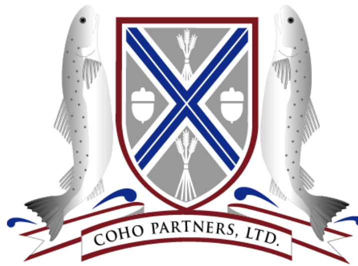

2Q Commentary

"it appears to us that the recovery has made an important transition…..towards a recovery being led more by private final demand."

Ben Bernanke

The U.S. economy may be nearing an inflection point as we enter the second half of 2010. As the majority of economists and strategists long ago moved into the V-shaped recovery camp, we continued to look for signs that would give us confidence that a handoff from government stimulus to sustainable consumer demand was at hand. We have seen little. Rather, what we have seen was the impact of the largest global fiscal stimulus ever combining with a powerful inventory cycle to continue to mask weak underlying demand. The rise in the S&P 500 of over 80% from the lows of March 2009 may have only served to reinforce confidence that the optimism that was found at the start of the calendar year was warranted. Many of us are often guilty of establishing a conclusion and then seeking out the data to support that thesis. As our mid-year report card is due, we feel it appropriate to reprint two key paragraphs from our 2009 annual commentary that unfortunately still accurately reflect our concerns.

"Our shorter term crystal ball is not as clear. As we have done annually in these pages, we try to focus on the more secular concerns and how they are evolving while venturing out with trepidation into the cyclical projections for the economy and capital markets. This recipe had focused over the prior few years on the growing risks of a highly indebted consumer amidst an unsustainable credit and housing boom. A key theme last year was the implications of a pronounced de-leveraging cycle and the likely long term change in consumer behaviors. The distinctions between cyclical and secular concerns are often blurred with the shorter term dominating the discussions. While the unprecedented experiments of the Federal Reserve and Treasury may have succeeded in placing a floor under our financial system and jump starting the capital markets, we may wake up some time in 2010 to find that we have yet to fix the causes of the most recent financial crisis. Indeed, we even have most of the same players making the key decisions."

"Forecasting 2010 is highly predicated upon the actions of the administration and the Federal Reserve. As it currently stands, the Fed will complete the balance of the purchases of mortgage-backed securities in March and the homebuyer tax credits will expire at the end of April. Municipal budget shortfalls are estimated to exceed $260 billion amid a 12.5% revenue decline. This is placing further pressure on reduced services and the prospect of increased taxes. As we factor in the expiration of the Bush tax cuts in 2011 and the possibility of higher interest rates, the risk of another economic leg down in the second half of the year into 2011 increases. Certain political risks must also be considered. What will be the administration's response if unemployment rises (at least statistically) as we expect? Will continued waves of populism lead to stricter capital requirements which further curtail consumer lending? While much of the current focus is on Fed exit strategies to withdraw prior economic stimulus and fend off inflation, the opposite may occur. We project it to be unlikely that the Fed will give more than lip service to exit strategies and that interest rates and inflation will not be a concern. Given mid-term elections on the horizon, we would not be surprised to see more stimulus programs discussed. Presently, consensus growth estimates have GDP increasing 3% in 2010 with most of these forecasts on the rise. We feel that the peak growth rate may actually be in the 4th quarter of 2009 with sequential moderation into the second half of the year. Without further stimulus, we see the risk of a second half downturn becoming more likely and project full year GDP to come in somewhat below expectations at 2%."

Where are we currently on these important issues? Well, we enter the second half of 2010 having now enjoyed three consecutive quarters of real GDP growth averaging 3.5% on an annualized basis with nominal GDP at about 4.2%. Consensus estimates forecast a 3% growth rate for the balance of 2010 and all of 2011. Though these numbers appear to be back to trend line growth, looking beneath the surface data may show otherwise. During the recession, industrial production declined over 15%, drawing inventories down to a bare minimum. The inventory cycle has accounted for over 66% of GDP growth during this mini-expansion and real final sales (GDP less change in private inventories) have averaged only 1.2% growth. Coming out of recessions, this number is normally closer to 4%. The Institute of Supply Management (ISM) which correctly foretold the manufacturing led recovery last spring has now contracted for 2 consecutive months. Sixty-eight per cent of ISM respondents now feel that inventories are at desired levels. The benefit of the inventory cycle may be completely behind us after the 2Q GDP release meaning that GDP will now converge with real final sales. We fully expect 2nd half GDP to approach 1.5%, way below consensus. We are not believers in a "double dip" but clearly acknowledge that the risks have increased substantially.

While business investment should continue strong, it represents only 6.5% of GDP and may be dwarfed by the cutbacks in State & Local government spending which account for more than twice that amount. As the impacts of the European austerity programs wash ashore, our Administration's 5-year goal of doubling exports may be in for a slow start. Is the consumer ready to pick up the slack and increase spending? Employment, wages, and housing will continue to hold the keys.

We have often pointed to the household survey of employment as being a more accurate indicator of job growth at cyclical peaks and troughs than the more popular non-farm payroll survey as it picks up small business hiring and firing. Indeed, we had noted after the first quarter that the worst of the job market was clearly behind us and this metric tallied job growth of over 1.6M jobs in the first 4 months of 2010. The most recent job reports have alarmingly interrupted that growth trend showing consecutive losses totaling over 350K jobs. Though the headline unemployment rate has steadily dropped from a peak of 10.1% last fall to the most recent 9.5%, this is another statistical quirk as in the last 2 months over 1M people have now dropped out of the work force as counted by the Bureau of Labor & Statistics. As they have given up looking for work over the last 4 weeks, they are not counted as unemployed. Had these people been counted, the unemployment rate would have been 9.9%. We continue to maintain that as the job market improves even modestly, more people will start looking for work and we still see the unemployment rate moving towards 10.5% as early as the end of the year. The structural imbalance in the labor statistics is perhaps even more disconcerting as more than 6.8M people are now out of work for more than 6 months with the average duration of unemployment over 35 weeks. There appears to be an increasing disconnect between labor market needs and employee skill sets.

This slack in the labor market has had the expected negative impact on wages and salaries, which have risen less than 1% over the last year through May. Government transfer payments to individuals have grown to represent over 20% of total personal income. Real disposable personal income (after taxes and inflation) is now negative on a year over year basis and basically flat over the last decade. Without wage and job growth, the 3% pace of consumer spending in the first quarter appears to be slowing towards 2% in 2Q. Retails sales declined in May by 1.2%, the first decline since September. A quick read of June appears likely to extend this spending moderation as even Auto sales (previously the strongest retail sector) declined 5% month over month and experienced the 2nd worst month of June ever.

These wage and job concerns have served to only heighten consumer aversion to debt and we continue to witness the secular theme of a deleveraging consumer. Consumer credit outstanding has now contracted in 18 of the last 20 months for a total of over $160B with over 80% representing a reduction in credit card debts. Recent data released by the Federal Reserve Board indicated the debt service ratio (ratio of debt service payments to disposable personal income) has declined from 14% in 2008 to below 12.5%, a level last broached in 2000. While a frugal consumer is a short term hit to economic growth, we continue to maintain that it plants the seed of future investment and continues to be one of the longer term positives in all the economic data.

Much of the economic data over the month of June has deteriorated but none more so than housing. Throughout much of the economic downturn, our Administration has made many short term choices as opposed to seeking longer term solutions. Many of these choices have been made to support our housing market. The First Time Home Buyer Tax Credit has artificially stimulated demand at the same time as increasing foreclosures have been held back from the market by the bank mortgage-holders

controlling supply. With historically low mortgage rates of below 4.6%, housing affordability (as defined by the median family income and the cost of servicing the median priced home) is at record levels. Despite this, we may now be entering the second leg of a housing downturn as the tax credit was allowed to expire at the end of April (with closings extended to the end of September) and mortgage modification efforts having the unintended consequence of increasing the speed of the foreclosure process and, thus, inventory. The Pending Home Sales Index (PHSI) of contracts signed but not yet closed plunged over 30% in May while the New Home Sales figure declined 33% to an all-time low just as the stimulus expired. With a large supply of shadow inventory and bank owned real estate (REO) still to hit the market, prices are poised to decline. Still weak wage and job growth and additional mortgage resets that do not peak in quantity until the middle of 2011 will add to this concern.

With excess capacity everywhere from housing to employment, we have continuously noted that the huge increases in government obligations would be absorbed into the marketplace with no inflationary impact in the intermediate term. Credit crises by definition are deflationary and we have seen the headline Consumer Price Index (CPI) decline outright in April and May and are now below 2% year over year. The core CPI (excluding food & energy) is up less than 1% year over year. We anticipate that inflation will moderate further for the balance of 2010 towards 1.5%. As expected, the 10-year Treasury note reversed course in the second quarter declining from the 4% level to as low as 2.93% and may continue to decline further. We will continue to look for inflationary signs but our eyesight is not as acute as years gone by.

The weakening economic data proved difficult in the 2nd quarter for markets that appeared priced for a V-shaped recovery to continue their upward climb. From the current year's peak in late April, the major indices experienced declines of over 15%. For the 2nd quarter, the S&P 500 declined 11.4% and the Dow Jones Industrial Average dropped 9.4% bringing the respective indices into the red for the year at -6.7% and -5.0% respectively. With analysts increasing earnings estimates for the S&P 500 to over $82 for this year and $96 for 2011, stocks appear to be priced at about 13 times 2010 and only about 11 times 2011 earnings estimates. After massive labor cutbacks and commensurate productivity increases, corporate America is the one leg of the 3-legged stool including the government and consumer that is actually in excellent fiscal condition. In fact profit margins are currently approaching the levels of 2007 that had already represented a 57-year peak.

Under these assumptions, equity valuations currently look very attractive. However, we fear these estimates for the second half of 2010 and 2011 to be extremely optimistic. We are entering a period of slower growth. With inflation nearing 1.5% and GDP slowing by our estimate to about 1.5%, nominal GDP should grow about 3%. Nominal GDP is essentially a proxy for the revenues of all companies and ultimately, of course, has a very high correlation to earnings per share growth. The major difference over shorter periods may usually be found in profit margin expansion or contraction. With margins already approaching prior highs, we feel expectations of 20% EPS growth to all-time highs in 2011 to be unrealistic and look for 2010 earnings to come in closer to

$76 with 2011 a little over $80 per share. While earnings disappointments are rarely good for the markets, we note with enthusiasm the extremely attractive valuations of defensive, high quality companies. Though valuations are rarely a catalyst for short term performance, we feel they are the basis for solid longer term returns. In a slowing economic environment, stable growth companies with strong and growing dividends should represent the best value.

As anticipated in the annual commentary, Sovereign debt concerns in developed nations continue to pose acute global consequences. The paradox of thrift to which we have referred previously was postulated by John Maynard Keynes. The theory states that the impact of trying to save more during recession decreases aggregate demand and consumption with the eventual unintended consequence of lower economic growth and lower savings. This theory is now being tested globally. The austerity measures agreed to in the European Union as consideration for the near $1T loan package by the EU and IMF may succeed only in deferring the default or restructuring of much of the outstanding debt of the troubled nations. In fact, as most of that debt is held by the banks of the more stable European nations of Germany and France, the true intent of the package may simply be to buy time allowing the financial institutions of the bondholders to shore up their capital with debt restructuring being inevitable. The resulting austerity may only serve in the intermediate term to reduce the potential for economic growth in the region and thus impact U.S export growth.

The decrease in our public and political will to assume more deficits is evidenced by Congress recently declining to extend jobless benefits, housing tax credits, or send additional state aid and by the increasing attacks on public pensions by our state governments. The extreme Keynesians, such as Nobel Laureate professors Paul Krugman and Joseph Stiglitz, criticize the global austerity measures and continue to call for additional stimulus without which Krugman has stated puts us in the early stages of a "third depression". As countries start to cut spending and increase taxes, they are in essence hoping for the private sector to be able to increase demand and more than make up the difference. While we agree that we have yet to see signs of this sustainable private demand and while we continue to maintain that the largest risk is deflation, we do not believe that a continuation of poorly targeted stimulus is the longer term solution. The International Monetary Fund (IMF) has estimated that global stimulus added over 1% to world GDP over the last 2 years and now estimates that fiscal tightening will now drain about 1% from baseline GDP. We concur and feel we have entered a longer period of below trend growth that may be characterized by shorter expansions and increasing slowdowns. From a starting point of high debt and unemployment and now staring the largest tax increase in U.S. history in the face in 2011, the margin of safety has most likely decreased. Though not our base case, the odds of a double dip recession have certainly increased.