (CPI) averaged 7.1%, accelerating to 13.3% by the end of the 1979. Even after stripping out food and energy to look at 'core' inflation – which seems rather foolish anyway – inflation still averaged 6.5% rising to 11.3% to end the decade. The level of the S&P 500 Index in that time rose at a cumulative 17.25% when looking at price only. However, when dividends and dividend growth are included the return moves to almost 77%, with dividends contributing over 70% of total return for the decade.

Dividends will remain crucially important in the next cycle as well. Why is this the case? A major factor is the ability for dividends to grow, offering the potential to keep pace with inflation, preserving the purchasing power of investor assets. Companies with established dividend cultures, and particularly cultures of growing their dividends, generally have the financial strength to withstand temporary margin compression that comes in the early stages of inflation. It's not always possible to pass on higher costs to consumers at the first sign of inflation, thus being able to weather times of margin compression will be important. Ultimately those franchises that can pass on broad based price increases leading to higher revenues may also see their stock prices rise as well.

Simply put, there are three components of total returns: dividends, earnings and P/E multiple expansion or contraction. In an inflationary environment with rising interest rates it will be difficult to get much, if any, multiple expansion (rising P/E's). The burden of total return will fall on dividends and earnings. As was displayed in the 1970's, a focus on dividends was extremely important to capturing the bulk of total return.

Please feel free to call or email with questions you may have regarding our strategies or Martin Capital Partners in general. You can also find information on our website at www.martincp.com.

We are humbled and excited to wake up each morning and serve those that have entrusted us with their capital. It is a sincere privilege.

Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC