

# WEDGE WATCH

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## Turning Up the Heat?

*"These days people seek knowledge, not wisdom. Knowledge is of the past, wisdom is of the future."*

—Vernon Cooper, Lumbee Elder and "Faith Healer"

In the mid 1970's several prominent print media featured stories sounding the alarm regarding global cooling (e.g., *Science Digest*, *The Christian Science Monitor* and the *New York Times*). In particular, an April 28, 1975 *Newsweek* article titled "The Cooling World" pointed to "ominous signs that the Earth's weather patterns have begun to change," referencing a drop of a half degree (Fahrenheit) in average ground temperatures in the Northern Hemisphere between 1945 and 1968. The article claimed, "The evidence in support of these predictions (of global cooling) has now begun to accumulate so massively that meteorologists are hard-pressed to keep up with it." The article went on to roundly criticize a lack of governmental intervention to address the emerging problem stating: "The longer the planners (politicians) delay, the more difficult will they find it to cope with climatic change once the results become grim reality."

Around the same time, a group of leading climatologists, meeting in Bonn, West Germany, warned that "the facts of the present climate change are such that most optimistic experts would assign near-certainty to major crop failures within a decade (because of global cooling). If national and international policies do not take these near-certain failures into account, they will result in mass deaths by starvation and probably in anarchy and violence that could exact a still more terrible toll." Echoing those dire warnings was one of the year's best-selling books, *The Cooling: Has the Next Ice Age Already Begun?* Lowell Ponte, its author, who lectured widely on the subject, stated that a number of the world's most conservative scientists have warned of the possibility of a new ice age evolving in the near future. "Global cooling," he wrote, "presents humankind with the most important social, political and adaptive challenges we have had to deal with for 10,000 years. Your stake in the decisions we make concerning global cooling is of ultimate importance: the survival of ourselves, our children, our species." However, unbeknownst to Ponte and the other doomsayers, *the thirty year global cooling trend had essentially run its course. From there, temperatures would slowly creep higher* (though this would not be apparent until many years later).

Today, as we know, high decibel alarm bells are being sounded worldwide regarding what appears to be an increasingly imminent threat from global warming (e.g., Al Gore's *An Inconvenient Truth*). Although the science underpinning these warnings is far more sophisticated than that of the 1970's, only time will tell if the broadly trumpeted concerns are truly warranted. The old saying, "An ounce of prevention is worth a pound of cure" probably applies though. As Berkshire Hathaway's Warren Buffett recently stated in response to a question on global warming: "You have to build the ark before the rains come. If you're going to make a mistake, err on the side of the planet (it's the only one we've got)." Coming from a man who knows a thing or two about "green," we *emphatically* second that motion.

### Second Quarter 2007 Financial Statistics

DJIA: 13408.62

S&P 500: 1503.35

90-Day T-Bill: 4.80%

30-Yr. T-Bond: 5.12%

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# Heat

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Speaking of the planet, at least the Wall Street side of it, where the climatic outlook is often as unpredictable as the trend of global warming or cooling, **fear regarding a different sort of stealth threat has begun to stir, after a remarkably extended dormancy.** On June 7th it was reported that Bill Gross, manager of the world's largest bond fund and a long-time bond bull, had pronounced the end of the 25-year bull market in treasury bonds. This occurred after the yield on the 10-year treasury experienced its biggest one-day move up in three years, piercing the key 5% threshold closely watched by investors. Gross cited solid global growth and a mild acceleration of inflation in the U.S. as reasons for his change in posture. That broadly disseminated opinion shift, combined with an accumulation of tightening moves by the European Central Bank (eight increases since late 2005) and a surprise tightening by New Zealand monetary authorities, helped conspire to trigger the abrupt and unexpected reversal in investor sentiment toward bonds. Going forward, any distinct signs of true fundamental weakness in the corporate credit markets, especially in high-yield land, could exacerbate bond tension and cause still tight spreads to widen noticeably. (Something to watch – according to *Ned Davis Research*, high yield debt is now underperforming equities by the largest margin since 2002.) Needless to say, given this evolving backdrop, **inflation and interest rate fears have abruptly resurfaced on the radar screen of equity investors** (at least for now).

As highlighted earlier, long-term forecasts of any kind are inherently treacherous, though they remain a daily staple of the Wall Street diet. With that in mind, a year-end 2004 *Financial Analysts Journal* article on forecasting by Peter Bernstein, the esteemed author of *Against the Gods: The Remarkable Story of Risk*, merits careful review, in our opinion. We believe the research underpinning the article is *especially relevant now, given renewed fears of inflation and its potential impact on stock returns.* Appropriately, the article opens with a cautionary warning that “forecasts based on an extrapolation of the past are at the outside limits of peril.” It goes on, however, to make the case that “forecasters who make predictions without regard to past experience are just playing games.” In other words, “without any reference points” a forecaster has

“no benchmarks to distinguish between what is radically different about their expectations and what experience has already taught.” Clearly, as the author points out, “the future is never going to replicate the past,” but “a careful analysis of the history of long periods covering a wide variety of experiences should provide insights into how the capital markets have behaved in response to changes in macroeconomic fundamentals” and, therefore, help form “the essential building blocks of a rational forecast.”

As discussed in prior issues of this newsletter, we have felt for some time that the recent upheaval in the treasury market was long overdue. However, it may be too early to conclude whether or not inflationary pressures have truly begun to take hold globally. It could be that the recent steepening of the yield curve was simply an unwinding of an unsustainable structural imbalance (e.g., the recycling of global trade flows back into and then eventually out of U.S. treasuries), or just a delayed normalization and nothing more. No matter, equity investors, as a result, promptly raised their “inflation-seeking antenna” in an anxious effort to uncover more tangible signs of that universally-feared “boogey man.” They were reacting, of course, to the perception that rising prices for goods means higher bond yields and, therefore, lower multiples of earnings for stock prices. For the true long-term-oriented fiduciary, however, **this fear must be carefully balanced against time-horizon-specific durations.**

In the Bernstein article, the author “compares a set of major U.S. economic variables and capital market returns over a sequence of 20-year periods beginning in 1873 and ending with 1983-2003 (see **Chart 1**). The comparison moves forward from the first period measured 5 years at a time for a total of twenty-three 20-year eras, of which twenty-two contain a 15-year overlap with their predecessors.” Given the extended durations of those periods, however, it's important to remember that “*The interactions between economic fundamentals and capital market behavior that investors experience week-to-week or even year-to-year may be entirely different from the interactions over the long run; a distinction warranting close attention.*”

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“I've had a long, long life full of troubles, but there is one curious fact about them – nine-tenths of them never happened.”

–Andrew Carnegie (1835-1919)

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When an equity investor thinks about the future, he or she should probably think about **inflation** before anything else. According to Bernstein, “The data that matter the most are the *real* data – what happened after adjustment for inflation – and these numbers often bear only a vague resemblance to the nominal data from which they are derived. For example, the first three 20-year periods and the 1918-38 segment were all characterized by *deflation* in the CPI. Although nominal equity returns in those years were below the long-term average, *the real returns were all above average.*”

Inflation is typically perceived as a negative for stock prices and in the *short run* that is usually true. However, as Bernstein points out, “the *long-run* relationship between inflation and equity returns is not what many investors would expect.” The data highlighting this relationship are contained in **Chart 1**, “where a comparison of the CPI column with the nominal total stock return column, shows that *stocks have done better* (on a nominal basis) *when inflation was high than when it was low.*” In fact, “in the nine 20-year segments when nominal total returns were in double digits, the inflation rate averaged 3.5 percent, more than 100 bps above the long-run average of 2.4 percent; inflation fell below that

average during only one of the nine periods, 1948 to 1968.” Looked at another way, “The three periods with the highest rates of inflation were those beginning with 1963, with 1968, and with 1973, when inflation ran higher than 6 percent, but nominal equity returns in that period still averaged 9.7 percent. The stock market beat even the difficult hurdle of 6 percent inflation by more than 3 percentage points a year.” **Over the long run then (and with few exceptions) it appears that equities have soundly passed the test as a worthy inflation hedge.**

Circling back to the present, **is it possible that we are on the cusp of a long-term upturn in global inflation** after a wonderfully extended 25-year period where inflation and interest rates progressively declined from the crippling double-digit levels of the early 1980’s? Will the recent 70 basis point yield spike in the ten-year treasury prove to be the “canary in the coal mine” signaling a secular shift in price trends? The answer, of course, is we don’t know for sure, though equity prices would likely experience *noticeable* turbulence, at least in the short-to medium-term, if more tangible evidence of renewed inflation emerged going forward. As is our mandate, we will continue to maintain a vigilant watch for signs of

Chart 1

### Economic and Market Data by 20-Year Periods, 1873-2003

Period	Total Stock Return Index (%/yr)		Real GDP (%/yr)	CPI (%/yr)	Nominal Bond Yield (%)		Real Bond Yield (%)	
	Nominal	Real			Start	Finish	Start	Finish
1873-1893	5.7	7.1	3.6	-1.3	7.8	4.7	8.5	5.2
1878-1898	6.9	8.0	4.2	-1.0	6.5	4.0	9.8	4.7
1883-1903	6.4	7.0	3.9	-0.5	5.2	4.0	7.0	2.3
1888-1908	5.7	5.6	4.5	0.1	4.6	4.2	3.6	3.2
1893-1913	7.2	6.8	4.9	0.4	4.7	4.4	5.2	2.4
1898-1918	7.1	3.6	4.1	3.4	4.0	5.2	4.7	-15.3
1903-1923	5.9	2.4	3.2	3.4	4.0	4.4	2.3	1.8
1908-1928	10.9	7.7	3.1	3.0	4.2	3.3	3.2	4.3
1913-1933	4.4	3.1	-0.6	1.4	4.4	3.3	2.4	2.8
1918-1938	7.9	8.7	1.0	-0.8	5.2	2.6	-15.3	5.4
1923-1943	6.0	6.0	3.5	0.0	4.4	2.5	1.8	-0.7
1928-1948	4.4	2.6	2.2	1.7	3.3	2.4	4.3	-0.3
1933-1953	12.8	8.8	6.1	3.6	3.3	3.0	2.8	2.3
1938-1958	12.7	8.7	4.6	3.7	2.6	3.4	5.4	0.7
1943-1963	15.2	12.0	2.9	2.8	2.5	4.0	-0.7	2.7
1948-1968	14.6	12.6	4.4	1.8	2.4	5.3	-0.3	1.0
1953-1973	11.7	8.9	4.1	2.5	3.0	6.8	2.3	0.6
1958-1978	7.7	3.4	4.1	4.2	3.4	8.4	0.7	0.8
1963-1983	8.3	2.1	2.9	6.1	4.0	11.1	2.7	7.9
1968-1988	9.5	3.0	2.5	6.3	5.3	8.8	1.0	4.7
1973-1993	11.4	5.0	2.1	6.1	6.8	5.9	0.6	2.9
1978-1998	16.9	11.6	2.2	4.7	8.4	5.3	0.8	3.7
1983-2003	12.6	9.2	3.3	3.1	11.1	4.0	7.9	1.7
Avg.	9.2	6.7	3.3	2.4	4.8	4.8	2.6	2.0
Std. dev.	3.6	3.1	1.4	2.3	2.1	2.1	4.7	4.2
Min.	4.4	2.1	-0.6	-1.3	2.4	2.4	-15.3	-15.3
Max.	16.9	12.6	6.1	6.3	11.1	11.1	9.8	7.9

Source: Peter Bernstein Inc., Courtesy of CFA Institute

such potentially *consequential* change. In the meantime, we will lean heavily, as always, on the ever dependable foundational principles of value investing to help us navigate the markets, both hot and cold.

We'll close with a paraphrased recollection (source: *Financial Analysts Journal*, January/February 2005) from Charley Ellis, founder of Greenwich Associates and a long-tenured Wall Street veteran, which provides sage and timeless advice for the investor no matter what the macroeconomic backdrop:

*Over 40 years ago, I was a freshly minted MBA just starting out in a Wall Street training program at Wertheim & Company. As part of our training, we met once a month with various senior members of the firm to gain an introductory perspective on their departments. One day, in particular, we had the good fortune to meet with Joseph K. Klingenstein, a senior partner in the firm who wore pince-nez glasses and was patrician, dignified and erect.*

*Mr. Klingenstein took the opportunity to speak about the history of the firm and of Wall Street and its traditions. At 10 minutes before noon, he finished his talk and asked, "Do you young gentlemen have any questions?" For a few moments there was only silence when quite abruptly the brightest and certainly the most outspoken*

*member of our little group said: "Yeah, Mr. Klingenstein, I've got a question. You're rich, Mr. Klingenstein. We all want to be rich too, Mr. Klingenstein. So, what can you tell us from all your experience about how to get rich like you, Mr. Klingenstein?"*

*Of course you could have heard the proverbial pin drop. We were all mortified. Such a way to speak to such a very great man!*

*At first, Joseph K. Klingenstein appeared to be angry, perhaps very angry. But then, to our great and collective relief, it became clear that he was silent because he was thinking – thinking carefully about his many investment experiences. Finally, looking directly at his questioner, he said simply and clearly, "**Don't lose.**" In other words, long-term investment success depends on not taking major losses, and **large losses are almost always caused by trying to get too much by taking too much risk.** If you avoid big losses with a strong defense (by carefully assessing the upside potential and downside risk before pulling the trigger on a stock), *the winnings will have every opportunity to take care of themselves* (via the magic of compound interest).*

Enough said.

Index	06/30/07 Price	2nd Quarter Price Change*	Year-to-Date Price Change*
Dow Jones Industrials	13408.62	8.5%	7.6%
S&P 500	1503.35	5.8	6.0
Value Line Composite	493.61	4.7	7.8
American Exchange Comp.	2356.38	8.3	14.6
NASDAQ Composite	2603.23	7.5	7.8

\*Does not include dividend income.



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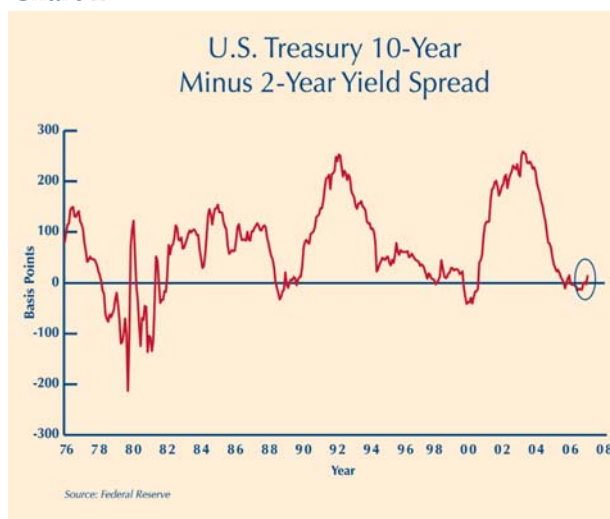
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## Fixed Income

# Yield Curve U-Turn?

For almost two years, we have been expecting the yield curve to re-establish its traditional upward slope. As can be seen in **Chart 2**, which measures the yield difference (in basis points) between the ten-year and two-year U.S. Treasury notes, the yield curve may be in the process of “normalizing.” However, this transition will probably take some time, and there is no guarantee that a scenario won’t emerge to interrupt or delay it.

**Chart 2**



What has been the impetus for the recent change? Beginning in mid-to-late May, several key economic statistics came in stronger than expected while foreign bond markets, particularly in Europe, began to deteriorate. At the same time, global economic growth continued to proceed apace. These things, in combination with other factors, **led to a substantial change in market expectations** relative to what had been embedded in the yield curve. Prior expectations were predicated on the notion that the next Fed move would be towards easing because the economy (and particularly housing) had slowed and inflation would soon follow, trending down to the Fed’s desired range. In the meantime, however, with short rates somewhat anchored by the Fed Funds rate, longer rates were the only place to express the lower rate view.

This points to an important factor in the yield curve “conundrum” - prior market expectations contrasted sharply with the Fed’s own view of the economy. Generally speaking, Fed officials had been much more sanguine about economic growth than the collective outlook of bond investors. Therefore, **any change in expectations, at the margin, would likely produce a fairly dramatic reaction in bond prices and yields.** In fact, according to the Fed Funds futures market, expectations of a cut in the Fed Funds rate were quickly priced out of the market (when sentiment abruptly changed early last month); indeed, expectations for a rate increase were summarily priced in.

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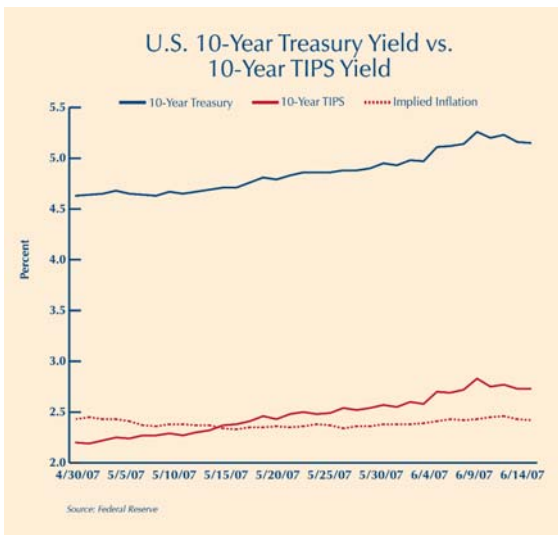
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It is interesting to note that longer-term **inflation expectations** of *fixed income investors* changed very little during this recent back-up in interest rates. Indeed, as can be seen in **Chart 3**, the implied inflation rate between the ten-year Treasury and the ten-year inflation-protected Treasury (TIPS) changed very little. Therefore, at least temporarily, the latest upward move in interest rates has been a “real” yield rally.

**Chart 3**



For quite some time, we’ve had portfolios positioned to take advantage of the yield curve reverting to a more normal shape. Going forward, we believe this strategy will continue to benefit relative portfolio returns **as we suspect the re-steepening of the yield curve is likely in its early stages**. Importantly, client portfolios should benefit from this strategy whether the yield curve follows a “bear steepener” path (as has occurred recently) or experiences a more typical normalization course with short rates declining more than long rates (bull steepener). Stay tuned. We anticipate sharing additional commentary on this evolving backdrop in the months ahead.

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Written by J. Scott Jeffords, James F. Walters, and Bradley S. Fisher of WEDGE Capital Management L.L.P.

301 South College Street, #2920, Charlotte, NC 28202-6002 (704) 334-6475 [www.wedgecapital.com](http://www.wedgecapital.com)

