

Investment Outlook

JULY 2010

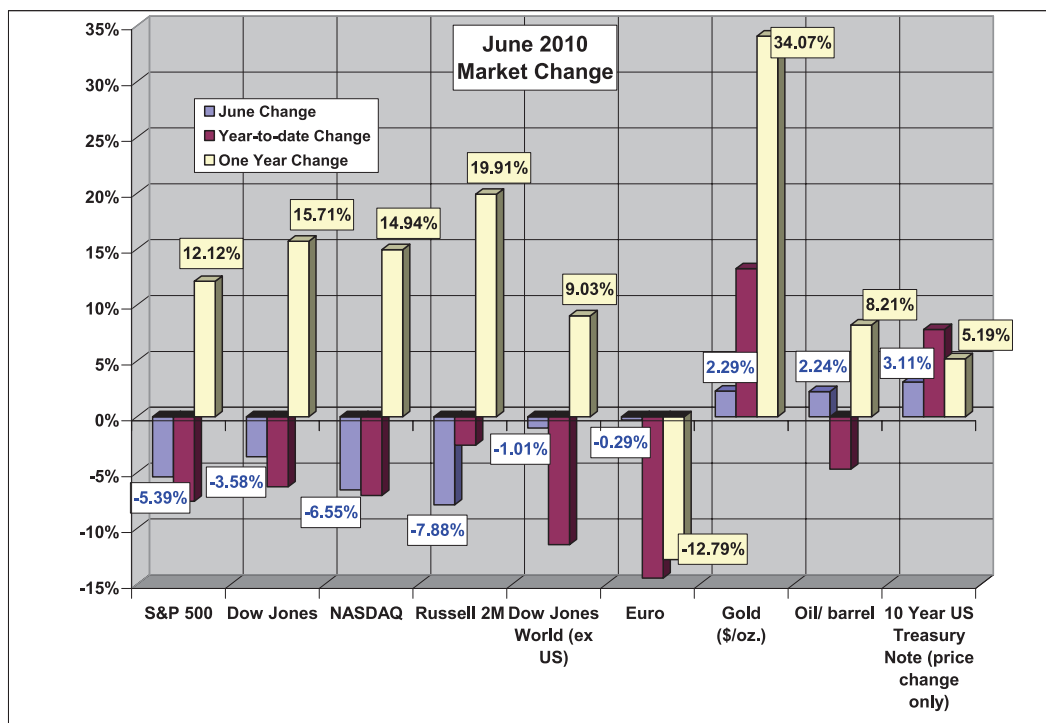
Paths to prosperity



June Markets *May grey to June gloom...*

...generally describes the coastal California weather pattern as summer approaches. This year it also describes investment markets, at least the equity portion.

As noted on the following chart, the market angst from May continued into June resulting in negative returns for all of the major stock indices and reversing any remaining year to date gains. Concern that the fiscal "austerity" that will be required in developed countries to address their budget deficits will slow global economic growth was bolstered by reports



from both the U.S. and China that the pace of recovery, while still positive, was already slowing. The resulting fear that current equity prices may be predicated on overly optimistic growth rates prompted a "sell now ask later" mentality as the quarter came to a close.

As might be expected Treasury bonds rallied in the ensuing flight to safety with the ten year Treasury note gaining over 3% for the month and almost 8% for the first six months of the year. Treasury debt would still seem to have been a poor choice for long term investors as the 5.19% gain for the past twelve months is second only to the -13% loss in the Euro for the lowest annual return among the asset classes charted above.

The month ended with investors pondering whether the stock or the bond market had the correct view of the economy and its ensuing risks.

Commentary "To Infinity and Beyond..."

...is the goal for *Toy Story's* character Buzz Lightyear. Our current goal is much less lofty; we're merely seeking to understand where we are in the economic recovery and when we might be approaching the expansion phase.

Change in GDP growth rate 2000-2010



The adjacent chart of the change in the annual rate of growth for nominal GDP (i.e. not adjusted for inflation) clearly shows the now infamous "V" shape of our economic meltdown, commencing with the Lehman Brothers failure in September 2008, followed by the sharp reversal to start the recovery in March of last year. To date we have yet to approach the economic vigor associated with the pre-recession period, in fact

most of the recent data has displayed evidence of a slowdown in the rate of growth. The recent decline in the equity markets is a direct result of weakening investor expectations for the second half of 2010.

In calibrating our own outlook a review of our expectations for 2010 seems in order. As noted in our January *Investment Outlook*, the consensus for this year among our Wealth Management Investment Committee members called for "...continued growth, but at a moderate and perhaps uneven pace, resulting in positive GDP for the year."

Clues to the strength of the first post-recession year will come from:

- *Stabilized employment markets marked by weekly Initial Claims falling below 400,000 and a lengthening work week,*
- *Continued healing in credit markets evidenced by the return of private-securitization of mortgages and similar assets,*
- *Reports from the Service sector of our economy that mark continued strength, i.e. ISM reports significantly over 50,*
- *Speed of recovery in the housing market measured by changes in the inventory and price levels.*

At this year's mid point only one of the four signposts noted above has demonstrated any positive results. The Institute for Supply Management indices (previously known as the Purchasing Managers' Index) for both the manufacturing and service sectors of our economy remain above 50 through June. (Please note that readings above 50 signal expansion with those below 50 are a sign of contraction.) While the most recent readings were somewhat below expectations and signal a slowing growth rate, they remain in the expansion mode.

Unfortunately the remaining three indicators have shown little progress. The weekly Initial Jobless Claims have actually reversed course in recent weeks and climbed back above 470,000 as the recovery in the labor markets remains elusive.

For reasons deemed to be more political than economic, the Administration and Congress have chosen to defer any resolution for the two federal mortgage entities until next year at the earliest. With these federal conservatorships remaining in limbo there has been little progress made in rebuilding the secondary markets for mortgage finance that is deemed necessary for any meaningful recovery in housing. Consequently housing markets remain pressured on at least two fronts; lower household income resulting from high unemployment and the absence of long term capital support.

In quantifying risk levels for the balance of the year there is a clear consensus among our Committee members that slowing economic growth poses the highest risk. While a return to recession, i.e. "double dip", is not expected, a drawn out period of sub-par growth is anticipated with the expansion phase coming some time later.

Political risk ranked second evidenced primarily by the "unknowns" surrounding fiscal policy, pending tax increases and various regulatory changes, many of which have been legislated in general but not yet detailed. These risks surpass Washington and are present at the state and international levels as well. Uncertainty tends to breed inertia which can serve to restrain any business or personal expansion pending improved clarity for those most impacted by the changes.

At their present levels market prices do not pose a meaningful risk to the Committee members. Equities are seen as trading within a range which can be expected to continue through the current quarter. Similarly the recent sell off has reduced much of the Valuation Risk associated with stocks. The Price/Earnings (PE) ratio looks reasonable presuming earnings for the quarter come close to expectations.

Interest rate and inflation related risks are also seen as nominal as the slackness in demand and excess capacity in many industries will continue to contain price pressures. Some notable exceptions relate to internal developments in both China and India where rising wage and price pressures have recently become evident. Although there are a number of potential outcomes for this, one result can be higher import prices in the U.S. as these costs are passed on in the "delivery chain". While this area bears watching it is too early for predictions or action.

Conversely deflation continues to remain a present danger, although one also expected to remain contained. The combination of excess capacity and supply, coupled with the natural outcome from the "deleveraging" of sovereign, corporate and personal balance sheets will continue to exert downward pressure on price levels. This remains visible in various real estate markets, as noted earlier, but has also been evident recently in energy and materials pricing as well.

With much of our January outlook still intact in July we'll have to be satisfied with glimpses of expansion for now and leave the search for *Infinity* to others.

Outlook and Strategy ***Relativity and other pursuits...***

Investment returns are generally measured on two bases; absolute and relative. The first connotes how much one earned; the second relates the earnings to something else. Investors will find both concepts important in navigating the current markets.

As noted earlier we see little interest rate risk in the near term. Consequently the absolute yields on cash can be expected to remain at their extremely low levels for some time. There are a number of tactics available to increase the yield on a relative basis but all entail a willingness to embrace some form of additional risk. For investors whose objectives require the preservation of a finite value for a definite period, holding those assets in cash is the only option, regardless of the low absolute return.

Less restrictive objectives have some attractive alternatives. For example although the current yield of 2.98% from Treasury debt due in ten years may seem “paltry” on an absolute basis it is 18 times greater than the 0.16% yield available on 90 day Treasury bills on a relative basis. Assuming a willingness to hold the longer-term bond to its maturity, with the understanding that market conditions can be expected to change to the investor’s detriment in the interim, current income can be markedly improved.

In the event that the absolute return of 2.98% is still too low, corporate bonds can provide a higher rate for those willing to also accept some credit risk. Exchanging some credit risk from corporate bonds for the interest rate risk of the 10-year Treasury may also allow income oriented investors to markedly improve their income, when compared to holding cash, without extending their exposure all the way to ten years.

Investors whose tax obligations sharpen their focus on what they keep compared to what they earned may further enhance their relative returns by substituting tax-exempt bonds in the previous example.

The recent sell off in equities has also improved the yield on dividend paying stocks. We continue to invest in quality companies with strong balance sheets and cash flows offering consistent dividend yields that generally exceed the 10 year Treasury yield noted above. An investment objective that is capable of enduring volatile price movement, while earning the improved relative income, is necessary for investing in these assets.

With the exception of the most risk-adverse investment objective we believe the best strategy to benefit from the uncertain macro issues described earlier is diversification between stocks, bonds and cash. Our goal in all client relationships is to structure a strategic plan that matches these investment classes with each client’s specific needs and expectations. We’ll be focusing on this in our conversations with clients this summer. Other investors wishing to join in are welcome to call.

S&P 500..... 1,060.27
10 year U.S. Treasury Yield:.....2.98%

Mark Fingerlin
July 7, 2010