

Second Quarter Investment Commentary July 2010

“The more you observe politics, the more you’ve got to admit that each party is worse than the other.” - Will Rogers

The Quarter in Review

- The G20 meeting wrapped up in Toronto on June 27th. Despite President Obama’s urgings not to reduce government stimulus too quickly, most of the nations, led by Germany, decided to pursue the path of austerity.
- Global stock markets slumped during the quarter, led by renewed fears of debt contagion in Europe, potential slowing of growth in China, and doubts about the economic recovery in the U.S.
- The yield on the 2-year U.S. Treasury note closed at a record low .625% on June 28th, indicating that the bond market does not fear inflation.
- Despite a couple of all-nighters, financial reform is not a done deal at this point. In its current form, the bill does not address the role of monetary policy (and 1% interest rates), the role of mark-to-market accounting, or Fannie Mae or Freddie Mac. Nor does the bill really address “too big to fail.” The government is taking no blame for the subprime crisis and is demanding more power over the U.S. financial system. In other words, the more things change, the more they stay the same.
- The S&P 500 had a rough quarter, down almost 12%.

The Job Market

You cannot have a vibrant economy without job growth. Additionally, the larger a government gets, the higher the unemployment rate. Most of Europe is a perfect example of this. Why are we having such a hard time creating jobs? Some of the problem goes back to the beginnings of the housing bubble in 2003. People were tired of losing money in the stock market, so they turned to a sector which had never lost money in aggregate – housing. In doing so, a bubble was not only created in housing prices, but also in employment in housing construction and the supporting industries, including finance. Many of these jobs, created as a result of a bubble, are not returning.

Another part of the problem is our government’s inability to see beyond the current election cycle and plan for the long-term. This phenomenon is not new, but is exacerbated during times of crisis. The situation is reflected in our current educational system, which does not effectively train our young people for the next generation of jobs. Per Kansas City area economist Chris Kuehl, the manufacturing sector in the U.S. still has close to a million job

positions going unfilled because the people available to hire lack the skills needed. The sectors of the economy that have seen rapid growth of late are being hampered by a shortage of people with the right training and education at the same time over 7 million people have been out of work for over a year. This disconnect damages both those looking for work and the companies that would see much greater opportunity for growth with the workforce they need.

We expect slow job creation unless new innovations appear. This could be in alternative energy, biotechnology or another industry that is unexpected. The old days of 5% unemployment will most likely not appear for a long time, and 7% may be the norm for years. However, as we have written before, demographics will dictate what happens in the job market. The oldest of the baby boomers will be turning 65 in 2011. Some will need to continue to work, but many will embrace the opportunity to retire. There are calls for labor shortages to appear by 2018, with some expecting these shortages to begin appearing in 2015. At that point, inflation could re-appear, driven by increasing labor costs.

Looking Ahead

“The issue at the heart of all the explanations of boom-bust cycles is the unpredictability of the future. This is what makes finance different—and more unstable—than other economic activities. The primary purpose of any financial system is to link decisions made today with events many years or even decades ahead. Savers, investors and businesses must resolve here and now how much to save or spend, whether to build new factories and which technologies to back, but all these decisions depend on views about the future—and those views, in most cases, can be based only on gut instincts, hopes and fears.”

- Anatole Kaletsky, editor-at-large, *Times of London*

Despite the challenges the financial markets now face, there is much to be encouraged about over the long run. The economy and sentiment have improved remarkably over the past year. Assuming even a modest continuation of this improvement, stocks are reasonably priced at the current levels, given the level of interest rates and inflation. Perhaps the most encouraging is the general pessimism and lowered expectations. This is encouraging because mass expectations tend to be dead wrong and an excellent contra-indicator.

One of the columnists we like to read is Martin Wolf of the Financial Times. Interviewed recently by Charlie Rose on Bloomberg television, Mr. Wolf showed the tremendous depth and breadth in his knowledge of the global economy. He is of the opinion that government stimulus should be withdrawn over time, but slowly. The austerity measures being proposed by his native England and some countries in the European Union may hurt their respective economies in the short run. Mr. Wolf contends that the deleveraging (i.e., households reducing debt) cycle is generating huge private sector financial surpluses across the developed world. For the most part, these surpluses will be invested in government liabilities. This situation helps explain why yields on the bonds of safer governments remain so low and may continue to stay low for an extended period. Also, if governments need to run deficits to support demand at a time of private sector weakness, they can always borrow from central banks. In summary, Wolf said, “The best policy is to put together measures that sustain strong growth in demand in the short run, while constraining the huge deficits in the long run. This is walking and chewing gum at the same time. Why should that be so hard?” This is easier said than done for most bureaucrats, and we saw evidence of the problems at the recent G-20 meeting.

We are still in the deflation camp and do not feel that inflation will be a problem for at least a few years. Let's take a closer look at why we feel this way. The consulting firm McKinsey did research to gain some historical perspective on what is happening today. They found 45 episodes (globally) of deleveraging since the Great Depression, and 32 of them followed a financial crisis. The historic episodes of deleveraging fit into four categories:

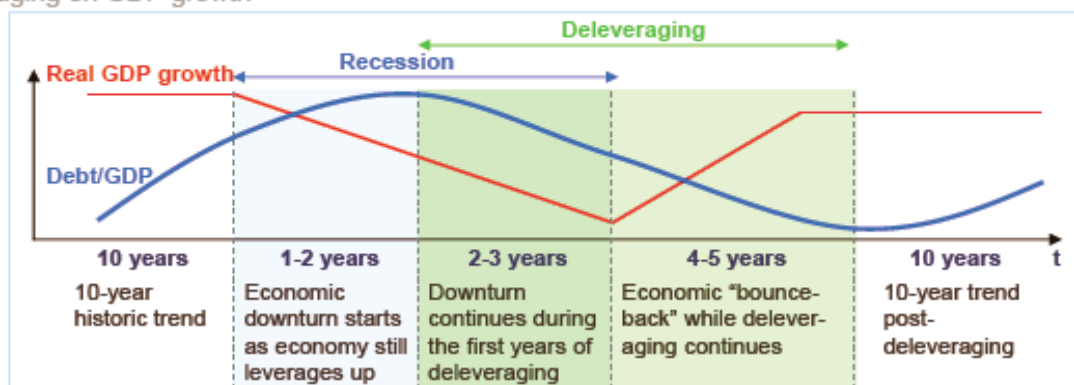
- 1) austerity, or belt-tightening
- 2) high inflation
- 3) massive default
- 4) growing out of debt

Austerity was the most common path chosen over time.

The following chart depicts the economic cycle after a financial crisis. Deleveraging, or the reduction of debt by individuals, companies and/or governments, continues for several years in order to purge the system of excess debt.

Real GDP growth is significantly slower in the first 2-3 years of deleveraging

Impact of deleveraging on GDP growth



Average annual real GDP growth, %

	10 years 10-year historic trend	1-2 years Economic downturn starts as economy still leverages up	2-3 years Downturn continues during the first years of deleveraging	4-5 years Economic "bounce-back" while deleveraging continues	10 years 10-year trend post-deleveraging
1 "Belt-tightening" n = 16	4.7	0.6	-0.6	4.8	3.2
2 "High inflation" n = 8	4.3	-1.7	-1.4	4.1	4.2
3 "Massive default" n = 7	4.3	-1.8	-3.0	5.7	4.8
4 "Growing out of debt" n = 1	7.9	0.8	← 12.8 ¹ →		2.3
Total n = 32	4.6	-0.5	-1.3	5.1	3.8

1 Deleveraging driven by off-trend growth is not linked to a recession.

SOURCE: International Monetary Fund; McKinsey Global Institute analysis

If you place the start of this deleveraging process in early 2007, when cracks in the mortgage market began to appear, we are in year 3 of the process, meaning that there are about 5 years or so left. However, because of the global nature of the crisis and the projected increases in government debt, it may take longer for the U.S. to work its way through the cycle. During the deleveraging process, deflation is the norm, not inflation. Deflation is a more difficult concept to grasp since few of us have really experienced it, unless you were born around 1920. The cycle works like this:

- 1) economic output slows due to low consumer demand as people increase savings
- 2) unemployment increases, reducing the ability of workers to consume
- 3) companies lower prices to retain market share
- 4) consumers wait for prices to drop more before they buy
- 5) the cycle repeats

Japan has been experiencing a version of this for the last two decades. You may notice that the GDP numbers on the chart do not look awful, but simply lower than what we have been used to in the past.

Closing Comments

The continuing problems in the Gulf of Mexico dominate the headlines as we close out another quarter. The official word from BP is that it expects to have relief wells operational by early August. While this may stop the flow of oil, it won't do anything to clean up the existing mess. That job is being left to Kevin Costner. It seems the star of such films as Field of Dreams, Bull Durham, JFK, The Bodyguard, and our personal favorite, Tin Cup, puts his money where his mouth is when it comes to environmental causes. After seeing the devastation caused by the Exxon Valdez disaster, Mr. Costner started a company to develop technology aimed at minimizing the damage from future spills. Mr. Costner's company, Ocean Therapy Solutions, markets centrifugal oil-and-water separators. The largest of these units can clean 210,000 gallons of water per day. BP has contracted to purchase 32 of the devices with plans to deploy them in the Gulf. Let's hope they are a huge success!

We have been positioned somewhat defensively for most of this year, and will remain that way until we see that economic conditions warrant taking on more risk. The positives are GDP growth (albeit slow), low interest rates, low inflation, and healthy corporate profits. Negatives are debt problems, a re-trenching consumer, poor consumer sentiment, and a crisis of leadership in this country. We are constantly evaluating investments that we feel are appropriate for the current environment.

We hope everyone enjoys the summer and is able to do some travelling, or just spend time with family and friends.



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