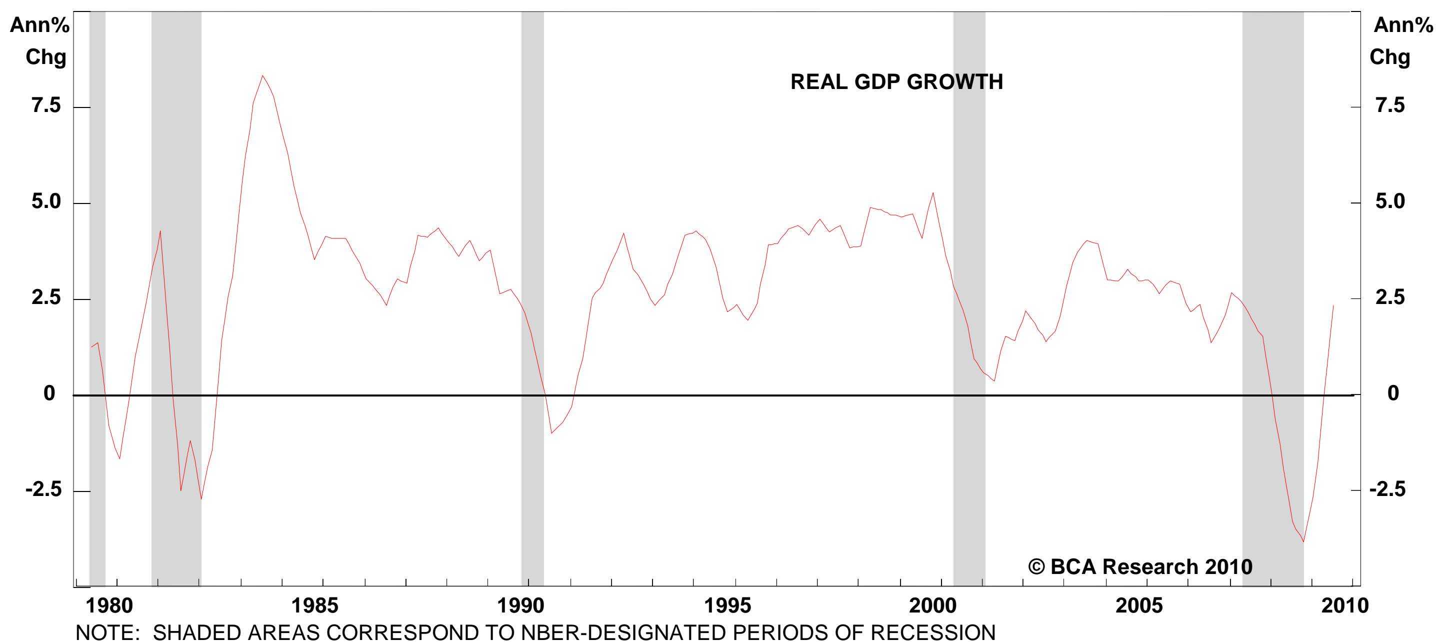
Economic & Market Commentary

Fear made a comeback in the second quarter. Beginning in May, the events in Greece and the rest of Europe abruptly reversed the year long rebound in stocks and the U.S. market ended the quarter 15% below its late April peak. The fear that these events would abort our economic recovery and lead to another recession was not confined solely to the U.S. Only 8 of the 65 worldwide equity markets monitored by Dow Jones had positive results during the period. This powerful reversal pushed most of these markets, including ours, into negative territory for the first 6 months of the year.

There was a virtual avalanche of bad news that pushed stocks lower, starting in May:

- the Greek mess focused attention on other weak countries in Europe – Spain, Portugal, Italy, Ireland, among them
- the Euro collapse and resultant fiscal reform called the European economic recovery and survival of the common currency into question
- the two Koreas rattled sabers
- the Gulf of Mexico oil disaster gets worse with the passage of time
- the so-called “Flash Crash” in the US markets on May 6 did little to bolster investor confidence
- the daily news about the US economy has been lackluster at best, and certainly calls into question the sustainability of our recovery
- the policy measures espoused by the administration are not pro-growth, and have a heavy anti-business tone.

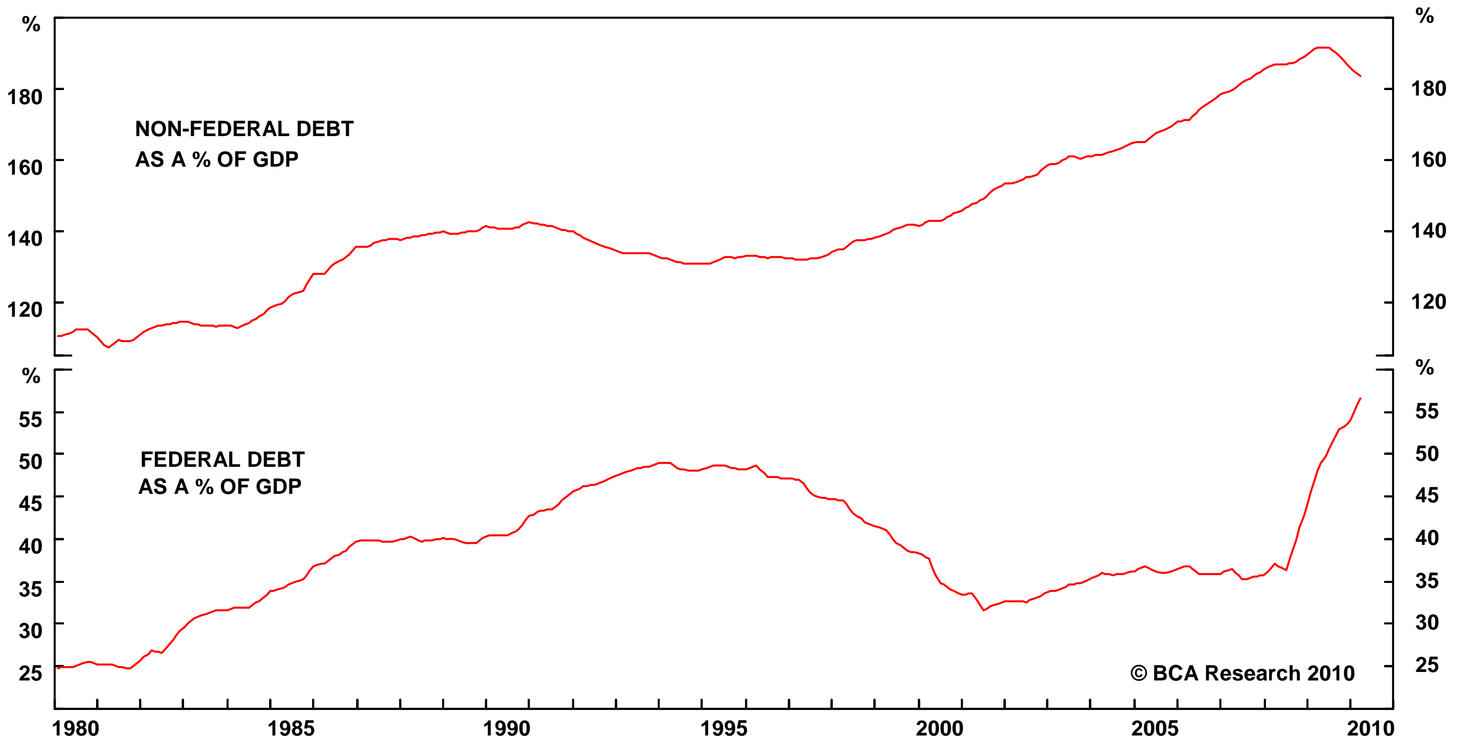
The cascade of negativity has obviously spooked investors, calling into question the sustainability of the economic recovery, and heightening the fear of a “double dip”. The most recently reported economic data feeds this view.



NOTE: SHADED AREAS CORRESPOND TO NBER-DESIGNATED PERIODS OF RECESSION

Q1 GDP was originally reported at +3.2% and subsequently revised downward to +2.7%. The June employment report was disappointing, with non-farm payrolls (adjusted for the census worker decline) growing more slowly than prior months, and both weekly hours worked and average hourly earnings declined. We, too, have been affected by the news of the past several weeks. Our view had been of a modest, sub-par recovery continuing for the next few years, at a pace below the standard forecast. Recent news and data however have increased the odds of a rollover or “double dip”, in our opinion. We are not yet ready to “throw in the towel”, and still hold the belief that we will have subdued, positive economic growth going forward.

The ramifications associated with a double dip are very serious given the high level of debt in the U.S. economy. Although non-federal debt has started contracting since the prior peak in economic activity, these borrowings are being offset by an explosion in federal debt that it unsustainable. The ability for the Federal Government to expand fiscal stimulus in a slowdown is very limited. See chart below.



Our viewpoint on the important components of economic activity is as follows:

Consumer Spending – has remained surprisingly strong during the first half in spite of all the well-known problems facing the sector, which we discussed in the first quarter report. Transfer payments and lower tax collections have been a significant part of this consumer strength. Government stimulus, and transfer payments will diminish as we go into the second half. Unemployment benefits have not been extended, and the auto and housing programs have ended. Stock prices are down, and housing could well suffer another relapse, denting consumer balance sheets, which could well push the savings rate higher than the modest 4% level currently. Consumer leverage has come down, but it remains well above where it should be. The hope is that employment growth gets back to the 200,000 per month level with hours worked and hourly income increasing to produce disposable income offsetting these other factors. On balance we expect consumer spending to be less robust for the balance of the year, and not be the strong contributor as it has been in the last 18 months.

Business – inventory change has been a plus, and with the supply chain stretched, it should continue to be for the rest of the year.

Capital Spending – has been strong for business fixed investment and equipment and software. The search for productivity enhancements should continue to push spending here for a while longer and corporations have the financial resources to make the investment.

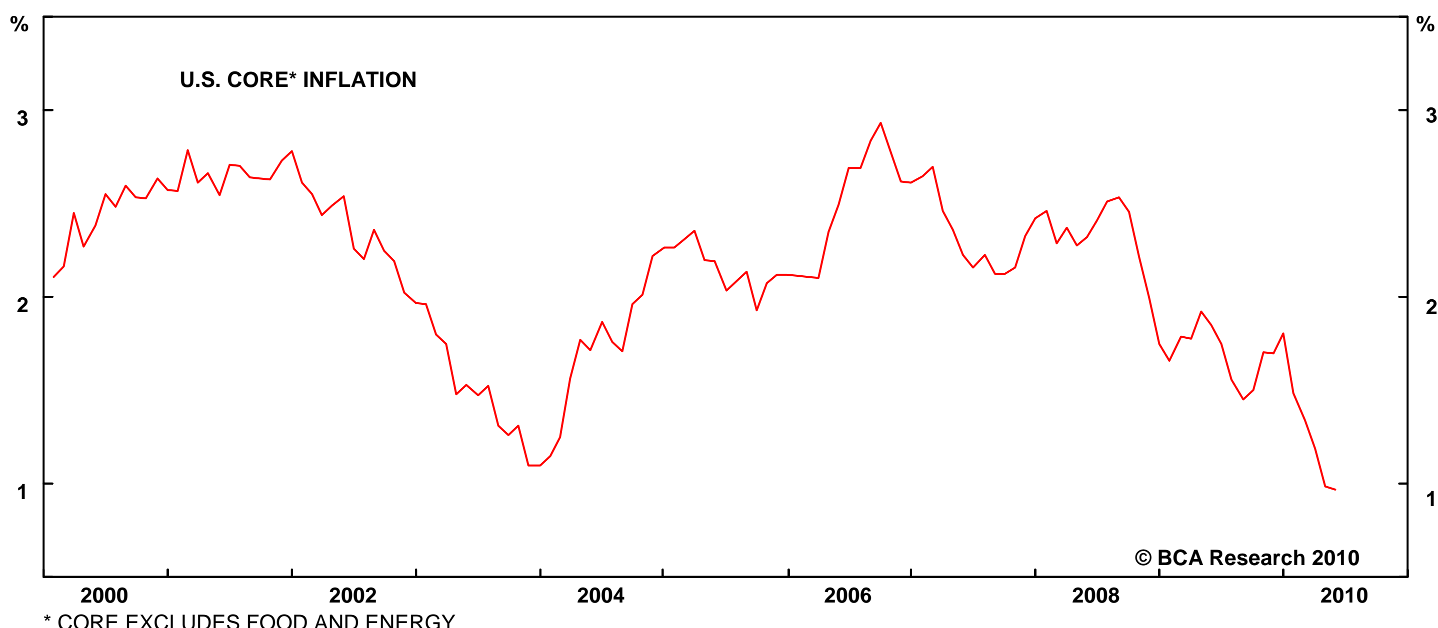
Exports – had been a positive influence in growth during the early part of the recovery. This moderated in Q1. With the stronger dollar looking more long lasting, and the Euro weakness and the Chinese Renminbi strengthening, the net export picture may not be as bright going forward as we had hoped a few months ago.

Europe – The events in Europe since mid-May have caused speculation about the possibility of a double dip recession there and its impact on U.S. growth. A default and/or spread of economic and financial problems in Portugal, Italy, Ireland, Greece and Spain (the so called PIIGS countries) would certainly heighten the fear factor in the U.S. However, only 3% of U.S. exports are shipped to those 5 countries. The whole of the Euro-zone accounts for 15% of our exports, with another 5% going to the U.K. Most economists conclude that a renewed slump in the PIIGS or the whole of Europe would have a minor impact on U.S. growth. They cite the fact that Europe's contribution to the increase in global growth has been only 4%. A more important factor would be a sovereign default, which spreads through the worldwide banking system, and creates asset deflation and/or liquidity problems similar to the fall of 2008. This could spread fear and reduce the private sector's propensity to spend.

China – is a much more important player on the world scene than in past economic cycles. Most expect China and the rest of Southwest Asia to be the locomotive in this recovery. After all, China accounted for 37% of the world's economic growth over the past 3 years. An upward revaluation of the RMB would make imports less expensive and could encourage Chinese consumers to spend more of their large pool of savings. In the meantime, it appears that the Chinese economy is slowing, which could be problematic for us. However the slowdown may be as benign as going from +9% to +7%. This obviously demands watching.

Policy – the policy measures coming out of Washington are anything but pro-growth. The list is long and growing: taxes going up; free trade stalled; the end to secret ballots in union elections; shareholder say in pay and directors; health care reform; energy and financial industries as whipping boys – these and others hardly encourage growth. Policy measures are part of our thinking about growth over the next several years, and at this point they do not appear positive.

Putting this all together, we are inclined to lower our expectation for real growth during the rest of the year. We wrote in April that a below average pace of growth, say +2-3%, was our expectation. We now feel that a more likely scenario would be +1-2%. We still think there will be growth, but the rate should diminish for the reasons stated previously. The fundamentals of the economy are still positive, so we are not ready to throw in the towel and move to the double dip camp. That type of recession has occurred only twice in the post-war period according to economic historians – the early 70's and the early 80's. In both cases there were significant negative shocks to the system – oil in the 70's and Volcker's inflation fights in the 80's. In the current environment, inflation is not a problem given the slack capacity in labor and production.

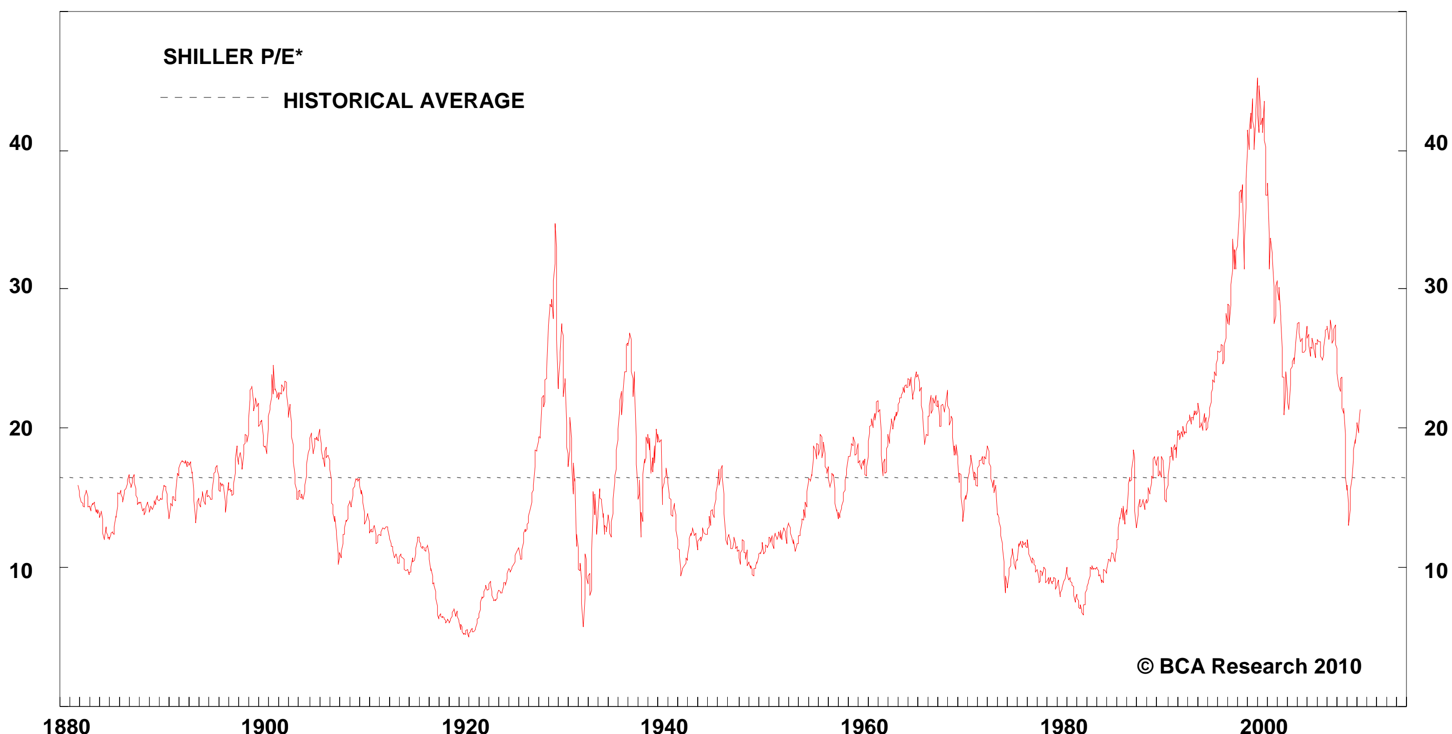


* CORE EXCLUDES FOOD AND ENERGY

Absent a similar exogenous event (e.g. financial contagion from Europe) we think growth should continue. Interestingly the Conference Board's Leading Economic Index (LEI) normally a reliable data point, is still growing. The latest report (May) grew, albeit at a reduced rate. Finally the June survey of financial economists published by Bloomberg reported the median and average forecast for the balance of this year of +2.8 – 3.0%. So the consensus view is positive, yet higher than we think most likely.

Profits have been the real bright spot so far this year. First quarter reporting season was about as good as it gets, with 80% of the S&P 500 index companies beating their already bullish estimates (according to Standard & Poor's). We are again, in another earnings reporting season which should also be good. Q1 was probably the peak rate of change quarter, but the second quarter should also produce well above average operating leverage and growth. Early reports confirm this. In April, we felt 2010 S&P pro forma earnings could be close to $75; this is probably now too low and could come in closer to $80. These estimates, by the way, are below the consensus numbers reported by Bloomberg.

The decline in the equity market during the past 2 months, while earnings continue to move ahead, has put the S&P 500 at 12x-13x – modestly below what could be considered "fair value" based on current earnings; however, based on normalized trailing earnings valuations are slightly above average.



*REAL S&P 500 DIVIDED BY THE 10-YEAR MOVING AVERAGE OF REAL EARNINGS. NOTE: EARNINGS CALCULATED ON AN AS REPORTED BASIS.

In addition, the rush to shed risk, causing a 180 degree shift from the first quarter, has compressed the range of P/E multiples dramatically. UBS reports that the dispersion of multiples is extremely tight, in fact close to the all-time low. This should increase the number of candidates for stock selection, which we think it does. The problem is that, as discussed earlier, risks have heightened. The bumps in the road have become larger and more frequent, and volatility has increased. As we wrote in April, ongoing equity performance will be highly dependent on earnings rather than P/E multiple expansion. Earnings are harder to forecast at this stage of the cycle, and the penalty for being wrong is high. In addition, our expectation on the pace of economic activity is slower than the consensus, and therefore if true has a negative connotation for stocks. As always, this means our focus on earnings and their progress will have to be sharp, as we look for productive ideas. It also implies we should err on the side of quality and perhaps be more conscious of defense as opposed to offense until we have greater clarity.

Fixed Income Review and Outlook

As the equity markets reacted negatively to the various economic and geopolitical events described earlier, the bond market (especially US Treasuries) provided a safe haven for those who wanted to escape from the risks of Greece, the decline in the Euro, and the whispers about double dip recessions and deflation in the US. The Barclays Aggregate Bond Index returned 3.49% during the second quarter, with Treasuries performing best at 4.68%. Long Treasuries, with maturities of 20 years or more, generated an astounding 14.71% for investors during the quarter.

From the beginning of April, Treasury yields headed lower as investors sought refuge from the perceived risks of Europe. Two year Treasury yields reached an all time low of 0.58% in late June. Ten year yields broke through the psychologically important 3% level at around the same time and the yield on the long bond, or 30 year Treasury, fell below 4%. Only during the financial crisis of late 2008 have we seen bond yields this low.

Agency securities, such as those issued by government sponsored entities (GSEs) such as Fannie Mae and Freddie Mac underperformed Treasuries during the quarter as investors sought the guarantee of the US Government that backstops Treasuries rather than the implied guarantee behind Fannie Mae and Freddie Mac. Agencies also issue significant amounts of callable securities which tend to underperform in a falling yield environment as attractive bonds are usually repurchased. The agency sector returned 2.54% to investors during the second quarter.

Corporate bond spreads widened during the quarter as fears of an economic slowdown worried investors that earnings could be weak. However, corporate spreads were not nearly as sensitive as stock prices to concerns about a slowing economy. This coupled with the significant rally in Treasury bonds resulted in strong performance for corporate bonds during the second quarter. Corporate bonds returned 3.42% for the quarter, roughly in line with the Barclays Aggregate Index. Credit quality was largely irrelevant during the period as all investment grade categories returned between 3.2% and 3.6% for the quarter.

Mortgage backed securities underperformed the Aggregate Index during the second quarter as lower interest rates gave homeowners the ability to refinance mortgages. As mortgages are refinanced, these prepayments cause portions of mortgage backed securities to be redeemed at par. Since most bonds now trade at prices well north of par since Treasury yields are so low, these prepayments will cause investors who have purchased bonds at a premium (above par) to lose money. This was the case in the second quarter for mortgage investors. While mortgages generated 2.87% for investors during the quarter, their performance was worse than that of corporate bonds or Treasuries.

The municipal bond market underperformed Treasuries as investors worried about the relatively poor condition of state and local economies coupled with increased bond issuance to fund economic shortfalls. These twin fears caused munis to fall short of the returns of all other sectors of the bond market. Nevertheless, municipal bonds still returned 2.03% to investors during the quarter.

For the rest of 2010, we expect the bond market to trade in a relatively narrow range. This is a change from our forecast earlier in the year of higher interest rates. While we still believe that the need for the US Treasury to issue securities to fund its deficit will likely push bond yields higher at some point, the fears of a slowing economy both here and abroad and other risks around the globe are likely to keep yields from spiking. We also expect inflation to remain benign for the balance of 2010.

As fears of a recession grew in Europe and concerns about discontent in places such as Korea and Thailand increased, the US dollar proved during the second quarter that it remains the world's reserve currency. When investors buy dollars, they often invest them in Treasuries. This demand is likely to keep rates from rising significantly in the near term. If this demand ends abruptly at any point in the near term, the Treasury market could experience a significant selloff as investors return to foreign currencies. Absent this event, we expect flat to slightly higher Treasury yields going forward.

As for other sectors of the bond market, we expect investors that are seeking slightly higher yields without credit risk to consider both agencies and mortgages. This could result in slight outperformance for agencies. Mortgages are still likely to lag as very low absolute yields will continue to accelerate prepayments. Corporate earnings are likely to drive

performance in the corporate bond market over the rest of the year. Spreads over Treasuries have widened throughout the year in large part because of the relatively better performance of government bonds. While spreads are wider, absolute yields on corporate bonds are relatively low. As a result, corporate bonds are less appealing to investors than they were a year or so ago when the financial crisis caused spreads to increase to historically wide levels. We expect corporate bonds to perform more or less in line with Treasuries over the balance of the year. Finally, the ongoing battle between concerns about fundamentals and the desire for tax-advantaged income will continue to drive the municipal bond market. Fundamentals caught up to technicals a bit in the second quarter as the market underperformed. Future results will likely be based on how states and municipalities address their budgetary issues. We urge investors to take caution in the municipal bond market and focus on high quality, diversified exposure to this sector of the bond market. We expect continued underperformance in the tax-exempt bond market and could see negative returns in certain securities with ratings of A or lower.