

Mid-Year Letter July 2009

After six straight quarters of negative returns, in the second quarter of 2009 stocks had their strongest quarter in over ten years. The sectors leading the quarter, including US financials, emerging markets, and very low-quality high-yield bonds, were amongst those hardest hit the past year. Much of the recent market swings are the result of the “global margin call” the world faced, and the subsequent recovery as the “market” realized that prices fell too far, too fast. As we enter the second half of the year, our current market outlook can be summed up as bullish near-term with longer-term concerns. In this letter we’ll comment on key economic factors and then highlight our market outlook and client portfolio perspective.

Economic Update

The credit crisis of 2007/2008 has left the economy in a somewhat fragile state. Many economic measures point to a “muted” recovery, and our assessment concurs with these economic “tea leaves.” Measures such as durable goods and consumer confidence appear to be bottoming. Additionally, it takes time to fully feel the impact of a monetary stimulus, and we believe much of this impact is still ahead of us. Longer-term, the economic forecast is still quite cloudy and potentially quite stormy. Uncertainty surrounding the deflation versus inflation debate, deficits, and employment continues.

We believe the likely outcome of the deflation versus inflation tug-of-war will be elevated inflation. Concerns regarding the unprecedented levels of deficits and the FED’s probable inability to “thread the needle” and pull back the monetary stimulus all point to the likelihood of elevated inflation. However, inflation is not a certainty. Despite the increase in government spending, consumers are counteracting with an increase in personal savings. The savings rate, which has hovered at zero over the last five years, has surged to 8%. The impact of increased savings could result in consumer debt being reduced by approximately \$800 - \$900 billion per year. In assessing all of this data, we still believe the longer-term risk to the economy is inflation, and with this in mind, we have taken positions that mitigate this risk for our clients.

Unemployment continues to be a great concern to the economy. Our expectation is that the unemployment rate will “bottom” somewhere in the low double digits. Some encouraging signs are the slowing of job losses and decreases in planned job cuts which are down dramatically from this past winter. While we ultimately need to see private-sector job creation in order to be convinced of sustainable improvement, it is important to remember that unemployment is generally a lagging indicator of recovery, and holding off investing until unemployment improves would likely cause us to miss a rally.

Market Outlook

The extreme sell-off in the second half of 2008 and the first two months of 2009 set the stage for the current rally. Equity valuations continue to be attractive by most valuation measures and in relation to bonds. The research firm, The Leuthold Group, recently reviewed the long-term comparative performance of U.S. equities versus bonds and concluded that on a generational basis we are at a point of maximum underperformance of equities versus bonds. Indeed, through the end of the first quarter ten-year treasuries had outperformed stocks over every major time period for the last twenty-five years. We believe this is due to individuals "quitting" the stock market. One who started investing ten years ago is probably flat in terms of cumulative return. These are the signs "contrarian" investors (including us) like to see. In fact, the above analysis indicated that we are at historic extremes and suggests that the next twenty-five years could be much different. Leuthold concludes its report saying, "The table is indeed set for equities to outperform Treasuries."

Another positive is the credit markets which had been one of the causes for the turmoil. These markets have firmed up and continue to set the stage for a recovering economy:

- The interbank lending figures are back to levels of pre-Lehman collapse; the infamous "TED spread" is no longer in the news each morning because it has returned to historically normal levels. (The TED spread is the difference between the short-term interest rates on T-Bills and interbank loans as represented by LIBOR.)
- The credit spread on fixed-income securities such as high-yield corporate bonds, bank loans, emerging market debt, and mortgage-backed securities relative to treasuries have all reduced dramatically although they still remain historically high.
- The yield curve remains very steep. The difference in interest rates on short-term vs. long-term government bonds represents the premium investors want to be paid for taking on long-term holding risk. This measurement has a very reliable track record of anticipating economic downturns when the yield curve is flat or inverted and projecting economic growth when the yield curve is steep. Currently the yield curve is at historically steep levels.

Portfolio Perspective

Given our short-term outlook, we have positioned our client equity portfolios at a neutral allocation relative to the client's target allocation. This positioning creates "dry powder" should the market pull back, while allowing for participation in any recovery. This current portfolio positioning is also designed to protect against the longer-term inflation risk.

As always we thank you for your continued support and confidence in our team. Please feel free to contact any of us with questions on this update or your portfolio.