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Second Quarter Investment Commentary July 2009

The Quarter in Review

Things are getting less bad. This is the refrain we have heard again and again during the past quarter. The financial markets have improved, which is plain to see in narrowing credit spreads and economic data, but they are not yet normal.

When the S&P 500 closed at 945 on 6/02/09, the stock index was **40% above** its bear market closing low of 677 set on 3/09/09 (i.e., 12 weeks earlier). At 945, the S&P 500 was also **40% below** its all-time closing high of 1565 set on 10/09/07 (i.e., 20 months prior).

The Treasury Department expects an initial payback from the nation's largest banks of at least \$50 billion in bailout funds, according to people familiar with the matter, which is double the amount the government initially expected to recoup. In addition, Treasury announced that up to nine of the biggest banks have approval to repay their Troubled Asset Relief Program funds. The \$50 billion of repayments is the latest sign of improvement in the banking sector. At the same time, many of the banks repaying their TARP funds are expected to continue using other government assistance programs, such as the Federal Reserve's financing facilities.

Bernie Madoff was sentenced to 150 years in prison. While that is not specifically economic news, it does help people feel that there is justice within the system.

Looking Ahead

As we look forward through an admittedly murky crystal ball, there exist arguments for both continuing strength in the economy and the stock markets, as well as weakness.

The Strength Argument

"Turning points in aggregate consensus forward earnings for the S&P 500 -- that is, when they've stopped growing and started falling -- have perfectly forecasted the last three recessions, including the current one. And when they turned up, they perfectly forecasted the recoveries from the last two recessions. The great news is that they're on the very verge of turning up right now. It's just a matter of days. They've already turned up if you take out the damaged financial sector. But even including that problem child, they're improving fast. Again, it's just a matter of days" - David Luskin, *Smart Money*

“The jump in bond rates is a desirable normalisation after a panic. Investors rushed into the dollar and government bonds. Now they are rushing out again. Welcome to the giddy world of financial markets. At the end of December 2008, US 10-year Treasury yields fell to the frighteningly low level of 2.1% from close to 4% in October (see chart). Partly as a result of this fall and partly because of a surprising rise in the yield on inflation-protected bonds (TIPS), implied expected inflation reached a low of close to zero. The deflation scare had become all too real. What has happened is a sudden return to normality: after some turmoil, the yield on conventional US government bonds closed at 3.5% last week, while the yield on TIPS fell to 1.9%. So expected inflation went to a level in keeping with Federal Reserve objectives, at close to 1.6%. Much the same has happened in the UK, with a rise in expected inflation from a low of 1.3% in March to 2.3%. Fear of deflationary meltdown has gone.” - Martin Wolf, *Financial Times*

“The unemployment rate will peak after the recession has ended. But if the U.S. unemployment rate ends this year at 10%, it isn't going to stay at 10%. It either goes up or it goes down. And as it comes down, we tend to see above-average economic growth. During the past 40 years, the average growth rate of the U.S. economy has been about 3%. But if unemployment comes down by, say, one percentage point per year, you get 4% GDP [gross domestic product] growth. Hard as it is to imagine today, once this economy begins to expand, it probably will expand at a faster-than-average pace. The single most likely scenario is that unemployment gradually comes down. If you look at unemployment historically, it goes up much faster than it comes down. When unemployment is going up, it goes up by two percentage points a year. But when unemployment is coming down, it comes down about one percentage point a year. Think of what that means: If we end up at 10% unemployment, it will come down one point a year for each of the next five years, and you get a five-year expansion even before you hit full employment. And during those years the economy grows by about 4% per year. That is the most likely scenario.” – David Kelly, JP Morgan funds

The Weakness Argument

“Recession pressures may well be subsiding next to the sharp contraction earlier this year; however, deflation risks are not only lingering but in fact are intensifying. We still believe the V-shape recovery hopes that have underpinned the equity market while undermining the bond market in recent months will inevitably prove to be under water.” – David Rosenberg, Gluskin Sheff & Associates

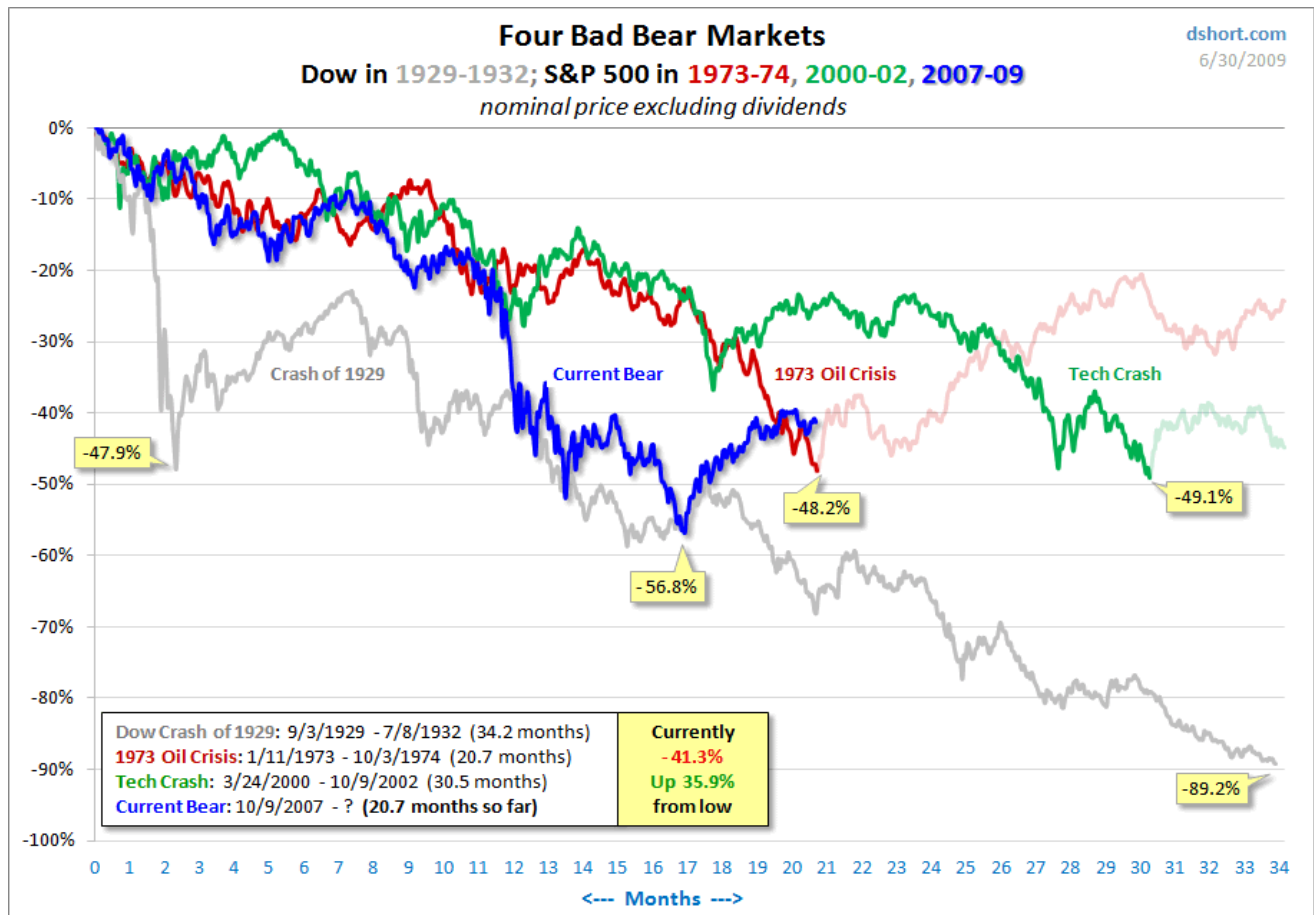
Our housing market is still a mess, with 20% of mortgages in the “upside-down” category, where the mortgage exceeds the value of the house. House prices do show signs of bottoming, but it will take some time for the housing market and government policies to work through this.

Many of you have read about “deleveraging” by businesses and financial institutions. This is a fancy word for reducing debt – and while decreasing debt levels will increase stability and reduce pain in downturns, it will also lead to lower earnings than we saw in the past few years.

Until there are indications that the economic data will improve sufficiently to lead to credible increases in earnings expectations, the stock market will have a difficult time posting significant further gains. The current earnings outlook reflects a high degree of optimism by individual analysts making company-by-company forecasts. This optimism is not shared by the market

strategists who look at overall economic conditions. If the broad market strategists are right in their top-down forecasts, the market is highly priced. Second quarter earnings reports will be out soon. Those reports will provide a better indication of whether earnings will start ramping up later this year.

The chart below compares the current market with three previous bear markets. While the chart indicates that we may not be embarking on a new bull market, the worst may be behind us and we may be in a range-bound market for awhile.



Our thanks to Doug Short of dshort.com for the above graph.

Closing Comments

I (Kevin) spent 10 days in June at Boy Scout camp with my son. During this time, I managed to read three books; one on investment strategy, one on behavioral finance and one on long-term geo-political trends. What did I learn, besides stay away from the breaded chicken patties in the mess hall? Well, to be an effective portfolio manager, you need to make forecasts about the future and those forecasts will sometimes be wrong; the last three recessions were preceded by greed and scandal (S&L crisis, Enron/World Com/dot.com and mortgages) and people need time to get over these scandals. Despite our current problems, the current century will still be dominated by the U.S.

Adversity has a way of revealing strengths and weaknesses, and this is certainly true among financial advisors. The recent meltdown was tough enough for even the most seasoned professionals, but for those who lacked a clear underlying investment philosophy, the devastating sequence of events that began in 2008 effectively deprogrammed them from whatever belief system they had and left them searching for a new “religion” to believe in—one they could report to unhappy clients was more likely to work in this “new world.”

Providing investment advice is not easy. (We are not fishing for sympathy.) As financial advisors we are called on to make decisions about an uncertain future based only on the incomplete information we have today. Meanwhile our clients’ confidence is always at risk of being undermined by the wide range of competing points of view and ongoing stream of short-term news and data that are always available in this age of information overload. Maintaining confidence is critically important; it requires the advisor to honestly convey what can and cannot be known with certainty, and to share the analysis that was used to weigh those uncertainties in order to make the best long-term investment decisions.

When asked in 2004 to name the most important lesson he had to unlearn, Peter Bernstein, investor and author, said: "That I knew what the future held, that you can figure this thing out. I've become increasingly humble about it over time and comfortable with that. You have to understand that being wrong is part of the [investing] process."

Going forward, expect continued volatility and headlines that will cause alarm. As a result, we are continuing to focus on balanced, diversified portfolios. We are also monitoring any signs of significantly higher inflation or a pattern of corporate earnings coming in below expectations, either of which would cause a rethinking of our portfolio strategy. In light of what’s happened in the last year, all investors need to take a hard look at their risk tolerance and financial situation. We will be happy to sit down to update your financial plan and discuss any changes arising from this process.

In conclusion, we wanted to express our thanks for your patience through what has been an exceptionally difficult period. All of us have found ourselves challenged over the past nine months – and we expect to look back on this period as a once-in-a-lifetime test of our discipline and resolve.

Best wishes for a relaxing and restful summer – and remember, should you have any questions whatsoever, we are here to take your calls.



Kevin S. McGrew Bruce E. Bower Paul L. Watkins Patrick L. Warren Matthew D. Ison

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