Moody, Lynn & Co.
Investment Counsel

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INVESTMENT REVIEW AND OUTLOOK

The Perfect Storm — Part Two

In our first quarter letter we described the perfect storm conditions that were gathering over world stock markets and outlined a very defensive portfolio strategy involving large cap global leaders, natural resource stocks, gold and elevated cash reserve levels. We were rigging the portfolios to ride out a major storm, to complete the nautical metaphor. It was a capital preservation strategy and it paid off in the second quarter, enabling Moody, Lynn & Co. portfolios to avoid the losses experienced by many in the period. For the full six months, however, we did inevitably sustain some damage. ***Underlying economic conditions may vary widely around the globe, but the bear market in stocks has been nearly universal.*** The 13% drop in the MSCI World Total Return Index represents the worst start to the year since 1970. According to Standard and Poor's, the value of global stock markets fell by $3 trillion in the *month of June alone*. Emerging markets of all stripes were also hit hard in the second quarter and first half with the Shanghei down 44% and the India Sensex off 34% through June 30th. As we mentioned in last quarter's letter, correlations rise across markets and asset classes in times of crisis. With the exception of cash, government bonds, natural resources and gold, there have been very few safe havens for investors in 2008. Performance is relative in a bear market, but our longstanding bullishness on gold and the commodity demand theme enabled Moody, Lynn & Co. portfolios to outperform the major indices in the difficult first half.

In the near term, the market is caught in a vicious circle of negative economic factors including falling house prices, a weakening economy, surging energy prices, rising inflation, plunging consumer confidence and a banking crisis that only exacerbates the situation. Election year uncertainties represent yet another overhang. The Federal Reserve and Treasury are doing all they can to shore up the financial system and with it the economy. But as we have noted in the past, the Fed can only fight one war at a time and has been forced to choose between the fight against inflation and the fight against asset deflation. Understandably they have chosen the latter. As a result, dangerous inflationary pressures have continued to build, raising the specter of stagflation. The key question is what will it take to break the vicious circle of rising oil prices, financial company implosions and falling stock prices? Clearly the direction of energy prices is one of the keys to any market outlook. No one can predict oil prices, but we may be nearing the tipping point at which the increased expense of energy *and food* costs begins to meaningfully dent economic growth rates around the world. (As this letter goes in the mail, a sharp correction in energy has begun. It is too early to tell whether this represents a major inflection point or a short term correction.) While the scenario of a commodity correction triggered by weakening global growth may appear bearish, it could set the stage for a significant rally in stocks as the markets begin to anticipate calmer commodities markets, lower inflation, stabilization in the financial sector, and an eventual economic recovery.

At times like these it pays to take a step back to remind ourselves why we are involved with "risk" assets - namely equities - in the first place. The answer, of course, is their superior long term return characteristics relative to other major financial asset classes such as bonds and cash. In a world where standards of living are on the rise as a result of the increasing adoption of free market, or at least quasi-free market policies, this should represent an even greater truism. The opportunity set is that much larger. ***With an unprecedented percentage of the world's population now engaged in some form of free market/capitalist endeavor, this would seem to be an inopportune time to be leaving equities***.

For now, our portfolio strategy is little changed. Our defensive posture includes global large caps, inflation beneficiaries, gold and cash. Investments in beneficiaries of emerging market growth, which is characterized by intense natural resource utilization, remain central to our positioning. As these markets have experienced greater urbanization, infrastructure enhancements and higher standards of living, demand for natural resources has exceeded supply. These dynamics have provided the main impetus behind the well chronicled rise in oil, natural gas and other commodity prices. ***Our investments in companies providing these essential ingredients to the developing world have essentially been in their own bull market against the backdrop of a weak overall U.S. stock market.*** While we may be entering a violent corrective phase for these highly successful holdings in the short term, they remain beneficiaries of secular trends that will persist regardless of a U.S. recession.

There are at least two prerequisites for a sustainable, broad-based stock market advance: a restoration of confidence in the banking system and a stabilization or drop in energy prices. The financials as a group are extremely oversold and will experience violent rallies such as the one under way as we write. Nevertheless, we continue to caution against bottom picking in the sector. ***The financial industry faces secular head winds that will take years to dissipate.*** When considering the financials, it is worth remembering high tech's fall from grace after the internet bubble burst in early 2000. At that time tech shares accounted for more than 30% of the value of the S&P 500. In the second quarter of 2002, only two years later, the sector's weighting had plunged to less than 15%. Financial shares have undergone a similarly precipitous decline in market weighting, yet it is worth noting that in 2008 technology *still* represents less than 15% of the S&P 500. Similarly, financial stocks could be no better than average performers for a long period despite their precipitous decline in recent months.

This is not a time for heroics, including the heroics of being aggressively bearish. The rules of balance and diversification still apply. The S&P 500 is already down 20% from its peak; European stocks are off 30%; and emerging markets more than 50% in some cases. Investor sentiment is extremely negative which has been a good contrary indicator in the past. Hence, while we are still very much in the defensive camp in the near term, meaningful long term opportunities are in the making. Bear markets are painful in the short term, but it is from their depths that some of the highest returns are made. ***Double digit long term annualized returns originate from bear market lows, not bull market highs, and one needs to be there to capture them.*** The trick is to preserve capital during the downturns and live to fight another day. Remember that markets tend to anticipate economic recoveries many months before economic fundamentals on the ground actually turn. Meanwhile, global infrastructure and natural resource themes still represent tremendous long term growth opportunities for many foreign and domestic companies almost regardless of the scenario. It is important to avoid being shaken-out of important secular investment trends during times like these. In addition to staying the course in strategically important themes, we stand ready to seize on the many undervalued situations that are sure to present themselves as a result of the current market upheaval.

In the current unsettled environment we would encourage all clients to check in with us at any time.