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INVESTMENT REVIEW AND OUTLOOK

The First Half of 2009: *Right Back to Where We Started From*

After a brief and frightening continuation of last year's market meltdown in the first few months of this year, stocks around the world staged a sudden and dramatic three month rally. Improbable as it may seem given the environment, the second quarter of 2009 was the best *on record* for global equities. As a result of this quick reversal, the breakdown of asset class and sector performance over the first half of 2009 turned out to be almost a mirror image of performance in 2008. Commodities and emerging markets rebounded from the bottom of the heap in 2008 to the top as of June. Small caps soundly beat large caps while government bonds suffered major declines. Most surprisingly, low quality/highly leveraged issues dramatically out performed blue chip/strong balance sheet issues during the second quarter of 2009.

Does the counterintuitive market action of the past six months signify a bottom for the economy and the onset of a classic "V" shaped recovery in the second half? It is possible, ***but we think the first half of 2009 was mostly about reversing the dislocations created in the second half of 2008.*** John Authers, columnist for the *Financial Times*, has pointed out that a clearer picture of what is going on emerges when one looks at the *twelve* months ending June 2009. Viewed over that time frame, equity market and sector returns look much more uniform with bonds clearly outperforming stocks. Markets have basically come full circle, back to pre-Lehman Brothers collapse conditions. In the second half of last year, markets were pricing in a kind of financial Armageddon. Volatility as measured by the VIX index surged, credit spreads widened to record levels, commodity prices crashed and yields on U.S. Treasuries plunged. In the first half of this year, with Armageddon seemingly averted, equity pricing and credit risk metrics reverted to reflect, not a depression, but something more akin to a prolonged recession. So here we sit, back at square one, waiting to see if the massive reflationary efforts around the world will succeed in creating some kind of economic recovery.

Will Deflation Now Lead to Inflation Later?

The current recession is profoundly different from others in the post war era as it is a "balance sheet recession." As such, the burning question for investors is not only about the timing and quality of economic recovery, but about something more fundamental. ***Investment decisions today turn more importantly on the outcome of the intense tug of war between deflationary and inflationary forces.*** We will skip ahead to tell you that we do not yet have an answer to this important question. It is the subject of much debate among leading economists. Suffice it to say that the binary nature of the inflation/deflation call makes long term asset allocation decisions extremely difficult at this time. With respect to current conditions, there is no debate: we live in deflationary times. Unemployment rates, excess capacity levels, the retrenchment in consumer spending and asset pricing trends, (particularly in real estate), all point to a deflationary cycle. ***The paradox is that the longer the deflationary pressures last, the more inflationary the policy response will be.*** Given these confusing crosscurrents, it is likely that the markets will remain somewhat volatile in the near term, swinging between reflation hopes and debt deflation fears and back again. Away from the inflation/deflation debate, it is important to note that while the risks of a financial system meltdown have clearly receded, new risk factors are emerging such as commercial real estate. Further, unemployment, which is usually dismissed as a lagging business cycle indicator, could play a much more prominent role during this recession. There is a distinct possibility, given the deflationary backdrop, that unemployment remains at high levels for a protracted period of time. ***Persistently high unemployment combined with sluggish growth could be a toxic political mix, creating the potential for a backlash against globalization itself.*** Regardless, the government is going to be more of an activist in economic affairs going forward, injecting a higher level of "governmental risk" into the market than many investors have seen in their lifetimes. It is imperative that the excesses in the financial sector be corrected and that stronger regulation be imposed. However, it is hoped that the dynamism of American capitalism, one of its unique and enduring strengths, will not be somehow diminished in the process.

Surviving in the Short Term While Investing for the Long Term

The good news is that most of the negatives are now widely understood, if still daunting. A pessimistic outlook of some severity is already reflected in valuations. There are some positives out there; they just take a little more imagination to see. The trailing ten year annualized return on U.S. stocks ranks as one of the worst on record. ***After a ten year bear market, most of the excesses have already been wrung out of stocks.*** From a purely mathematical perspective, the next ten years should be much better for stocks if we are to return to any kind of normalized long term asset class return alignment. Another positive relates to the historical stock market/ business cycle dynamic. The stock market *always* leads the economy out of recession, typically beginning its ascent amidst much gloom and doom. It has always been so, and to make the *there will be no recovery* argument is still a stretch. The more important question will be the sustainability of a recovery, not whether it is coming. ***Finally, there are only so many alternatives in investing and stocks look a lot more attractive than the alternatives over the next five to ten years.*** High quality common stocks look appealing relative to government bonds, real estate and particularly relative to high fee, illiquid and opaque private investments. Importantly, high quality stocks were not associated with the leverage or excessive speculation that brought the global financial system to its knees last year. They should benefit from significant asset class rebalancing over the next year.

An argument can be made that stocks from these levels are a very good bet for the long term. However, an environment dominated by a deleveraging private sector and massively expanding public sector is both new and challenging. Given the continued uncertainties associated with an equal balance between deflationary and inflationary risks, our current portfolio strategy can be summarized as follows:

- Stay cautious and nimble. Maintain above average cash. Be alert to the deflationary risks.
- Diversify. It is not the time for big bets.
- Focus equity investments on companies that enjoy strong balance sheets and above average profitability. Particular emphasis on technology and healthcare issues.
- Emphasize yield across the portfolio. Sustainable yield is a scarce resource. This would include high dividend common stocks, MLPs and, where appropriate, high grade bonds.
- Add to emerging market exposure on pullbacks. Most of the larger emerging economies do not have the structural problems of a vanishing consumer and huge deficits and debts that are a feature of the developed world today.
- Hold gold, TIPs and select hard asset plays as an inflation hedge.

As always, we welcome your comments and questions.