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INVESTMENT REVIEW AND OUTLOOK

It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so.

- Mark Twain

In these volatile and highly uncertain times, there is little that we as investors can “know for sure.” And as Twain’s quip implies, those rare certainties around which a hardened consensus has developed can be the most dangerous of all. Think of the “buy and hold” equity strategy of the past decade or the notion that diversification insulates portfolios from risk. More recently, real estate was a sure thing. Have we reached a point where we must question the ultimate “for sure”, namely that U.S. Treasuries are a “risk free” asset? We are not ready to go there, but the fact that the question cannot be dismissed out of hand highlights the unprecedented nature of the current crisis. It is, among other things, a crisis of confidence. After all, the risk free rate is the very foundation of the financial asset pricing structure. ***This much we know for sure. In times of extreme economic, fiscal and political uncertainty, portfolios must be managed in a dynamic, flexible and, above all, prudent manner.*** It is clearly not the time to rely on canned asset allocation models or dogmatic fully invested strategies.

REVIEW

A feature of uncertain economic times and choppy financial markets is that there is not a major trend to follow. Chasing an index around can prove futile and the risk of getting “whipsawed” in the markets can be quite high. The second quarter of 2010 was a case in point. It was a virtual mirror image of the first quarter. As the first quarter ended, the economy appeared to be gaining real traction. Leading economic indicators continued to improve and even the employment data took an unexpected turn for the better in May. Investors were in a “risk on” mode and stock market leadership consisted of some of the riskier industry segments and individual stocks. Three short weeks later the mood quickly changed to one of “risk off,” as the sovereign debt crisis in the peripheral European countries began to look not so much contained as *contagious*. From its high of 1219 on April 26 the S&P 500 fell 17% through June 30. Meanwhile, 10 year U.S. Treasury yields plunged by more than 80bps. ***It was a classic flight to quality.*** U.S. Treasuries and high quality bonds outperformed stocks, large caps

outperformed small caps and equity leadership came from the more defensive sectors such as utilities, consumer staples and telecom services. Additionally, gold continued to be a top performing asset in Q2.

OUTLOOK

The weight of the evidence points to a clear loss of economic momentum in the May-June timeframe. Leading economic indicators are suggestive of slower growth in the second half of 2010 and possibly into 2011. The June ISM report was a disappointment as were home sales and the most recent unemployment report. The crucial question for investors is whether this economic deceleration represents a mid-cycle pause or, more ominously, a slide back into recession. If it is just a pause, this could be a buying opportunity for global equities after an already meaningful correction. On the other hand, if the global economy has hit stall speed and the current slowdown degenerates into outright contraction, there could be another leg down in equity prices. The headwinds of debt, deleveraging and demographics are stiff and blowing across many parts of the globe. However, at this juncture we are still not believers in a “double dip” with respect to the U.S. economy. As we pointed out two letters ago, double dip recessions are extremely rare. Surprisingly, mid course economic slowdowns are not. In any case, the outcomes need not be binary. The most likely outcome is that we will experience a slowing *rate of growth* in GDP, not a negative growth rate. The bad news is that sluggish growth and weak job creation may be a fact of life for the foreseeable future, giving a deflationary tone to many facets of the economy. Conditions may not meet the technical definition of recession, but it may *feel* like a recession nevertheless. ***It will be hard to sustain any real economic momentum in the western world against a backdrop of deleveraging, fiscal belt tightening, higher taxes, increased regulation and aging demographics.*** The Federal Reserve will need to remain extremely accommodative, *perhaps for years*, in order to offset the deflationary forces of austerity and deleveraging. The recently released minutes of the FOMC meeting reinforce this view. If Chairman Bernanke was concerned about deflation in 2002-2003, when he earned the nickname “helicopter Ben,” he must be doubly concerned today. This may be the silver lining – a prolonged period of extremely low interest rates would be supportive of equities. Still, there are several wild cards, all negative, that bear watching. The first is the sovereign debt crisis in Europe. This situation is a long way from over and the concerns are as much about the debt *holders* as the debt issuers. The European banking system, where much of the “subprime” sovereign debt is held, is under extreme stress. The Euro zone economy looks increasingly like a sequel to Japan. The region could be facing years of economic stagnation as a result of austerity measures, weak growth and poor demographics. The second concern is closer to home and relates to the worrisome budgetary conditions in so many states and municipalities. What if California, Illinois or some other entity were to become our “Greece?” From a Main Street perspective, the concern is that a rash of public sector layoffs could offset any private sector job creation. From a Wall Street perspective, it is that the municipal bond market, long a rock of stability, could face a liquidity crisis in the event of a headline grabbing municipal bankruptcy.

The current situation in Harrisburg, PA may be the first shot across the bow. The final wild card relates to China. As Chen Zhao of BCA Research has noted, “The world economy has gotten used to double digit growth out of China.” Hence, the Chinese efforts to tighten credit and dampen real estate speculation in their economy must be watched closely. We believe they have the tools to manage the situation and avoid a “hard landing.” However, anything less than 8-10% growth in China could negatively impact an already fragile global economic recovery.

CONCLUSION

Despite Mark Twain’s warning about the dangers of what you know for sure, we feel quite sure that a capital preservation strategy is the right one for the time being. However, this does not mean getting out of stocks. Unlike the public sector, the corporate sector is not overleveraged. Many corporate balance sheets are flush with cash. And, generally speaking, the corporate sector is professionally managed and flexible, unlike the public sector. ***There are many quality large cap stocks that look like a better bet to us than buying the debt obligations of the Federal Government at historically low yields, at least if one has a time horizon beyond the next few quarters.*** In our last commentary we mentioned that high quality, low debt equities were attractive relative to other asset classes on a process of elimination basis. We are even more convinced today, given the price pullbacks that occurred in the second quarter. At the same time, the intractable problems of high debt, slow growth and unsustainable entitlement payments that exist in so many developed economies mean that portfolios must be protected against deflation as well as inflation. Cash and, where client mandates permit, high quality bonds are a part of that strategy. High quality, *sustainable* cash flows, whether in the form of dividends or interest payments will be at a premium in a deflationary world. ***Technology stocks may offer an interesting deflation hedge as well.*** In addition to offering strong global growth potential, the technology industry is uniquely suited to respond to a deflationary environment. It is an industry accustomed to dealing with price deflation. Finally, gold continues to be a core holding. In addition to its historical inflation hedging attributes, gold should protect against the currency debasement that is likely to occur as governments around the world try to fight deflation through various stimulus measures.

As always, we welcome your questions and comments.