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# Market Commentary

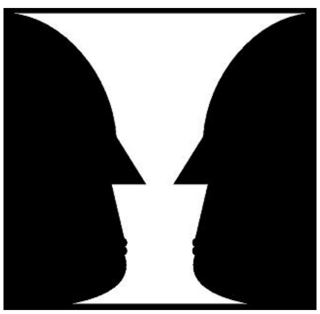
A Review of the Markets and a Look into the Future

## Perception vs. Reality

"Reality is nothing but a collective hunch."

-Lily Tomlin

**What does the image below look like to you?**



Some swear it is a vase, while others are just as sure they see two men looking at each other. But which is the reality? Perception is just an opinion of reality, after all. Or is reality just a perception?

We don't want to get too deep into this. We're financiers, not philosophers. But it does help us understand how so many "experts" can look at the economic situation, which is much more complex than the image above, and see such different things. Halfway through 2010, here is our perception on where things stand.

### Economy: A Summertime Cooling

The heat of summer has brought with it a cooling in the economic data. GDP growth in the first quarter has now been revised down to 2.7%. While the unemployment rate did fall in June, from 9.7% to 9.5%, it was widely seen as part of a bad overall jobs report. The labor force shrunk as a large number of people simply gave up the job search. The employment-to-population ratio fell to 58.5%, which is close to the 25-year low of 58.2% reached last December. Some commentators are getting spooked and throwing around terms like "double dip," or, in the case of the New York Times' Paul Krugman, even the D-word (Depression). Others have raised the possibility of a lost decade along the lines of Japan in the 1990's.

We feel this is an overreaction. With inventory levels having been built up from their low levels of 2009 and stimulus dollars fading, it was expected that mid-year growth would decelerate. That is what we are seeing. From our point-of-view, the recovery has entered a soft patch but still appears self sustaining. A period of slow domestic growth may follow, but a lost decade like Japan's seems unlikely. The U.S. economy is much more flexible than that of Japan, where lifetime employment and a web of corporate and government alliances helped prevent timely adjustment.

Much of the current economic worry may be, like our picture above, simply a matter of perspective. For example, some bemoaned the Institute of Supply Management's manufacturing index decline to 56.2 in June. But being above 50, it still indicates expansion. How strong that expansion might be will depend on demand, and about that there is difference of opinion as well. One issue economists do not seem to agree on is whether the best policy stance right now is for continued stimulus, or deficit reduction and austerity such as Europe is pursuing in the wake of the Greek sovereign debt crisis.

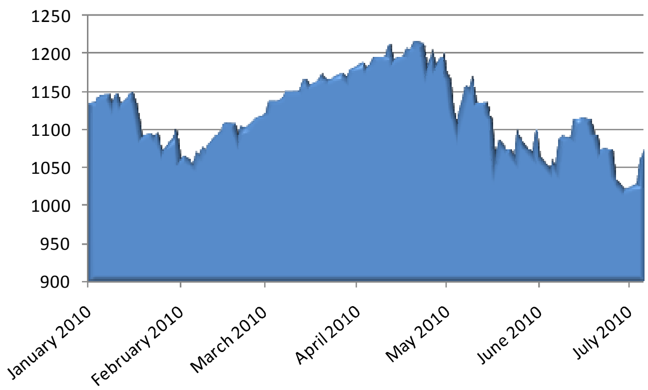
Will the Bush tax cuts be allowed to expire, or partially expire? Will the Federal government help states and localities facing budget difficulties? The answers to these questions have important implications for the level of demand in the economy. Uncertainty about them causes businesses and consumers to pause, which shows up as a flat spot in the economic data, such as we see now.

We feel the lesson to take from this is that it points up the importance of being globally diversified. Many of the economic challenges facing developed nations – such as slower growth, heavy debt and aging populations – have offsets in emerging nations like China and India. Thanks to these, the global growth outlook remains impressive, and that is a reason for optimism.

### Stocks: Opportunities at Home and Abroad

Despite strong first quarter earnings reports, as of this writing the S&P 500 stands some 5% below where it began the year (see Figure 1 on the next page). News of Sovereign debt problems in Europe, in particular, roiled the markets in May, and June was not much better, though July has, thus far, brought some welcome buoyancy.

*Figure 1. The S&P 500 in 2010 (Adjusted close, source: Yahoo! Finance)*




The mid-term elections may bode well for a lessening of uncertainty and continued upward momentum. There is an interesting history here. Perhaps reflecting Americans' distrust of concentrated power, the party opposing the sitting President has typically done well in mid-term congressional elections. The stock market has done well too. Since 1950, the average increase from July 1 of a mid-term election year to the following June 30 has been 21%. This has held under both Republican and Democratic Presidents. In light of this fact, and the weak performance we have seen so far this year, impressive gains may be coming our way as long as the economy avoids a double dip. Good returns should be possible even with mild second half economic growth. Deep cost cutting by firms during the recession has left them with strong margins. Even modest revenue growth should allow for good earnings if costs are kept under control.

Looking overseas, the European market is down in what may be a classic overreaction to the bad news of sovereign debt problems. The unified response from the EU has been impressive, with strong nations such as Germany agreeing to help and afflicted nations such as Greece acceding to demands for financial austerity. As long as Europe does not fall back into recession, European equities could be poised for impressive returns in the second half of the year. Bank stress tests to be published in late July could mark a turning point, assuming they go well, as they did for the U.S. in 2009. The risk is that the EU's focus on austerity, while admirable, could cut into an economic recovery that is more fragile than that in the U.S.

Asian markets also offer opportunities that we like. Chinese markets are trading at some of their lowest earnings multiples in years. Likewise, Korean markets near 10 times earnings appear to offer solid picks. Overall, we feel equities offer good possibilities at home and abroad now.

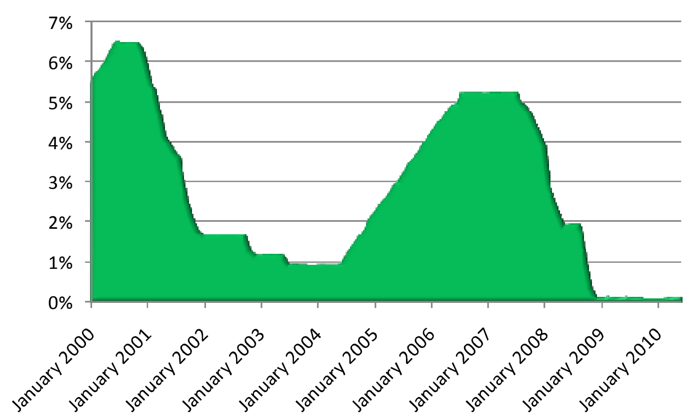
### Bonds and Interest Rates: Sticking with High Yield

The recent cooling in economic data has meant a lack of upward pressure on interest rates. In fact, yields have declined, especially at the long end of maturities. Cash rates remain close to zero. In June, the Federal Reserve Open Market Committee met and voted 9-1 to hold rates steady. Figure 2 shows the interest rate which the Committee watches most closely in its policy making – the Federal Funds rate. The chart shows a marked decline since 2007, when the Federal Reserve began steadily lowering rates as the economy fell into recession. In 2010 this rate has gotten so low you may need to squint to see it!

The day that the Federal Reserve reverses course and starts ratcheting up rates will come. But it will likely be well in the future unless there is an upside surprise on growth. With the most recent meeting occurring in the wake of Europe's debt problems, the Open Market Committee noted that "conditions have become less supportive of economic growth on balance, largely reflecting developments abroad." Given statements like this, the first rate increase from the Committee will be a big step, and we might not see it before 2012.

We will see effective tax increases as a result of the new healthcare and financial legislation, as well as expiring cuts. One positive aspect of this is that it may allow the Federal Reserve to be less aggressive in raising rates, since any unwinding of the stimulus that occurs on the fiscal side is that much less that needs to be done on the monetary side.

*Figure 2. A Key Interest Rate: 2000-2010 (Effective Federal Funds Rate, source: Board of Governors of the Federal Reserve System)*




With high quality offering such low rates now, high yield corporate bonds continue to be an excellent alternative. We believe corporates are a good place to ride out this slow patch in the domestic recovery. Our recently published white paper, *Seeking the Best of Both Worlds: Why a flexible fixed income strategy is important*, goes into more detail on how we allocate our fixed income investments in different rate environments. Feel free to contact us to request a complimentary copy.

### Financial Regulatory Reform

The regulatory reform talked about so much the past couple of years is coming close to fruition. Christened the Dodd-Frank Wall Street Reform and Consumer Protection Act, the bill's final details continue to be hammered out. Some commentators have already nicknamed the legislation Frank-n-Dodd. Having passed the 2,000 page count, perhaps it is a fitting moniker. New paperwork requirements, not to mention jobs for corporate lawyers, are a sure bet. The legislation could also result in a 4-17% hit to large-cap bank earnings in 2012, according to a Morgan Stanley report. But the real worry is whether the reform could crimp the lifeblood of credit that the economy needs in order to grow.

Many of the details remain to be determined. Specific rules will still need to be written even after passage. And considerable leeway will be given to regulators as to how the rules are applied. Keeping this in mind, let's consider some of the aspects most likely to be in the final bill.

- Greater transparency and collateral requirements in derivative markets.
- Hedge funds will fall under SEC regulation.
- Some version of the "Volcker Rule" will restrict banks' abilities to make risky investments on their own behalf.
- Financial firms deemed too big to fail will have to create resolution plans by which regulators could close and unwind them without threatening the entire system.

On balance, this bill contains some reasonable provisions and is far from an industry killer. It is probably much less radical than what might have resulted if it had been passed in the immediate aftermath of the 2008 credit crisis. It is nice to know that legislative inertia can sometimes work for good!

Instead of stifling credit, once the final bill is signed we feel it may, along with mid-term elections, help reduce uncertainty and spur credit and stock market gains.

### The Dollar and Commodities: False Hope from China

China generated some excitement in June by announcing that it would revalue the yuan. In last quarter's commentary we wrote about the need for the yuan to appreciate against the dollar. This would make Chinese goods more expensive to the U.S. and U.S. goods cheaper to China. It would help reverse the trade and debt imbalances between the two nations. Unfortunately, results disappointed as China let the yuan rise only slightly against the dollar (and somewhat more against the Euro) before stabilizing it.

The dollar has benefited from European uncertainty by becoming, somewhat surprisingly, a quality haven. While this may continue, we are not anticipating any major moves up or down in the near term.

On the commodities front, energy and infrastructure materials appear to have a good outlook thanks to a still-impressive world growth scenario. For example, Goldman Sachs recently revised China's forecasted growth for 2010 downward by 1.3%. That sounds unsettling until you realize that it is from 11.4% to 10.1%. And the Brazil forecast is up for 2010, to 8.3%.

Upside surprises in growth, especially in the developed nations, could result in strong upward movements for energy and infrastructure. The Gulf oil spill does not appear to have had a big impact on oil prices, which have been trading in a comfortable sub-$80 range. It does create potential legal and regulatory risks, but these would probably be felt more in equities than in oil as a commodity.

Gold is trading near record nominal highs. Further rises might require evidence of inflation or greater general uncertainty.

### The Bottom Line: Focusing on the Long Run

Now you know our perception of where global financial reality stands at the moment, and how it may move in the second half of the year. The thing about perceptions and reality is that neither exists in a vacuum. Changes in one impact the other, so that there is a constant adjusting between the two over time.

The good thing is that while different observers may have different perceptions in the short run, in the long run there are objective measures we can all agree on. As these appear, those who perceived correctly ahead of time will reap the benefit of financial returns, while the perceptions contest simply ratchets ahead to the future. The most important thing to keep in mind as investors is that a disciplined, long run focus is the most likely to be rewarded.

These remain volatile times, and we will continue watching the situation closely in order to respond quickly to any changes in outlook. As always, we send thanks to those of you that are our clients. We value the trust you have placed in our firm and we sincerely appreciate your business. If you have any questions or concerns, please do not hesitate to give us a call.