

HIGHLIGHTS

an economic & market review

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Debt, Deficits and Economic Growth. U.S. Government credit market debt is more than 100% of GDP (total goods and services produced in the U.S. annually) if the mortgage guarantors, Fannie Mae and Freddie Mac, are included. According to the extensive world-wide research conducted by professors Reinhart and Rogoff, when public sector debt reaches 90% of GDP following a credit bubble, real (inflation adjusted) economic growth is reduced by one percentage point on average.

The budget deficit has been 10% of GDP for the past three years. Deficits have never been this high in the peacetime history of the U.S. In the past, economists estimated that deficits exceeding 8% would have a measurably negative impact on economic growth.

We have historical evidence in the U.S. that suggests a correlation between an increase in total credit market debt (public and private) as a percent of GDP and the growth rate in real GDP. Ned Davis Research, using data from the departments of Commerce and Labor plus the Federal Reserve Board, found that when the total credit market debt to GDP ratio was less than 160% (1947 – 1980), real GDP growth averaged 3.7% per year. Between 1980 and 2000, total debt rose from 160% of GDP to 270% with real GDP growth downshifting to an average 3.2% per year. Since 2000, total debt has risen from 270% of GDP to 350%, and real GDP growth has been 1.7% annualized.

Non-farm payroll growth, according to Davis' research, shows a similar relationship to debt growth during the past 63 years. Payroll growth was 2.3% annualized during the post WWII low-debt period (below 160% of GDP) dropping to 1.8% annualized between 1980 and 2000 as total credit market debt continued to expand, and has actually declined at a 0.2% annual rate since 2000 during the high-debt period.

Correlation is not necessarily causation, of course, but the weight of evidence indicates that eventually the dead weight of debt, particularly the non-productive kind favored by the modern welfare state, and private sector debt geared toward consumption rather than investment tips the scales toward lower growth and possibly economic stagnation.

“What are the ways out of a debt crisis?” Niall Ferguson, Professor at Harvard University, posed this question last year in a presentation to the Peterson Institute for International Economics. He noted that, in theory, there are six solutions. The first three he listed are relatively attractive from the standpoint of the affected population and government. They are:

- ① a higher economic (GDP) growth rate,
- ② low interest rates on the public debt,
- ③ and a bailout or capital injection from a trading partner or some other international entity.

The following three solutions are significantly less attractive, but unfortunately normally describe the lengthy journey toward financial recuperation and renewed economic vigor. They are:

- ① cuts in public spending and/or higher taxes,
- ② inflation generated by central bank “quantitative easing”,
- ③ and default meaning outright repudiation of the debt or restructuring which refers to the rescheduling of interest and principal payments.

“Financial Repression” is a term economists use to describe debt restructuring schemes used by governments through regulation or taxation to force or encourage private entities to invest in government bonds even though yields may be low or perhaps negative in real terms. “Unthinkable” changes in the tax code might also



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be employed such as taxing IRA and 401k investments. A few years ago, in the midst of a debt crisis, Argentina seized private pensions to support the government. Ireland recently announced a plan to tax private pension funds in order to maintain government welfare spending while trying to work through an austerity program designed to avoid a debt default or restructuring. Americans would view retirement plan taxation as a financial atrocity, but pushed to the wall by the continuing crisis, U.S. politicians might conclude that it would be one of many heretofore unthinkable but necessary solutions for the common good. It has been discussed in bureaucratic circles for years and the subject occasionally surfaces today in academic papers. If anyone has doubts concerning the perfidiousness of government in this regard, consider that Social Security retirement income was once exempt from taxation. Prior to 1983, Social Security recipients and prospective retirees believed this to be an inviolate compact with the American people. In that year, President Reagan with bi-partisan support signed into law a new rule that up to 50% of Social Security benefits could be added to taxable income, "If the taxpayer's total income exceeded certain thresholds." In 1993, new legislation raised the portion of Social Security benefits subject to taxation from 50% to as much as 85% for "higher income" beneficiaries. A value-added tax (VAT) or national sales tax, common in Europe, has also been discussed as a way to broaden the tax base and pull in revenue from every segment of society. Today, only half of income tax filers actually pay taxes and seizing 100% of all personal income above the magic \$250,000 level would still leave the government short of funds.

Standard & Poor's recently assigned a negative outlook to the U.S. AAA credit rating saying, "We believe there is a material risk that U.S. policy makers might not reach an agreement on how to address medium and long-term budgetary challenges by 2013". Something like this has happened before. Moody's credit rating service issued a similar warning in 1996 during the Clinton Administration amid a contentious budget debate that led to talk of a congressional refusal to increase the debt limit. This time, of course, the long-term debt picture is considerably worse. The mismatch between future government revenue and spending under current policy guidelines cannot be resolved without significant reductions in entitlement spending and probably higher taxes. Hard decisions will eventually have to be made. When, how and under what financial circumstances are

questions that remain unanswered.

The simmering sovereign debt crisis in the Eurozone has come to a boil again. Portugal was recently bailed out (temporarily, in all likelihood). Greece is teetering on the edge of default. Italy's credit rating has been downgraded. Spain's economy is barely growing with unemployment exceeding 20%, the highest in the developed world. Optimism that Spain might avoid a crisis moment is fading. So far, the European Central Bank and Eurozone politicians have favored stop-gap measures to keep the financial crisis contained as if it were only a matter of providing near-term liquidity for a temporary cash-flow problem. The real issue, according to the reams of research papers devoted to it, is solvency. Greece is apparently flat broke with no chance of repaying all of its debt. Portugal is probably in the same boat. Spain is supposed to be in better shape, but we see reports claiming that a large portion of the Spanish banking system would be insolvent if housing related loans were written down to fair market value. There was a very, very big housing bubble in Spain.

Since Greece has been in a perpetual state of crisis due its dire financial condition, it receives most of the attention from European leaders and financial institutions. The latest deal under negotiation would, according to the Financial Times, include "international involvement in tax collection and privatization (sale) of state assets in exchange for new bail-out loans for Athens...the package would also include incentives for private holders of Greek debt voluntarily to extend Athens repayment schedule, as well as another round of austerity measures." Standard & Poor's warned it will downgrade Greek debt to default status if the repayment schedule is altered, voluntarily or otherwise. This is called a "credit rating event" in the bond world. If that happens, then any bank or financial entity that sold insurance protection (credit default swaps) to Greek bond investors would be required, by contract, to pay out potentially billions of Euros to the bond holders. French and German banks are rumored to be the primary writers of these insurance contracts.

No one knows to what extent their capital would be impaired if forced to pay claims except perhaps the banking regulators, and they have been silent on the matter. We assume that a great deal of preparation and contingency planning would precede any restructuring announcement in an attempt to calm markets. There can be no assurances, of course, that the markets would greet a default of any kind with equanimity. It is possible the European financial system

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would experience a Lehman Brothers' moment with some spillover into all markets worldwide. On the other hand, a carefully crafted solution might only generate ripples rather than waves. We simply do not know which is more likely. We do know that the debt problems of the "PIIGS" (Portugal, Italy, Ireland, Greece, and Spain) require more immediate attention than those in the U.S. The near-term risk to the markets is here.

Whether or not we manage to avoid rioting markets in the short-term, the developed world, including the U.S., remains over-indebted and undercapitalized. The process of public and private de-leveraging is in its early stages. Slower economic growth, on average, is to be expected until reasonable debt to capital ratios are restored.

Economic statistics tell us that the economy entered the expansion phase of the business cycle some months ago following the recovery period that began in the summer of 2009. It has not been much of an expansion, however, compared to the typical post WWII cycle. The initial bounce off the bottom didn't measure up either. It is not particularly surprising that the U.S. economy and other economies in the developed world are still struggling two years after the "Great Recession" ended. The adjustment period following a severe credit bust, according to Reinhart and Rogoff's historical study, lasts from five to seven years. Using this historical time-table as a guide, "normal" economic conditions might not return until sometime between 2014 and 2016. Economists as a group have consistently over-estimated U.S. growth potential during the past two years. We have been puzzled and on occasion amazed by growth projections that seemed to be supported by unrealistic assumptions and meager evidence. It could be that the forecasters have been using econometric models which are less reliable following a balance-sheet recession, or perhaps more likely, magical thinking of the wish-fulfillment form is at work.

Psychologists and academics who study investor behavior have found that magical thinking becomes more prevalent when individuals or groups become anxious in a very uncertain environment. The "magic" helps to restore a sense of control. In the present case a crowd of analysts, economists and market pundits appear to have engaged in group think and in effect have said, "we believe economic growth will accelerate. We want economic growth to accelerate. Therefore it will accelerate." Unfortunately, when reality eventually pushes aside the veil of magic, the

collective consciousness turns from wishful thinking and hope to doubt and despair. This is what happened following May's disappointing employment report, continuing softness in regional ISM manufacturing indices and no evidence of improvement in the housing sector. Fears of a renewed recession were immediately rekindled.

Just as the strength of the economic expansion was exaggerated, so too have been the recent claims that the economy is on the brink of recession. Leading indicators do not suggest that a decline in GDP is imminent. There will be another recession, of course, but it is highly unlikely that one will occur during the next six months. Measures of employment, consumer spending, and signals coming from sensitive "real-time" indices of business activity, however, argue for a relatively subdued pace of growth going forward. Our guess would be something on the order of 2%+ rather than the 3%+ figure that until quite recently represented the consensus. Considering the financial problems facing the Eurozone, growth in the region will probably be less than 2%. The emerging regions of the world should continue to record higher growth rates, but here, too, the pace of growth is likely to decelerate.

Prospective Returns from Stock and Bond Indices.

We noted earlier that the U.S. and the developed world remain over-indebted and under-capitalized. Markets have not been allowed to clear and the de-leveraging or debt reduction cycle for both private and public sectors has further to run. It is probable, therefore, that economic growth will remain subpar for quite some time. Emerging economies will probably continue to grow much faster, but their share of global output is much smaller which means that their contribution to total global growth will not be enough to completely offset the drag from the developed regions.

There is a correlation in the long run between economic growth and stock market returns. Slower economic growth suggests slower revenue growth, slower profit growth and potentially lower returns from common stocks on average unless profit margins expand. Profit margin trends in the Standard & Poor's Industrials have exhibited a certain amount of cyclicality in the past and a tendency toward mean reversion. Since profit margins are currently near historic peaks, we should conclude that little improvement is in store.

Since WWII, according to Ned Davis Research, U.S. GDP growth and corporate profitability, while not a perfect fit, has proven to have a meaningful positive relationship.



For planning purposes, investors should probably consider a mid single-digit total return number to be a baseline estimate for balanced portfolios.

Nominal GDP growth has been trending lower since 2000 and at the end of the first quarter equaled 4% year-over-year. A significant improvement does not seem likely based on available evidence. Total personal income and disposable personal income are growing at 4.0% and 3.4% rates respectively, considerably below trends in place before 2007. Real (inflation adjusted) hourly earnings, year-over-year, were -1.6% at the latest reading. The personal savings rate was consistently above 7% until the mid 1980s when it began a steady decline, reaching a low of 1% between 2005 and 2007. It spiked to 7% during the recession and has averaged about 5% since, roughly equivalent to the savings rate in the mid 1990s. In the long run, more saving ultimately means more investment which is a good thing. In the short run, however, more saving means less spending and that's not so good in a consumption driven economy like ours.

The weight of evidence argues for moderate growth at best in the U.S. and in the developed world generally because of shared circumstances. Corporate profit growth, on average, is also likely to slow going forward, particularly in comparison to the surge since 2008. Valuation measures that incorporate elements of the economic and profitability series discussed here indicate that stocks in general are no better than neutrally valued at present. Neutral value in a slow growth environment suggests low to moderate single digit gains in the primary capitalization weighted indices. As an illustration of what to expect using a cyclical time frame of 3 to 5 years, we show in the attached illustration our guess where the price of the S&P 500 Index will be four years from now based on a compilation of these valuation models. We asked Crandall Pierce to include brackets at the four year line on their Stock Market Recovery Monitor Chart to mark our price range estimate. Not including reinvested dividend income, the Standard & Poor's 500 Stock Index (price only) might still be anywhere from 5% to 12% below its previous high in 2007. If we add dividends to the expected 2% to 4% annualized price appreciation range shown in the chart for the S&P 500 Index, we get an estimated total annualized return range of about 4% to 6%. This estimate says nothing about the path of the index from here to there, nor does it

suggest that individual stock performance will be similarly constrained. Some issues will move on to new highs. Others will decline to new lows. Selection by region, sector, industry and security will remain the key driver of equity portfolio returns. In all probability the secular bear market which arrived following the technology bust in 2000 will still be with us, but hopefully aging rapidly.

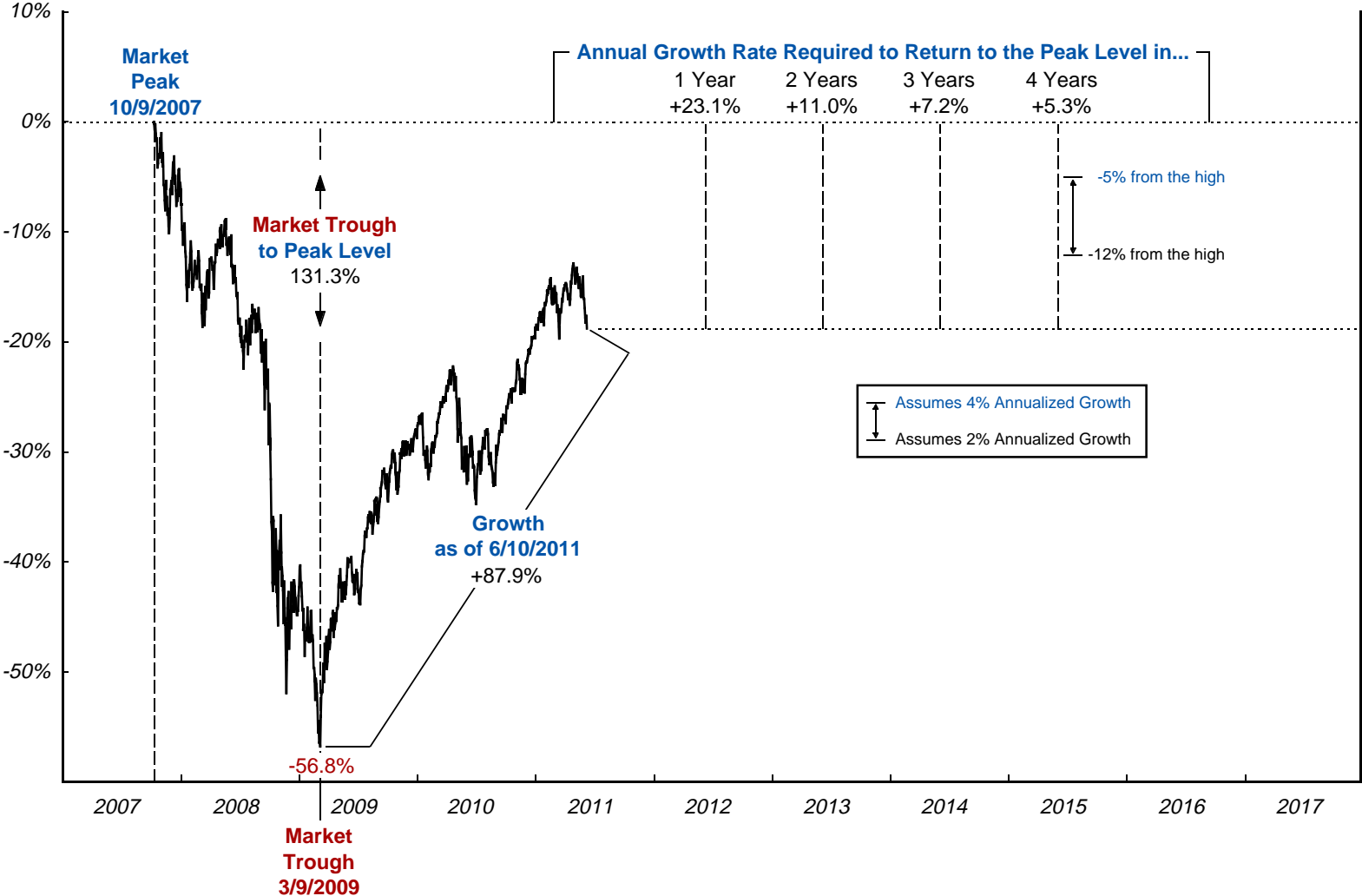
Bonds usually deliver competitive returns versus common stocks during secular bear periods. That has certainly been the case for the Barclays Intermediate Term Bond Index. For example, its total return was 6.1% annualized from 12-31-2000 through 6-30-2011 compared to .90% for the S&P 500 Index. We don't expect a similar return spread during the next several years. The current yield on intermediate to long-term high quality taxable bond index portfolios ranges from about 3.5% to 4.0%. Assuming that inflation remains relatively stable with moderate economic growth the norm as we muddle through in the aftermath of the crash, the current yield might be a good approximation of future total returns. So, expected total returns from diversified, high quality bond portfolios between now and 2015 might be around 4%.

The accepted asset mix policy for investors willing to accept a moderate amount of risk in the quest for long-term capital growth has been 60% stocks/40% bonds. This mix seems to be a reasonable policy decision given current valuations and the probable path of economic growth. The implied total return for the next four years derived from this buy-and-hold index portfolio strategy would be approximately 5.0% using the S&P 500 Index to represent the equity portion and a representative high-quality fixed income index fund for the bond portion. Better returns might accrue to actively managed portfolios, but for planning purposes, investors should probably consider a mid single-digit total return number to be a baseline estimate for balanced portfolios.

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Stock Market Recovery Monitor

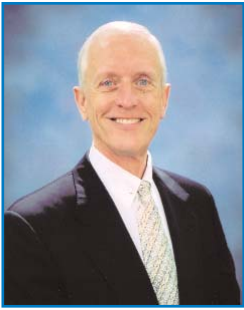
Standard & Poor's 500 Stock Index



Annual growth rate data over one year is expressed as a compound annual rate.

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John, a Chartered Financial Analyst, sets and manages investment policy and strategy for Hancock Horizon Investments (HHI). He manages the Hancock Horizon Quantitative Long/Short Fund and oversees the day-to-day activities of the Hancock Horizon Diversified International Fund. Prior to joining HHI in 1998, John served as Chief Investment Strategist for First Commerce Corporation and as portfolio manager for the Marquis Growth Equity Fund and the Marquis Value Equity Fund. He has over 37 years of investment experience including investment management responsibilities at Wachovia Bank where he specialized in endowments, foundations and charitable trusts. At NationsBank, he introduced quantitative investment techniques in the management of institutional portfolios. He received his B.A. in Economics from Rhodes College in Memphis, Tennessee, in 1962.



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