



Portfolio Manager Q&A

Matterhorn's Global Perspective

An Interview with Portfolio Managers Juan Landa, Stefan Gräter, CFA, and Harry Flavin, CFA

This is the second in a series of interviews with the portfolio managers at Matterhorn Capital Management, LLC, aimed at making the firm's internal investment process and market views more transparent and accessible to the firm's clients.

To what do you attribute the stock market's strength over the past twelve months in light of weak economic growth both here and abroad? How sustainable is this divergence?

The stock market's 30% run over the past 12 months has been driven primarily by a combination of easy monetary policy (QE2) and stronger-than-expected corporate earnings. Fed Chairman Bernanke's Jackson Hole speech last August marked the beginning of a new round of quantitative easing, which enabled the market to shrug off a series of external shocks, including Arab unrest, a devastating earthquake/tsunami in Japan and mounting sovereign debt issues in Europe and the U.S. Throughout that time, corporate earnings have remained strong as exceptional operating leverage from cost control, productivity and global outsourcing has led to record-high margins. While we fully expect this current divergence to dissipate over time, we do expect to see these benefits continue over the near-to-medium term. Given that earnings growth has been 12 times GDP growth this cycle compared to 4.2 times from the mid-80s through early 2000s cycle, there is plenty of room left for continued upside EPS surprises the remainder of this year.

Are you worried the U.S. will default if the debt ceiling is not raised?

Our view is that there will be a last-minute compromise on the debt ceiling issue that will involve some combination of spending cuts and tax increases. Using IMF historical data on austerity measures as a guide, the average deficit reduction plan has been comprised of 83% cuts and 17% revenue (tax) increases.

For the sake of market stability, we would prefer those issues be worked out well in advance of the August 2nd deadline. Pushing too close to the deadline could have unintended consequences, particularly if market participants start to reposition their portfolios in anticipation of the deadline being breached and, in the process, set off a domino effect that could have wide-ranging implications. While the probability of that occurring is low, both sides of the partisan divide could potentially use the deadline as leverage to structure a favorable deal. A default or near default of U.S. debt would have severe consequences and set in motion a series of negative cascading effects that will be impossible to undo. For that reason, we think political imperatives dictate that a deal be reached sooner rather than later. The impending "crisis" may also provide both parties with the political cover needed to enact deep cuts to entitlements ahead of the 2012 elections.

What are your thoughts on the debt ceiling and our debt load?

While much attention has been paid to the raising of the debt ceiling, it is nothing new. In fact, it has been raised 10 times over the past 10 years and over 80 times since the end of the second World War. What is different this time is the highly polarized political nature of the debate, which has increased the near-term risk of default. While these negotiations are certainly important, we have been, and continue to be, equally alarmed by the size of the debt load (\$14.3 trillion and counting) and its impact on future economic growth. History has shown that the deleveraging process is painful as valuable resources are rationed and diverted to pay down debt, leaving less of these resources available for productive uses. In the past, this has often led to prolonged periods of muted and even negative economic growth. Moreover, the true cost of our national debt has also been masked by low interest rates. The sheer size of the debt load implies that even a relatively benign 25 to 50 bps move in interest rates can have a dramatic effect on interest payments. Interest rates could spike substantially higher on any numbers of events, driving this interest burden even higher, further adding to our federal deficit.

For more information, please contact:

Jeff Bailey

16410 Blanco Road, Suite 2 • San Antonio, TX 78232

Tel (210) 694-4329 • Cell (210) 393-3299

jbailey@matterhorncap.com • www.matterhorncap.com

(continued next page)

Portfolio Manager Q&A (continued from 1)

In a July 1st speech in Jackson Hole, Wyoming, former U.S. Senator Alan Simpson, Co-Chair of President Obama's Bowles-Simpson Deficit/Debt Commission, raised the alarm that the U.S. Debt crisis is at a tipping point. On its current trajectory, the cost of interest on the U.S. Federal Debt will reach \$1 trillion by 2020. The Federal Government simply cannot continue to borrow \$0.42 for every \$1 in revenue. According to Mr. Simpson, for many decades, U.S. politicians' job was to "bring home the bacon" for their constituents from Washington. As he succinctly pointed out, "There is not more bacon. The Pig is Dead."

What do you make of the proposed Greek restructuring?

Our view is that Greece will ultimately default on their obligations. The fiscal situation is quite dire and simply unsustainable. The size of the new bailout from other eurozone countries and the IMF could approach €90 billion, on top of the €110 billion rescue package last year. The ongoing discussions and negotiations are really about two things: the timing of an eventual default and who will ultimately take the pain. The French proposal, which has gained lots of traction lately, is really not all that different from the German proposal. They both call for investors to swap a portion of their Greek government bonds for new bonds with longer maturities – essentially kicking the can down the road once again. In our opinion, these deals offer little more than temporary life support, essentially buying some extra time for German and French banks (which collectively hold roughly €30 billion in Greek government debt) to shed their exposure. For the time being, however, Greece is viewed as "too big to fail," at least in terms of the Eurozone. This means the bailout spigot will remain open at least until French and German banks decrease their exposure to acceptable levels or northern European voters decide they have had enough. Or both.

What is the likelihood of other European countries defaulting?

We are often asked this question, so we decided to share an insightful table from Lombard Research, which provides an overview of debt – as a percentage of GDP – for each of the countries in the eurozone periphery, compared to the U.S., Japan, Germany and the U.K. As shown in **Exhibit 1**, Greece had the highest level of government debt as a percentage of GDP by a large margin (save for Japan), which helps explain their current situation. Italy is the next highest, which helps explain why hedge funds and the financial media have all turned their attention to Italy as the next sovereign debt default candidate. Equally alarming is Ireland, which not only had the highest household, corporate and total debt as a percentage of GDP, its government debt also had the highest year-over-year increase (on a percentage basis). Even if a short-term solution for Greece is negotiated

Exhibit 1 Non-Financial Debt by Sector, 2009, % of GDP

	Households, Gross	Non-Financial Companies, Net	Gov't, Net	Total	Net Gov't 2010
USA	96.1%	38.7%	59.8%	194.6%	64.8%
Japan	65.5%	57.9%	110.0%	233.4%	117.5%
UK	103.5%	72.4%	60.9%	236.8%	69.4%
Germany	63.4%	47.7%	55.9%	167.0%	53.8%
Ireland	120.6%	170.6%	38.0%	329.2%	68.4%
Greece	52.4%	48.8%	126.8%	228.0%	142.0%
Portugal	96.8%	137.6%	71.9%	306.3%	79.1%
Spain	86.0%	115.5%	41.8%	243.3%	48.8%
Italy	42.2%	65.6%	97.1%	204.9%	99.6%

Source: "The True Scale of Club Med and Irish Debt," Lombard Street Research, June 2011

soon, Italy and Ireland may not be far behind, particularly if contagion takes hold and investors start demanding a higher risk premium from the countries in Europe's periphery. We will continue to monitor the situation closely, since – despite proclamations from Ben Bernanke to the contrary – any default-driven credit seizures in Europe will significantly impact the U.S.

Hasn't the U.S. economy already experienced deleveraging by the U.S. consumer and household?

Yes. However, when one considers the aggregate debt picture of the U.S., one finds that we have not yet begun to deal with deleveraging. The debt growth of U.S. households and consumers has improved from growth rates of +10% to +12% per annum in the 2001-2007 period to -2% per annum in 2008-2010. Conversely, U.S. Government debt has increased from growth rates averaging about +2% per annum in the 2001-2007 period to +8% to +12% in the years 2008-2010. For the most part, excessive U.S. debt has not been extinguished, merely transferred to the public sector. This could leave Treasury rates at risk of an upside breakout, especially if foreign bond buyers begin to lose confidence in our fiscal management.

That said, there are some encouraging signs. Ongoing negotiations regarding entitlement cuts at the federal level, as well as public pension negotiations at the state and local level, are indicative of the importance deficit reduction has taken since the 2010 election cycle. To the extent these initiatives continue to gain traction, real progress can be made toward deleveraging our total debt.

Is a 16 times trailing and 13 times forward P/E not attractive for the S&P 500 Index? Isn't much of the "Wall of Worry" already discounted by the market?

History suggests that when inflation is below 4%, the S&P 500 has traded in a P/E range of 17-18 times trailing earnings. By that measure, one could argue that current valuations are

(continued next page)



Portfolio Manager Q&A (continued from 2)

somewhat undervalued. However, there are several factors now weighing on multiples that have been present only a few times in recent history. First is the elevated level of debt and deficit as a percent of GDP. Holding other things constant, P/Es tend to be lower when the deficit as a percent of GDP is a large negative number. Today that number is near 10% (in red on **Exhibit 2**). An additional weight on the market P/E is the excessive Gross Federal Debt/GDP ratio which is currently about 90% (blue).

As shown in **Exhibit 2**, the only other time these negative leverage ratios have reached these levels was during the second

World War. In that case, excessive war spending was an abnormal factor, which quickly receded after the war. Further, because domestic consumer durable and non-durable goods were rationed during the war, a huge pent-up demand allowed the country to grow out of its excessive debt and deficits rather rapidly. Neither element is present today to ease the debt and deficit ratios.

Also weighing on the market multiple is the global overleveraging of sovereign balance sheets and potential debt defaults, particularly among the periphery countries in the Eurozone as well as the U.S. Until real progress is made in deleveraging the U.S. and European periphery countries, P/E ratios are likely to remain depressed. ■

