We are approaching the five year anniversary of the beginning of the Financial Crisis. By this time in 2008 we had already experienced the complete seizure of the Auction Rate Preferred securities market and the takeover of Bear Stearns by JP Morgan Chase. In September of 2008, we would see the collapse of Lehman Brothers and the government takeover of AIG. We stand here today, shoulders slumped, and heads bowed mourning the lack of real progress in addressing the structural problems that are impeding sustained economic growth and private credit expansion. The brutal reality is that as long as the Federal Reserve maintains any form of open market purchases of securities as a means to manipulate interest rates our economy and capital markets remain on life support, unable to function on their own. As a result, we expect returns on financial assets to be relatively low over the near term as economic uncertainty impedes fixed investment and business expansion.

With over $2.6 trillion in monetary stimulus from the Federal Reserve, the economy at best is just muddling along. And, now there are signs that are raising concern for us. These include an increase in consumer debt, slow growth in job creation, slow growth in small business, and constrained private credit expansion. On the positive side, the domestic manufacturing sector, highlighted by the auto industry has shown solid growth while the recovery in domestic housing remains strong.

There is a significant disconnect between the underlying fundamentals of the economy and the valuations reflected in the capital markets. In particular, valuations in the bond market have been pushed to an extreme with low interest rates and tight spreads. Even with the mild 50 basis point correction in the yield of the 10 year U.S. Treasury last month, we believe fixed income securities are still modestly overvalued. In our bizarre new world order, the equity markets seem to rally more on news of continued Federal Reserve stimulus and ignore the deteriorating fundamentals in corporate profits and slowing economic activity. We have made investors numb by applying aggressive monetary stimulus like an anesthetic. The Federal Reserve's challenge is to begin to wean investors off of the anesthetic without hurting economic growth and impaling the capital markets.

Our long time readers know that we have three tenets that we are looking for in order for us to have a more constructive view of earnings growth and financial assets. These include:

1. A plan for the Federal Reserve to withdraw its stimulus from the capital markets
2. A plan for the government to reduce the budget deficits, and ultimately the reliance on debt
3. Financial regulatory reform that has teeth

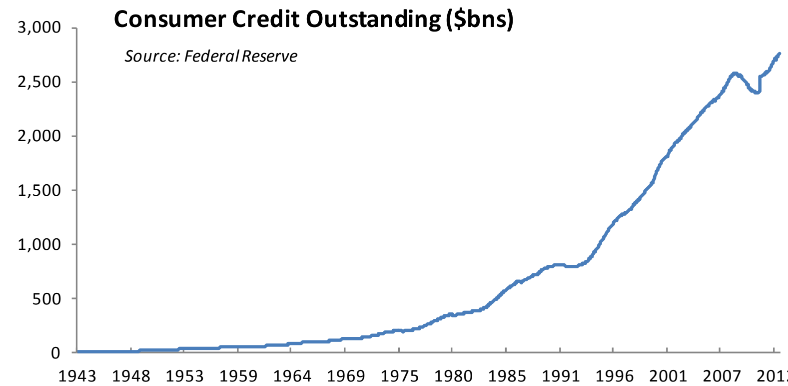
Last month, we reached an important milestone: the Federal Reserve indicated that it is expecting to reduce asset purchases (which are currently running at $85 billion a month) and let its portfolio run off over the next seven to eight years. While the bond market initially overreacted to the Fed's statement, the initiative was the first clear sign that the Fed was getting ready to allow the economy to move off of life support. We count that as progress toward the first item on the list. Of course, the economy needs to continue to show a sign of recovery before the Fed will reduce its intervention in the capital markets.

In our view, we have not seen any serious fiscal initiative from Congress since they passed the Troubled Asset Relief Plan in 2008. This may sound critical, but our government's response over the past five years has leaned toward increased regulation which has put pressure on profit margins and impeded business formation and investment. Financial services, healthcare and FDA are just a few areas where there is uncertainty in regulation. As an example, the complexity of the Healthcare Reform Act is creating confusion and uncertainty in the business sector and acting as another barrier to job growth.

The government has shown improvement in its fiscal position moving from a deficit of $1.1 trillion to a deficit closer to $660 billion. That has helped to put the rating agencies at ease for the time being. While Congress has been relatively quiet as it works through immigration reform, we expect the upcoming debate on the budget to open up partisan wounds and provide volatility for the market.

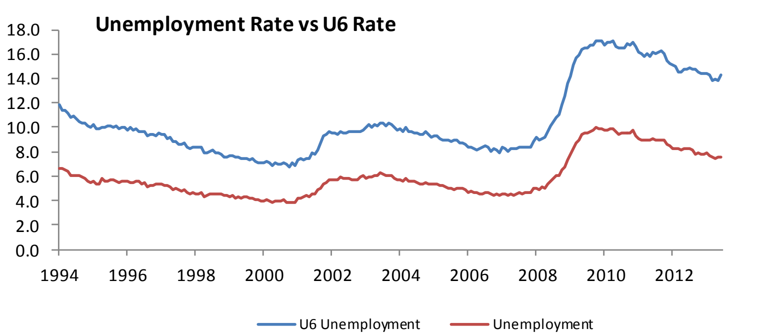
The Economy

Domestic economic growth is coming in slower than we anticipated at the beginning of the year. We believed that by mid-year, the domestic banks, having replenished their capital levels, would help to spur lending, which in turn would help spur business investment and economic growth. That has not happened. GDP for the first quarter was revised to 1.8% and we expect second quarter growth to be in the neighborhood of 1.9%. On the positive side, we are seeing improvement in the housing, auto and construction sectors. However, the increase in consumer debt is a concern given the rate of unemployment and the dismal growth in income levels.



Job growth is averaging roughly 202,000 per month as job gains in June reached 195,000 and the unemployment rate held steady at 7.6%. Frankly, the economy is not producing enough jobs to make meaningful progress in reducing the rate of unemployment. *We expect it will take another two years to reach the Fed's target rate of unemployment of 6.5%.* The other problem is that the jobs that are being created are in the service sector which includes store clerks, waiters in restaurants and hotel staff. These are not high paying jobs which contribute to spending and consumption that would drive the economy higher.

Fed Chairman Bernanke has indicated that the Fed will maintain its aggressive stimulus program until the rate of unemployment reaches 6.5%. *We have several thoughts on that. First, monetary policy does not create jobs, business does. Second, the economy is simply not strong enough to sustain higher interest rates at this time. Finally, by tying its asset purchase program activity to one measure of the economy, it puts the Fed in a potentially awkward position of having to explain future actions that may be inconsistent with economic growth in the face of lackluster job growth.* To this point, the broadest measure of unemployment known as U6, which includes marginally attached workers who are neither working nor looking for work but still indicate an interest in employment, rose from 13.8% in May to 14.3% in June. We are troubled that the trend in the U6 rate of unemployment is not converging with the rate of unemployment as it did in the period between 1998 and 2001.



Source: Bureau of Labor Statistics

In order for there to be sustained domestic economic growth, three issues need to be addressed. We need:

1. A healthy banking system which facilitates the expansion in private credit
2. Reduction in the structural problems that are acting as impediments for business formation and job growth and compensate entrepreneurs for taking risk
3. The Federal Reserve to curtail its asset purchase programs

U.S. imports jumped in May reflecting a rebound in domestic consumption. At the same time, weakness in U.S. exports represents a growing problem for the economy as Europe struggles and China slows. Fueled by a weaker dollar, U.S. exports helped give momentum to the early stages of recovery and supported U.S. growth until recently.

Monetary Policy

Monetary policy is the grease that lubricates the wheels of the capital markets, which in turn allows the economy to function and grow. Monetary policies that are considered accommodative allow for growth in the supply of money and the access to credit. Since the Fed began initiating its quantitative easing programs and directly manipulating the term structure of interest rates, we have opened the lid on the can and just dumped grease all over the capital market machinery. We are no longer using the little can of WD 40 on the shelf.

The Federal Reserve's quantitative easing program has provided massive liquidity to the global financial system. To date, the Federal Reserve has purchased $2.6 trillion in mortgage-backed securities and U.S. Treasury securities through its asset purchase programs. This aggressive monetary policy has proven effective at manipulating the term structure of interest rates, allowing businesses and consumers to refinance their outstanding debt at significantly lower interest rates, allowing for the economic machine to continue functioning and inflating the prices of financial assets. At the same time, these liberal monetary policies have masked the risks in the market place and created a false sense of security for investors by lowering volatility. *The takeaway from last month's statement is that as the Federal Reserve contemplates the withdrawal of its stimulus, the move back to more normalized interest rates will likely include increased volatility for the capital markets.*

Financial Regulatory Reform

The health of the financial system is critical to the health of the economy. In a large part, the dismal economic recovery is a reflection of the amount of healing and repair required by the domestic banks. We have made the case that, in the absence of the Glass-Steagall Act which prohibited banks from many financial activities including investment banking, insurance, hedge funds, and other capital market activities, the banking system is less efficient in its role as an extension of monetary policy for the Federal Reserve. Banks have more diversified forms of revenue and have been prudish at lending and putting capital at risk. At the same time, a recent report from the Basel Committee on Banking Supervision reported that banks have shown a consistent structural bias toward understating the risk embedded in the majority of their investments in an effort to make them look better capitalized and safer than they actually are.

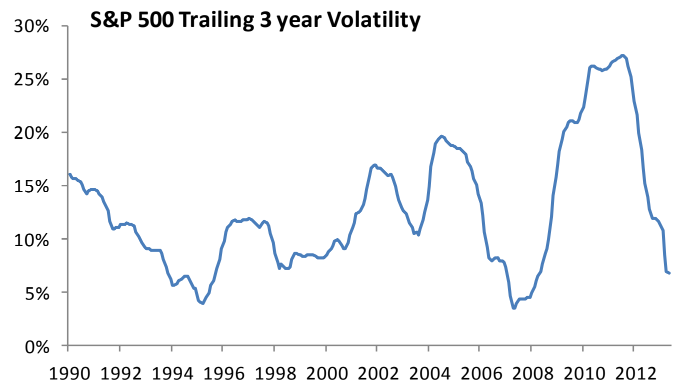
One of the lessons learned during the Financial Crisis is that the previous laissez-faire form of regulation was not rigorous enough to keep pace with the growing complexity and sophistication of Wall Street. *Five years after the Financial Crisis, financial regulatory reform is still not complete.* The number of lawsuits filed since 2008 against the banks and employees has been staggering. The litigation covers predatory mortgage lending practices, subprime loan malfeasance, credit card abuse, insider trading at several hedge funds, the manipulation of LIBOR (which is a key benchmark for short term interest rates), selling collateralized debt securities without appropriate risk disclosures, and even manipulating electricity markets in California and the Midwest. This litigation is the carnage from the "catch me if you can" culture of business practice promulgated by the banks in the years leading up to the Financial Crisis.

There is still a significant amount of regulatory reform work that still needs to be completed. One example is the financial services industry is split between broker-dealers with armies of financial advisors that sell securities under the rules of FINRA and registered investment advisors that provide investment advice under a *fiduciary* standard under the Securities and Exchange Commission. The SEC is looking to put one common standard over the entire financial services industry in an effort to reduce confusion and provide a common standard of care for investors. We believe this is an important initiative that deserves the highest level of attention.

Other regulatory reform initiatives that still require attention include the standardization and implementation of global Swaps rules, the completion of the Volcker Rule which will limit proprietary trading by banks, a plan for the orderly liquidation of failing banks, a plan to deal with the Federal National Mortgage Association (FNMA) and Federal Home Loan Mortgage Corporation (FHLMC) and derivatives trading reform.

Investment Strategy

The challenge for investors is that expected returns for domestic stocks and bonds are relatively low and investors are not adequately compensated for the risk. Based on current levels, we are looking at near term expected returns for domestic equities to settle in around 7% to 8% and for fixed income to be around 2.5%. Through the second quarter, the trailing three year standard deviation of return on the S&P 500 has declined to 12%. We believe that expected volatility should be targeted near 18% to 20%. *This divergence is critical to the asset allocation and risk management of a diversified portfolio of assets.*



Source: Standard & Poor's

The shift higher in interest rates last quarter has made the fixed income market marginally more appealing. We still argue that fixed income is an important asset class since it is one of the major asset classes that is less correlated with equities. With our expectation for fragile domestic economic growth, we believe interest rates will have a natural ceiling between 2.75% and 3.0%. *As much as the Federal Reserve would like to manage investor expectations to not rely on the central bank's continual support, we don't see the economy growing fast enough to supplant the stimulus money the Fed would like to withdraw from the financial markets.*

We are concerned that corporate earnings for the second quarter will reveal slowing global economic activity. Much of that will likely be attributed to China and Europe where demand is declining. Some will be attributed to declining demand in the emerging markets. But, the reality is that without meaningful growth in revenue, corporate profits have likely peaked for now. The tail winds of low interest rates are, for the most part, behind us. Future corporate profits will be challenged by a litany of rising costs including higher regulatory costs, higher interest rates, and higher heath care costs. How much of this is passed on through increased prices for consumers will remain to be seen.