WINTHROP Capital Management

The Economy

We expected the economy to decelerate in the second half of the year and it has. Remember, the goal after the devastation of the Financial Crisis in 2009 was to get the economy back to *sustainable* economic growth. As the stimulus from the Financial Crisis wore off in 2010, we pointed out that the structural problems imbedded in the economy and capital markets, including a huge debt burden, the lack of credit expansion, high unemployment and uncertainty in new healthcare laws were an impediment to sustained growth. Compounding those problems this quarter has been the cumulative effect of the debt ceiling drama in Congress, the S&P downgrade of the US government and Europe's inability to effectively deal with its debt and currency problems. Democracy and capitalism go hand-in-hand. However, the entrenched partisan politics in Washington are hurting consumer and business confidence which is having a negative impact on the overall economic recovery. *We expect to see Congress reconvene this fall and get serious about initiatives for economic growth and job creation. However, the mechanism for credit expansion in the private sector is broken and may take years to fix resulting in a continued drag on economic growth.*

One of the major structural problems in the economy remains the residential housing market and the high rate of foreclosures. Low interest rates can only do so much to allow homeowners the ability to refinance their mortgage loans. As a country that values homeownership at the same level as democracy, we believe we are in dire need of a new mechanism that would allow the banks to purge their inventory of foreclosed loans and at the same time allow the foreclosed properties to be economically productive. Until we address the excess inventory of foreclosed homes, our economy will continue to languish. And, whether we are heading into a recession or not is really *not* the issue; we are in a slow growth economy and portfolio structure should reflect the risks and relative value within that type of investment environment.

Monetary Policy

With short term interest rates near zero and $1.7 trillion of central bank liquidity in the capital markets, the current monetary policy being implemented by the Federal Reserve is best described as, umm, talking to the market. Admittedly, we did not learn this in business school; and, the reality in spite of what Bernanke says is that the Fed does not have many tools left in which to affect the growth rate of the economy or employment. In a turn from its normal "extended period" language, the Fed earlier this month said it would keep interest rates at extremely low levels until mid-2013.

At this point, the Fed is trying to maintain policies that support sustainable economic growth without impairing the financial system. Yet, the Federal Reserve cannot do it all and we are in dire need of policy initiatives from Washington that support job creation and credit expansion. We have some of the lowest interest rates in history and banks still are not lending at a meaningful level to support sustained economic growth. The prolonged regulatory reform process under the Dodd-Frank Act combined with the new capital rules under Basel III and economic uncertainty have resulted in banks hoarding capital and focusing on growing non-interest income rather than making loans which support business development and credit expansion. While maintaining the current low interest rate policy, we expect the Federal Reserve to remain on the sidelines and not provide any additional quantitative easing programs or accommodations to the capital markets over the near term.

The Capital Markets

After reviewing earnings this past quarter, we are in the process of ratcheting down our earnings expectations for the S&P 500 to reflect fracturing business and consumer confidence. The increased market volatility is a concern because, the volatility itself, can impact consumer and business confidence and chip away at economic progress. The European debt crisis, the downgrade of the US government to AA+ and our inability to deal with our growing debt burden all contributed to capital market volatility so far this quarter. And, due to the unwitting actions of the financial regulators which have allowed the Wall Street banks' and hedge funds' rapid electronic trading platforms to access the stock exchanges directly, we believe that we are in a prolonged period of heightened volatility.

Paradoxically, corporate balance sheets are extremely strong as companies hoard cash given the economic uncertainty. Rather than reinvest capital in equipment and business expansion, American companies are sitting on $2.7 trillion of cash. *The fact that companies are choosing to sit on their cash hoard and earn a zero percent return illustrates the structural problems in our economy and capital markets.* At some point, that cash either needs to be distributed to shareholders through dividends, reinvested in the business, or used to manipulate the capital structure through stock repurchase programs. We expect the large cash pools to provide some sort of floor to the overall equity market. *We believe the recent market correction in stocks has already priced in any economic slowdown and adequately compensates investors to assume incremental equity market risk.* Still, Europe's inability to deal with Greece and its ongoing debt problems will provide additional volatility until there is a resolution.

The Demise of the Banking System

After the repeal of the Glass-Steagall Act in 1999, banks were incentivized to diversify their revenue into more stable fee oriented businesses which didn't require high levels of capital. At the same time, the Federal Reserve allowed interest rates to drop to extremely low interest rates. In turn, this helped to perpetuate the transaction oriented businesses, such as securitizations, that the banks had developed. The result is that banks are less reliant on loan growth and interest income to generate revenue than they were under the Glass-Steagall Act. While still integral to the monetary system, we view banks today as closed distribution companies that cross sell their own products into their client base. Bank of New York Mellon's recent announcement that they will charge clients with over $50 million in deposits a fee of 13 basis points underscores this notion. Under Glass-Steagall, banks relished those deposits because they could make loans against them and earn a nice profit.

The Federal Reserve relies on the banking system in order to execute monetary policy. Through various mechanisms including adjusting required reserves, manipulating the Fed Funds rate and altering the monetary supply, the Federal Reserve utilizes the banking system to expand or tighten monetary policy thereby stimulating or slowing economic growth. Today, that system is broken. The result is that the Federal Reserve has to revert to large asset purchase programs to alter interest rates and credit expansion is impaired. Without the efficient expansion of credit, there is little incentive for risk taking and business development. *Until we deal with the structural problems embedded in the economy and provide a more efficient means for credit expansion than our current banking system allows, we will remain in a period of slow economic growth and persistent high unemployment.*