The Challenges Investors Now Face

And, to top it off, we have Russian spies in Manhattan! A throw back to the Cold War and James Bond, the FBI captured a Russian spy ring attempting to infiltrate American society. What amuses us is that if you lived during the 1960's, this would have sent a chill down your spine; but, today it seems rather comical. The real joke is that there isn't that much dirt we're hiding that can't already be found on the internet. A quick scan of the events over the past quarter will help to outline the challenges that Americans face. There is no shortage of challenges that investors face too.

First, the tragedy of the collapse of the Deep Horizon oil well and the growing oil slick in the Gulf makes this the largest manmade disaster – ever. And, it appears the best we can do is to dig a relief well that won't be completed until August. The economic toll that the oil slick will create as it sloshes around the sandy beaches of at least four states still can't be calculated. Like the oil slick, there is also concern that the European debt crisis spreads and pollutes the US financial system. The European Union has been slow to respond to the growing concerns that several EU member states, including Greece and Spain, can't service their debt and the European banking system is undercapitalized. On the geopolitical front, Iran continues to lead the list of problems that America faces. Iran continues to work on their nuclear program which crosses the line into weapons grade nuclear capabilities. The United Nations Security Council passed new sanctions last month which are designed to prevent the financing of Iran's proliferation program.

Closer to home, unemployment concerns and the economic recovery are the dominant themes. But, a survey of the economic landscape requires a deeper understanding of the structural problems that are imbedded in our economy and capital markets. These structural problems, which include a huge debt burden, weak capital levels in the banking sector, unfunded pension liabilities that many states can't afford to pay, sustained high rate of unemployment, huge level of excess capacity in the manufacturing sector, and an excessive level of government intervention in our capital markets will keep stock prices range bound over the near term and will impede the price appreciation of financial assets over the long term.

At the beginning of the year, we outlined three things that we needed to see before we became more constructive on financial assets. These included:

1. The administration and Congress need to articulate a rational plan to address the bloated debt level.
2. The Federal Reserve needs to remove itself from supporting our capital markets.
3. We need to see meaningful financial market regulatory reform that addresses the speculative excesses and moral hazard that exists in our financial markets currently.

One of the major accomplishments of this Congress was to pass legislation that addresses financial regulatory reform. In spite of the powerful lobbying groups that the banks employ, legislators pushed hard to address tough issues including derivatives, proprietary trading, a standard of fiduciary duty for the brokerage industry and oversight of the rating agencies. In the end, the success of the new regulation will be the ability of the regulators to effectively oversee the firms and enforce the new rules. But, we can cross one off the list.

With Financial Regulatory Reform (FinReg) largely complete, we do not expect to see much from this Congress until after the November elections. Look for the economy, job growth and business initiatives to be major themes in the upcoming elections.

There is a Long List of Problems that Still Need to be Addressed

Still, the list of issues that need to be addressed is daunting. As part of the regulatory reform Bill, Congress agreed to not deal with addressing the sticky issues of Fannie Mae and Freddie Mac, the two insolvent mortgage loan companies that were placed in the care of the US government in 2008. According to the Congressional Budget Office, since becoming wards of the state, we've pumped $145.9 billion into the combined entities as losses continue to bleed. And, there is no plan to address the broken business. To us, it sounds a lot like the oil spill in the Gulf.

During the height of the financial crisis in 2008, the U.S. government made investments in Citigroup, American International Group (AIG), General Motors and Chrysler. While the government has successfully been selling off its shares of Citigroup (so far booking a profit of over $2 billion on its investment), AIG still has not articulated a plan to pay back the massive investment by the government. General Motors is expected to IPO shares in August which could cut the government's holdings by 20%.

Another problem is U.S. fiscal policy which is out of control. The government grew its debt load to $12 trillion over the past two years as a means to support the financial system and allow for an orderly transfer of debt from the capital markets to the government. While the Congressional Budget Office projects a decline in the budget deficit from its current 10.6% level to 5.6% over the next ten years, the figures are based on the flawed assumption that increasing taxes on the wealthy will increase revenue to the U.S. government. With the Bush tax cuts expiring at the end of this year, expect higher taxes over the coming years.

We believe that we operate now in capital markets that have severe structural barriers that will impede the appreciation of financial assets and economic growth over the long term. And, until many of these structural issues are addressed, economic growth will suffer, we will remain range bound in stocks, and interest rates will stay low. The result is that the markets are not pricing risk efficiently. History shows, whenever that happens, investors should be concerned with principal preservation and not capital appreciation.

The Economic Recovery is Slowing

After back-to-back quarters of solid growth, it appears that the U.S. economy is moving to a slower gear. First quarter GDP was revised downward to 2.7%, and we expect growth for the second half of the year to land in the 2.4% area. Much of the rebound has been lead by the manufacturing and government sectors, with industrial production picking up 1.2% mid quarter and capacity utilization moving up over 70% in the manufacturing sector.

It is not uncommon for economic growth to pause early in a recovery. After rebounding from the recession in late 2001, the economy hit a twelve month stretch where it grew at a dismal 1.5%. However, the U.S. economy is challenged by structural issues that have the effect of impeding future growth. These structural issues include large budget deficits, weakened capital levels in our financial system, excess manufacturing capacity and sustained high unemployment. Small business growth typically leads an economic recovery; however, with an uncertain tax policy, the recent burden of healthcare reform and tight credit markets, there are no meaningful initiatives for business expansion currently.

The sustainability of the recovery comes down to two issues: business growth and job growth. Without incentives for business growth, our economy is not capable of producing 1.5 million jobs a year over the next three years.

The Consumer Sector will be Challenged

One of our themes this year is the belief that the consumer will be challenged by high unemployment, slow job growth, slow wage growth and a stagnant housing market.

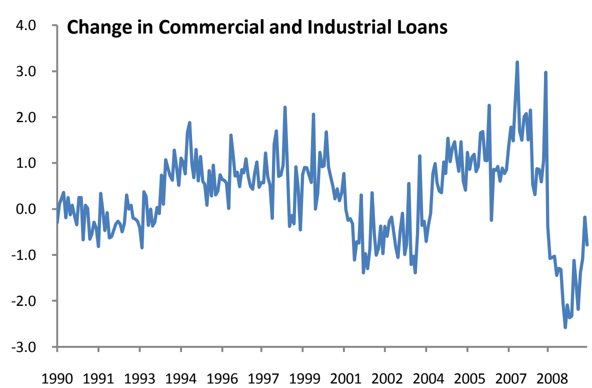
The economy lost over 8 million jobs during the financial crisis with many of these jobs coming out of the bloated financial sector. While the June unemployment rate dipped to 9.5% from 9.7% the month prior, we don't believe that reflects the systemic rate of unemployment as people, discouraged at not being able to find a job, have left the workforce. With the economy impaired and not able to produce jobs, college graduates are having difficulty finding employment. It is estimated that 25% of college graduates are currently unemployed. While the government sector created jobs by hiring census workers during April and May, job growth in the private sector has been slow. Because the census worker jobs are only temporary, they will go away during the third quarter. One of the keys to sustained economic growth is growth in the number of private sector jobs.

The recent consumer confidence readings published by the Conference Board showed a drop to 52.9 from 62.7 the prior month, reflecting the tough job market and renewed consumer austerity. The housing market has shown recent signs of weakness as the government supported first time home buyers credit expired. And, while auto makers saw sales increase in June from their depressed levels a year ago, sales slipped from levels reached in May.

The Impaired Banking Sector Is an Anchor for the U.S. Economy

One of the challenges in the face of economic growth is the recovery taking place in the impaired U.S. banking system. Very subtly over the course of the last two decades, the large bank business model changed from making loans and managing balance sheet risk, to one of revenue growth, transaction volume, and maintaining profit margins. Along the way, banks helped to pollute the capital markets with bad loans that in previous decades would have been kept on their own balance sheets. When a bank sells a loan into the market place, it is no longer required to hold capital in support of the loan. As a result, during the 2001 to 2007 period, banks became masterful at recycling their capital and consistently improving their profitability. And, they paid themselves handsomely thinking they were actually creating value for their shareholders. As management searched the world over for the best investment opportunities, each decided that buying back their own stock was the best investment they could make.

While Financial Regulatory (FinReg) reform is not designed to prevent the stupidity and greed of the management of the banking sector, it is intended to provide a more comprehensive set of rules that investors can hold to and regulators can enforce. FinReg does not address the price transparency of the loan portfolio on the bank's balance sheet. During the height of the Financial Crisis, the regulators allowed for the relaxation of the mark-to-market rules for financial institutions. As a result, we believe the loan portfolios of the major banks are still overvalued by 15% to 40%.



Source: Federal Reserve

We expect to see continued writedowns in the bank loan portfolios. Similar to the loan problems in the banking sector in 1991 – 1992, we expect the Fed will hold short term interest rates low for as long as possible. This will allow the borrowing rate for the banks to remain low and the potential for higher profit margins to remain. As a result, we expect that over the next several quarters, a large portion of bank earnings will go toward loan reserves and to bolster capital.

During this period, which could last two more years, loan growth at the major banks will likely be slow, further impeding the economic expansion. Since banks aren't required to hold reserves against government securities, it is actually more profitable for banks to buy US government securities, particularly mortgage-backed securities, than it is to make loans.

Investment Strategy for the Third Quarter

For the quarter, the S&P 500 index posted a decline of 11.86%, marking the worst quarter since the Q4 2008 loss of 22.56% (Q1 2009 was off 11.67%). The first half of 2010 showed the S&P 500 index down 7.57%. This is the worst start for the S&P 500 since 2002 when it lost 13.78%. A sharp increase in volatility hung over the market as trade volume slowed. We remain concerned that much of the move in the market is a reflection of quantitative models and program trading, not real buyers who remain on the sidelines.

Corporate earnings still matter and first quarter earnings clearly surprised on the upside. Over 80% of companies in the S&P 500 beat their earnings estimates for the first quarter. The result was a 4.7% increase in expected operating earnings to $81.73. With the S&P 500 currently trading at 1037, the market is currently trading at a forward price/earnings ratio of 13.3 times 2011 earnings. Assuming, a dividend yield of 2.4%, P/E multiple contraction to 13.5 and earnings for the S&P 500 grow to $80 in 2011, and we are forecasting twelve month horizon returns on domestic equities in the range of 6.0 to 8.5%. At current valuations, the equity market appears to have some near term upside opportunity in the 8 to 10% area. We are still looking for growth in revenues to support a more robust earnings outlook – so far, we haven't seen it.

Our outlook for fixed income is sanguine at best. The 10 year US Treasury declined 90 basis points during the quarter to finish near a 2.95% yield. Our outlook for total return investors is meager from the current levels. The opportunity for lower rates in the face of a slowing global economy is aggressively discounted in current levels. The poor fiscal position of the US will ultimately lead to higher interest rates. As a result, we recommend staying short the benchmark.

The trend in corporate credit quality has been positive as companies accumulate cash on their balance sheets. Spreads on corporate bonds widened during the quarter as interest rates fell sharply. With the spread widening, we see value in certain corporate issues out to 10 years. Short municipal bonds offer better relative value than many investment grade corporate issuers and should be considered from a diversification standpoint. Credit problems in the municipal bond markets continue to grow as states come to grips with unfunded pension liabilities and small municipalities around the country restructure their heavy debt load. We still believe high quality general obligation bonds and essential service revenue bonds with good credit fundamentals are excellent investments.

Finally, given the increase in the price of gold, we sold our position this past quarter. Given the fiscal mismanagement around the globe, we still think an investment in gold makes sense, but we see more opportunity in equities over the near term.