

Economic & Market Commentary

Just as in each of the past 5 years, the US stock market experienced a late spring swoon in the second quarter. From late April to June 15 stocks were down about 7%, as Alfred E. Neuman (“what, me worry?”) was banished and renewed fears of a “double dip” recession appeared again on the scene. The S&P 500 ended the quarter about flat, while other stock market measures hovered between $\pm 1-2\%$. Most bond indices posted gains in the 3% area for the same period. During the final week, with a temporary resolution of the Greek debt crisis seemingly in hand, stocks rallied about 1.5% closing the first half with gains of 5-6% for the most common measures. Once again, it was a period where investors’ risk appetites changed frequently, which can create both opportunities and risks for investors with longer time horizons, such as ourselves. Large company stocks did better than small or midcap stocks during the quarter, not quite catching up for 6 months. Growth stocks continued to outperform value and cyclical issues, as has also been true for the year to date. These are trends we had been anticipating and we expect them to continue for the balance of 2011.

The “Great Recession” was officially declared over in June 2009, so we are 2 years into the recovery – and a weak recovery it is. Annual real GDP growth has averaged +2.8% since, just over half the annual average of all post war recessions. Virtually all data points used to monitor recoveries show similar or worse results: jobs, personal income, personal spending, home prices, are all well below their average pace of recovery. Most of the data reports do indicate an upward trend and point to indications of sustainability; however, we seem to be in a two steps forward, one step back pattern (witness the recently released June jobs report which was dreadful). As a result, most observers and economists have reduced their projections for economic growth in the second quarter and the year as a whole. First quarter real GDP growth was +1.9% and second quarter had been expected to be over +3%. Current expectations are being brought down below +3% and full year expectations are following. For example, the Federal Reserve has lowered its forecast for the year from +3.1% - 3.3% to +2.7% - 2.9%. These reduced expectations are not surprising to us, as they match ours. We have described in the past several quarterly commentaries that the most likely scenario is for sluggish, erratic, below trend economic growth for the foreseeable future. We continue to hold that belief.

The different segments of the economy are developing about in line with our expectations. Business investment has been a strong point, as corporations have strong balance sheets and are willing to spend on productivity enhancing projects. Consumers have continued to spend in spite of high unemployment, slow income growth and expanded savings. Their balance sheets are slowly improving as the pace of deleveraging quickens, while the decline in housing prices slows and financial asset values increase. It should be noted that high income consumers are doing substantially better than low income individuals, who are struggling with job losses and inflation.

Exports have been strong (thanks to a weak dollar and growth outside the U.S.) and, in fact, are one of the few data points that are above its historic average for past recoveries. Unfortunately, exports have not been a net contributor to economic growth. Imports, which are larger than exports, have matched the pace of growth, so the net export figure has been a drag. Residential investment has been a large drag, but going forward should be less so as its relative importance to the economy is approaching historic lows. Government expenditures have declined recently, as stringency exists at the federal, state and local levels.

We are at an important juncture as we enter the second half. It has been estimated that close to \$1.2 trillion in fiscal stimulus has been injected into the system since President Obama took office. The Fed has cut interest rates to near zero, and in two rounds of quantitative easing (QE), ballooned its balance sheet to \$2.9 trillion from \$800 billion in 2008 with the purchase of securities. And still, the recovery is tepid. QE2 ended June 30, and there will be significantly less stimulus in the second half. In addition, the many risks we have discussed in previous outlooks remain, any of which could have a significant negative effect on growth.

- Employment growth is the key to the economy remaining on a self-sustaining path. The data have been modestly positive, at least until the recently released June report. This demands watching. If we don’t get stronger job

- growth, the US economy would be in trouble.
- An additional \$20-\$30 spike in crude oil prices would be a negative. The likelihood of this happening in the near term seems low. Unrest in the mid-east has calmed and the slowing pace of economic activity around the world reduces demand. Hence, our baseline forecast does not anticipate a spike.
 - According to the Case-Shiller index, housing prices have now declined further than during the Great Depression. The good news is that the pace of decline appears to have slowed and there even are some pockets of strength in parts of the country. A further significant decline would injure both consumer and bank balance sheets, would be negative.
 - The deleveraging that began a few years ago continues. Household balance sheets are deleveraging more quickly than expected. This is partially due to non-recourse mortgage loans that allow homeowners to walk away from foreclosures and negative equity, transferring the liability to banks and taxpayers. In addition, the rise in financial assets has rebuilt that side of the household balance sheet. On the other hand, the improvement in the household position has been more than offset by the expansion of government debt, so the net result we are still in a highly levered position. This must be corrected.
 - How we solve that problem, of course, is the topic of negotiations now ongoing in Washington, concerning the Federal budget, the deficit and debt limitations. These discussions have an early August deadline before a potential Federal default occurs. The path we are on now is not acceptable. Government debt close to 100% of GDP, a budget deficit of 9% of GDP and interest payments that absorb close to 10% of tax revenue (the average cost of Treasury borrowing is 2.5% compared to the average of 5.7% for the last two decades) is not sustainable. The unspoken additional problem of trillions of dollars in unfunded Social security and Medicare obligations create a difficult dilemma. If a compromise is reached to mollify this problem, it will certainly mean less stimulus going forward. Some combination of spending cuts and tax increases will surely be proposed, both of which are anti-stimulative.
 - Finally there is the Euro zone issue which could spread beyond Greece and cascade into another major financial crisis. Italy seems to be the most recent addition to the list that includes Ireland, Portugal and Spain. This could have an unsavory shock effect, and be tragic.

We had said in prior writings that we thought both the economy and the markets would be okay until mid year. We are at that juncture and close to an inflection point. We noted earlier that fear of a double dip has returned to the radar screen. We do not think we are there yet. The usual fundamentals presaging a recession are not present; the Fed is friendly, rates are low, the yield curve is steep, liquidity is more than ample, inventory accumulation is not significant, the leading indicators are still positive, etc. We are concerned that any of the risk factors mentioned earlier could serve as a tipping point for economic activity. With reduced stimulus, these have probably raised the odds and all demand scrutiny. However for the moment we will remain in the slow growth, muddle through camp, where we have been for some time.

As has been the case since the recovery began, corporate profitability has been one of the few positive factors over the past 2 years. Corporate revenues have had modest growth, margins are near all time highs and profits are about 25% above the average for this stage of recovery. As usual, we are just beginning reporting season now, and we expect reports to be generally good. Through mid-year, S&P pro-forma earnings should be at a 12 month run rate that is higher than the prior peak in mid 2007. Profits have been the driving force behind stock performance, as they should be. The markets have close to doubled off their March 2009 lows. The S&P 500 is selling at 13-14x estimated 2011 earnings; the norm for S&P valuation is generally considered 15x. This begs the question - are stocks cheap? Interestingly, two firms (Leuthold, UBS) produced some useful research on just this subject. They compared several valuation methods, looking at current valuation levels compared to historic norms. They examined absolute models (current P/E, trailing P/E, normalized P/E/ Price to book value, Price to sales, Price to cash flow), as well as the relative comparison of stock market prices to interest rates. Cutting through all of the details of their analysis, what they both found was that except for current forward looking P/E, and in relation to bonds (interest rates), stocks were judged to be fairly priced to modestly expensive. We do our own valuation work using a discount model and find that stocks as a

whole are about fairly priced, using assumptions that we believe are reasonable.

The two methods that find stocks “cheap” have potential flaws. Stocks are cheap relative to bonds with 10 year Treasuries at 3.15% - there is no argument there. However Treasuries at 3.15% are historically expensive and we think subject to a rising rate environment. As far as the current P/E ratio of 13-14x (it is near the historical median), the question of equity risk premium must be examined. In plain English, the equity risk premium (ERP) is the extra return investors demand to compensate them for the risk of investing in stocks rather than risk free government bonds. That premium is generally thought to be in the area of 4 percentage points in normal circumstances. However we are hardly in “normal” circumstances today. The issues raised earlier all add to making today a more risky environment. Hence the argument for a greater ERP is plausible. With a higher ERP comes a lower multiple (P/E ratio), and the case can be made for a normal P/E being below the historic 15x.

Where we come out on this is that stocks, in general, are fairly priced. Interest rates on the intermediate and long end of the yield curve will, in our opinion, have an upward bias, while the Fed anchors the short end near 0%. Our current circumstance can be viewed as a crab crawl environment where there will be a much sideways movement as all of these risks get sorted out. In view of this, we have begun to take steps to become slightly more mindful of defense than offense in portfolio structuring. The good news is that the market of stocks continues to be compressed in terms of valuation with less than the usual P/E multiple disparities, which should enable successful stock selection to produce above average returns.

Fixed Income Review

The second quarter of 2011 was a very positive one for fixed income securities. All major sectors within the asset class generated strong returns. Only a quarter-end selloff prevented even more gains for bonds. Like the second quarter of last year, bond returns were, in large part, a result of events outside the US. Financial after-effects of the earthquake/tsunami in Japan and continued concerns about economic difficulties in peripheral Europe drove investors back to the safety of the US Treasury market. This, in turn, boosted returns for all fixed income asset classes. Unlike last year’s second quarter, however, risk was not as handsomely rewarded.

Treasuries rallied strongly throughout most of the second quarter. Worries about smaller European economies and the impact of their financial woes on both larger European nations and the global economy as a whole, again, resulted in a flight to quality. However, not all Treasuries performed equally. Rather than a consistent purchase of Treasuries at every maturity, most investors chose bonds in the three to five year maturity range. As a result, yields on these securities declined by over 50 basis points during the quarter. By comparison, thirty year US government bond yields only fell by 14 basis points. This may indicate, that while investors look to the Treasury market for a safe alternative to Europe, even US bond investors acknowledged that all is not well with the US fiscal situation. This claim is not without merit. Moody’s placed the United States on watch for downgrade on July 13, based on its inability to reach an accord to raise its debt ceiling and pass corresponding deficit cutting measures.

The Barclays Aggregate Bond Index returned 2.29% for the second quarter of 2011. Among its components, Treasuries were the best performers, returning 2.39%. Close behind were both corporate bonds and mortgages. Each generated 2.28% for investors last quarter. Agencies were the weakest performers in the index, returning 1.60%. Since many agency bonds are issued with call provisions, a strong Treasury market usually results in the exercise of these options by the issuing agencies. These calls enable the agencies to issue new bonds at lower rates and forces investors to give up the bonds early at their call price rather than at maturity. Although not a sector included in the Barclays Aggregate Bond Index, municipal bonds were the best performing sector of the fixed income market for the second quarter. Munis returned 3.89% to investors last quarter. In spite of bold predictions about defaults from some market pundits and ongoing news about states and municipalities struggling with their budgets, investors continue to demand

tax-exempt income. While the negative news impacted the muni market earlier in 2011, buyers returned in droves during the second quarter and returned the market to levels last seen late in 2010, just before Meredith Whitney made her proclamation that the municipal market would see large numbers of defaults.

The high yield bond market was the performance laggard this quarter, generating a 1.05% return according to Barclays Capital. For the past two and a half years, risk tolerant investors were rewarded (in some periods very well) for their willingness to move down the credit risk spectrum. Bondholders, perhaps, have reached a point where the relatively low yields of securities, such as high yield bonds, no longer offer the compelling values that they did in 2009 and 2010. In spite of this relative underperformance, however, high yield bonds, like every other fixed income category last quarter, generated positive returns for investors.

Fixed Income Outlook

The recent announcement from Moody's about potentially lowering the AAA rating of the US, while not a complete surprise to the market, is just another example of the numerous exogenous shocks that the bond market has experienced over the past several years. It is unlikely that the US will default on its debt. However, the gamesmanship in Washington over the debt ceiling makes this possible. The implications of a US default are far reaching and are likely to be very significant. It is hard to imagine a scenario where the impact of a default is resolved and forgotten by the markets in a very short period of time as some have predicted. That said, this outlook will assume that there is no default or downgrade of US debt and the markets continue to function normally.

While the bond market has shown signs of strength in response to concerns in Europe, there are challenges within the US economy that could result in higher rates in the near future. Debt to GDP levels in the US continue to climb and inflation continues to appear in items such as fuel, food, and commodities. These fundamental factors are likely to put upward pressure on interest rates. The Federal Reserve also ended its purchases of government securities on June 30. The end of the Fed's second round of quantitative easing takes a large buyer out of the Treasury market. This is also likely to move yields higher. The Federal Reserve will not be the driver of this move, however. It is unlikely for the Fed to take any action on short term rates before 2012. Any move in yields will come from investors rather than monetary policy. Finally, the corporate bond market has seen some widening of spreads after a more than two year period of tightening relative to Treasuries. A sluggish economic recovery and rising costs are likely to slow the increase in corporate earnings over the next few quarters. Corporate bond spread widening is likely to continue.

In summary, the likely direction of both Treasury yields and corporate spreads for the remainder of 2011 is higher. While this movement should be relatively slow, a lack of resolution of the debt ceiling and what that may bring could result in some very sharp and unpredictable market moves. Absent a Treasury default, fixed income returns should be slightly positive for the balance of the year, as income earned from coupons should slightly offset a price decline based on small increases in Treasury yields and corporate spreads.