QuarterNotes

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Fitful Recovery Requires Investor Patience

The crystal ball is still a bit clouded this quarter. Is the growth of the last three quarters, albeit anemic, sustainable, or are we on the verge of a double-dip recession? Is inflation around the corner or are we heading toward deflation? The data are mixed and a good case could be argued for any of these outcomes.

This week, *The Wall Street Journal* reported that the University of Michigan/Reuters Index of Consumer Confidence for May and June rose to its highest levels since January 2008. The same day, the Associated Press proclaimed, “Consumer confidence tumbles in June.” If you are feeling whipsawed by the daily news, it’s because you are. The noise on all sides is deafening.

GDP growth estimates for 2010 remain in the 3% range, well below the 5.7% jump we saw in fourth quarter 2009. These data point to a decelerating growth rate, but they do not necessarily indicate contraction.

The US economy requires monthly job growth of 100,000 just to stay even, and 200,000 to make a real dent in the unemployment rate. Jobs creation in the past few months has not been sufficient to reduce the long-term unemployment rate. Altering government policies alone cannot fix the problem. A great deal of patience is required.

Although we can’t rule out a double-dip recession, that scenario rates only a small probability. Two primary statistics economists use to gauge recessions come from The Economic Cycle Research Institute (ECRI) and the Conference Board. The ECRI Weekly Leading Index is currently signaling deterioration in growth. The Conference Board’s leading economic data had begun to show negative trends in April, but was recently revised upwards to show flat or positive growth through June.

Index	6/30/2010	% YTD
Dow Ind.	9774.02	-6.30%
S&P 500 Index	1030.71	-7.60%
Nasdaq Comp.	2105.26	-7.00%
Russell 2000	609.49	-2.50%
MSCI EAFE	1348.11	-14.70%
10Year Treasury	2.95%	

The most likely scenario for the next six months is a continued period of slow growth as the world economy moves to pay down debt and cut spending. Events that historically exacerbate recessions are unlikely to have similar consequences today. Contraction in monetary policy prior to or at the onset of a recession tends to slow investment and spending. Today monetary policy is extremely loose. The Fed funds rate remains at 0-0.25%. Revised interest rate forecasts suggest the Fed will not tighten any time soon, perhaps not before 2012. Also, recessions usually trigger businesses to lower inventories, reduce capital investment, and cut payrolls. Much of this austerity is already present. Were a double-dip recession to arise, businesses would already be defensively positioned with large cash reserves and stronger balance sheets than found before recent recessions.

As government stimulus and inventory rebuilding play smaller roles, we will rely on manufacturing, exports, and consumer spending to contribute a greater share of growth. Consumers are still paying down debt. But they have been able to increase their consumption because wages have risen faster than inflation and spending.

Current expectations for inflation are consistent with a slow but steady recovery.

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In this Issue

Market Summary

Stocks have had a difficult quarter. After nearly a year of very strong recovery the markets pulled back. For the 2nd Quarter all major indices dropped by 10% or more. Individual investors, having been subjected to the setbacks of the 2008 bear market, are dealing in an environment of fear and uncertainty. They have been reluctant to commit funds to investments with any risk. Although we acknowledge the risks on the horizon, we do not foresee a repeat of disastrous markets of 2008.

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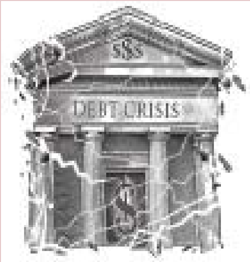

Worried about Deficits?

Should the markets be worried about deficits? Maybe they should be, but they don't seem to be reacting so.

If the markets were worried about deficits, then the yield on 10-year Treasury bond wouldn't be at 3%, low by historical measures.

Markets don't seem worried about inflation either. Bond markets are forecasting an average 1.9% rate of inflation. How do we know this? Because this is the yield premium a Treasury bond offers when compared with the yield of the inflation-protected TIPS (Treasury Inflation Protected Security).

What this may be telling us is that investors are so defensive that they are willing to settle for a 1.1% long-term real rate of return in order to avoid risk.

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Neither excessive inflation nor pervasive deflation appears to have taken root; the trend still shows weak inflationary pressures. Despite historic increases in US debt and the Federal Reserve's balance sheet, core inflation increased just 0.9% over the last 12 months.

With an inflation rate of barely 1%, unemployment still high, and excess manufacturing capacity, we are concerned that any further deterioration in the economy could cause deflation to set in. On the other hand, supportive monetary policy in the form of low interest rates and ample money supply could amplify inflation on any rapid improvement in the economy.

Recovery from such a deep recession will not be a straight line up. We do see positive signs including stabilization of housing prices and a modest rise in manufacturing. Productivity is rising as employers are squeezing more out of each worker. As demand builds, firms will need to start hiring.

How do we position portfolios in this environment? Longer-term bonds would look great in the face of deflation, but they will be trampled if the interest rates rise as expected in the foreseeable future. With shorter-term bonds and cash earning next to nothing, putting all our eggs in either basket looks foolish. US stocks are generally thought to be in fair value range with a forward P/E ratio of about 13 times 2011 earnings, but if growth lags expectations, P/Es and stock prices could fall. Tactical positions can help, but they tend to be drag on portfolio performance when the market rallies. In sum, we prepare for these uncertain markets by keeping adequate liquidity and diversifying our risks.

Taxes Are Going Up

At $13 trillion and climbing, the level of national debt is a concern to all of us. The debt now represents 89% of US GDP, a level we haven't seen since WWII. Taxes will inevitably rise. As part of the healthcare reform, a 3.8% surtax on investment income will hit upper-income filers.

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Without Congressional action, the Bush tax cuts of 2001 and 2003 will expire at the end of 2010, increasing tax rates at all income levels. It is unlikely that Congress will allow that to happen. The President proposed allowing the tax cuts to expire only for couples earning over $250,000 or singles earning $200,000, meaning the top two rates would rise to 36% and 39.6%. Long-term capital-gains rates would rise to 20%. Dividend income would return to ordinary income tax rates, but the President's proposal was for a 20% maximum rate on dividend income.

World Outlook

The G20 meeting that concluded in Toronto last week highlighted the differences in economic philosophy among the protagonists. The European economies led by Germany pushed for austerity. The US argued that an abrupt contraction in spending would damage the recovery. In the end, the leaders of the world's 20 largest economies settled on a strategy of "growth through intelligent austerity." The leaders tried to strike a balance between the "imperative of fiscal consolidation and the need to support a job-rich recovery." There was recognition that all countries can't contract at once or we would risk the fragile recovery and delay creation of needed jobs. There is some cause for optimism as world growth in the years ahead is projected to average 4.75%. Emerging markets, however, are expected to contribute more than half that growth.

More than ever the US exists in an interconnected world economy. Under pressure from Washington, China's decision to let the Yuan float against the dollar should help US exports. This should have a positive affect on employment, profits, and growth. On China's part the move recognized the need for a more balanced relationship with the US. The revaluation should reduce deflationary pressures in the US as Chinese imports are no longer artificially underpriced. In 2005, the last time the Chinese allowed the Yuan to revalue, both stocks and commodities had strong gains. The result, however, could be bad for Treasuries. A rising Yuan reduces China's need to purchase of Treasuries to support the arbitrary fixed exchange rate.