Paths to prosperity

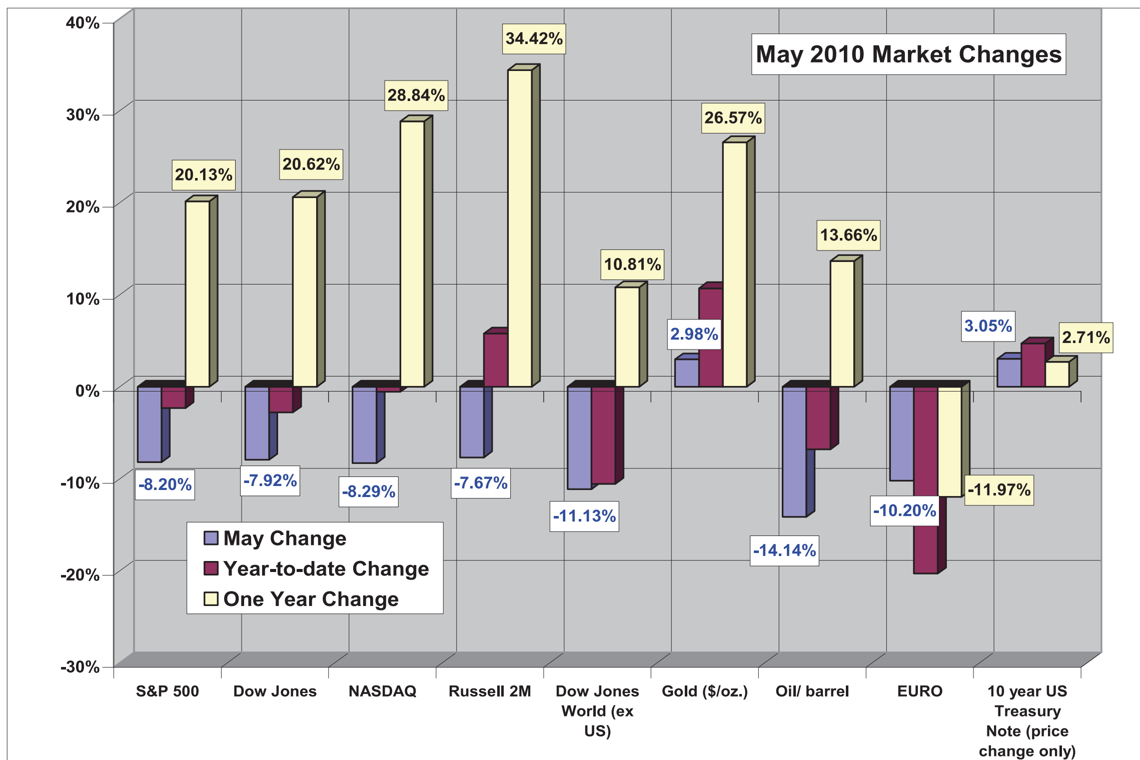
Investment Outlook

June 2010

May Markets

The flowers that bloom in May…

…had an abundance of thorns this year in the form of continued risk related to sovereign debt in Europe, a 1,000 point crash and sharp reversal in the Dow Industrials, some mixed economic results regarding the pace of our current economic recovery and renewed legislative activities in Washington, this time related to "reforming" financial regulations. As detailed on the following chart the value of all "risk assets" were pressured



during May, with only the "safe-haven" Treasury notes and gold offering positive returns.

Equity prices declined 8% in May as the long awaited "correction" took hold resulting in the worst monthly performance since February 2009 and the worst May since 1940. May's losses erased the 2010 gains for all equities, other than the small company Russell 2,000. Gains for the twelve months ending with May still remain robust for assets other than the Euro, which was down -12% from May 2009, and 10 year Treasurys which produced only a modest gain of 2.7% for the time period.

Commentary
"It's the return of my money…

… that the early 20th century humorist Will Rogers reportedly considered taking precedence over *"the return on his money"*. In a similar vein 19th century philosopher and writer Alexis de Tocqueville surmised that democratic societies are threatened when the demands of the populace exceed the willingness of the citizens to pay for them. To this we'll add the adage that the only money a government has is that which it extracts from its citizens or can borrow from others.

Taken together these statements reflect the sentiment we believe is presently impacting sovereign debt specifically and global markets in general. By now investors are well versed in the saga of Greece's maturing debt and the machinations necessary to create a means for the European Union (EU) to provide support. That the support materialized and the debt was repaid when due last month has done little to mollify credit market's concern.

While the European Union may have passed the initial test, the process laid bare the facts that most of the sixteen members are out of compliance with their constitutionally mandated economic metrics and that the governing documents are woefully short on detail regarding how these matters are to be resolved. We have also come to understand that the use of a common currency may serve to exacerbate the differences in wealth and productivity that exist between the member countries. Consequently government budget actions generally described as "austere" will be required by some countries to bring their spending deficits into compliance with the prescribed limit of 3% of GDP.

An unintended consequence of the proposed austerity programs is their potential to actually reduce GDP as government spending is cut and taxes are raised. This may further complicate compliance with the EU rules and set the stage for a negative spiral where further cuts and higher taxes are needed for compliance which puts more pressure on GDP, etc. This possibility has already resulted in rating agencies marking down Spain's credit rating and putting others on "watch". In the meantime France has voluntarily acknowledged that its own credit rating may be at risk as it views achieving near term compliance as "difficult".

All of this brings us back to Will Roger's comments. Lenders, or bond buying investors, have the expectation of the return of their money as agreed at the time the debt was issued. The more likely the return, the lower the perceived risk and the lower the interest rate or cost charged to the borrower. The opposite is true as the uncertainty of payment rises. Of course higher interest rates make repayment more difficult which encourages "serial borrowers" to seek the best possible credit ratings for their debt in hope of negotiating the lowest possible costs.

The holders of Greece's maturing bonds were no different than Will Rogers, i.e. they expected to be paid at maturity. Greece's "economic misadventures" since joining the European Union, coupled with apparent misrepresentations intended to mask the scope of their financial non-compliance, virtually eliminated the present government's ability to issue new debt as a means of repaying that which was coming due. Consequently the alternatives were

to either default on the payment and restructure, or seek support from others to aid in resolving their plight.

Among the interesting observations of the path taken to the present situation is the self-fulfilling prophecy of the outcome. Proponents of an EU-supported rescue argued it was necessary to prevent contagion from spreading to the debt of other members; primarily Italy, Ireland, Portugal and Spain. Whether it is in spite of the efforts taken to contain the problem, or because of the delay in assembling the clumsy response, seems irrelevant as the debt crisis failed to be contained in Greece and has now spread among the EU as a whole as originally feared.

It seems counter-productive to discuss the possible outcomes had Greece been allowed to default. With $75 billion of the Greek bonds held in French and German banks the global financial system seems much too fragile to test the outcome of the replay of the Lehman Brothers default scenario. That said, the "moral hazard" issue remains prevalent here as the rescue of Greece rewards investors for taking a speculative risk and may further condition markets to expect similar outcomes in the future.

This brings us back to the other two maxims noted earlier. First, de Tocqueville's admonition regarding risk to democracy's from populist demands. Government funded "entitlement" programs and labor laws seem to be the major source of the EU budget deficits, with Greece being the "poster child". De Tocqueville also noted that "public welfare" creates a disconnect between the donor and the recipient not present in "private welfare", with the donor feeling no obligation to give more under changing circumstances and the recipient feeling no obligation to accept less. The social-political tension that can emanate from this seems obvious; it is the solution that is elusive.

Finally, our remaining adage regarding the limit to government, or sovereign, resources indicates that permanent solutions cannot be indefinitely postponed. Like Greece, all debtors will find a limit to their available credit when either their willingness or ability to repay is seriously questioned. Greece's debt problem was resolved by the "willingness" of EU governments to obligate their taxpayers for the ultimate resolution.

How well that resounds with the taxpayers, as well as what entity will stand in some future gap for the EU remains unclear, but we can expect debt and currency markets to adversely reflect these issues until the longer-term resolution is better understood. We would also note that the adages referenced here are not "Euro-centric" but are applicable to all debtors, including those on our side of the globe.

Outlook and Strategy

A summer of discontent…

The equity and bond markets seem to be setting up for a volatile summer. Market action will bounded by the headlines related to the political/economic issues discussed above, coupled with any further deterioration on the Korean Peninsula or the Middle East on one hand, and confirmation that the global recovery remains intact and that the earnings growth presently expected is reasonable, on the other. The complexities involved in each of these

would seem to preclude any definitive resolution of either side in the near term which can easily result in prices for both stocks and bonds vacillating within a narrow range.

In the meantime some positive fallout from all of this includes the expectation that any changes to the Federal Reserve's interest rate policy continue to remain "on hold" for the foreseeable future. The absence of any inflationary pressures and the Fed's desire to aid economic recovery should prevail in this summer's policy meetings. The unexpectedly strong dollar allows our Treasury to fund its current deficit at relatively low rates while also reducing the price of imported goods, including energy. Although the same dollar strength makes our exports more expensive to others, low interest rates and energy costs can only be a positive for U.S. consumers this summer.

Lost in much of the recent media commentary are the facts that corporate balance sheets are quite strong with significant liquidity available. Corporate operating margins have also widened which will be further enhanced by the dollar strength to the extent that imported goods or transportation costs are a factor. Both of these conditions are supportive of merger and acquisition opportunities which are generally bullish for equity markets.

Until we are presented with meaningful evidence that the sovereign debt crisis will cascade into a global credit rout, or that the current risk premium for equities should be substantially higher, we will continue to believe that the recent equity sell off is a correction from the prolonged rally that commenced in March of last year. Given the breadth of the stock price declines that led to the March 2009 lows and the pace of recovery to the recent April highs, some volatility should be expected as investors seek to understand the "current reality" and price assets accordingly.

The low yields presently available on cash and Treasury debt make these assets suitable for only the most risk adverse investors or those seeking to hedge risk elsewhere. In the meantime we continue to see value in certain municipal debt issues for tax paying investors, especially when one considers that the path of least resistance for tax rates is upward due to the principles noted in the prior section.

These same low yields on cash and debt also serve to make equities an attractive investment by comparison, especially for those investors with time horizons that extend beyond the next few quarters. To the extent that equity trading becomes "range-bound" this summer as we expect, the market retreats to past low points should provide investment opportunities while the subsequent ascents to recent peaks will allow portfolios to be rebalanced, as may be needed.

We'll be discussing these and related topics with our clients this summer and invite others who would like to join in the conversation to call.

S&P 500:.. 1,098.38
10 Year U.S. Treasury Yield:................... 3.334%

Mark Fingerlin
June 2, 2010

INVESTMENT OUTLOOK is provided as a courtesy of the Wealth Management team at Montecito Bank & Trust. It is not a solicitation to purchase or sell securities. The information cited is believed to be accurate but has not been independently verified. Questions and comments may be referred to P.O. Box 1440, Santa Barbara, CA 93120 or 805-564-0264.

Member FDIC
00157 MBT 0610