A View from the Tower

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2nd Quarter Investment Overview

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Stock Rally Continues Through the 2nd Quarter

The 2nd quarter ended on June 30 and what a quarter it was! Stock markets around the world turned in the best quarterly performance in several years as the S&P500 drove up 15.93% to 919. The 2nd quarter appreciation was a continuation of the rally that began in early March when the S&P500 bounced up from the 666 low as 1) investors came to believe the coordinated effort of massive stimulus plans instituted by governments would prevent a meltdown of the global financial system, that is, the system would be saved 2) the bubbly price of stocks had corrected to levels offering good value and 3) by far the most important ingredient was hope for the future, however modest, replaced bleak fear. Accompanying the stock upturn was a decline in bond credit spreads and stock price volatility. These factors provide important empirical data supporting the notion of improving confidence and increasing risk appetite. Further evidence was shown by investors bidding up the prices of more economically driven areas such as small cap stocks. Indeed, for the quarter small cap stocks outperformed large cap and stocks of the growth style outpaced stocks of the value style.

Rally Carried by Broad Sector Participation

A rally's strength can be measured by the breadth of the participation. A rally with a majority of stocks or groups participating is termed broad-based or having good breadth and indicates a stronger and more sustainable advance. The S&P500 is composed of 10 economic sectors with Information Technology the largest index weight at 18.3% and Materials the smallest index weight at 3.2%. The rally in the 2nd quarter returned 15.93% with the Financial Sector leading the surge with a return of just over 35%, followed by Technology returning 19.7%. The sector with the lowest performance was Telecom which returned 3.40%. Although that return may seem low, the importance is not the size of the return but that it was positive: all 10 sectors contributed to this rally, giving it very strong breadth. This supports the argument for the rally's sustainability.

The Economy & the Stock Market Recover

The news stories and business statistics that were reported during the quarter generally supported the notion of an economy that had stabilized from its downward spiral. As an example, JP Morgan's chief economist raised their economic forecast for the 3rd quarter from 1% to 2.5% growth. Other economic forecasters, including the International Monetary Fund, similarly raised their forecasts, suggesting the recession technically could end in the late summer.

However, two important factors for the strength of the economic recovery caused concern in the stock market. First, the late June employment report showed an unexpected increase in the jobless statistics. Second, the growth rate in certain monetary aggregates that are closely associated with an expanding economy have shown weak increases, stirring concern the Fed may not be providing enough monetary aggregates to support the recovery. The combination of these two concerns caused the stock market, which was already in a sideways correction, to sell off to lower levels. When examining the selloff, materials, energy, industrial and technology stocks suffered greater than average declines, implying the threat of deflation may be rising again.

The Inflation vs. Deflation Debate

Although it's not Lincoln vs. Douglas, among economists, market seers and investors, there is a heated debate as to whether the US is cruising to a 1970's redux of crippling inflation or a Japan-like period of deflation.

The common talking points from those advocating the "inflation is coming" argument stem from 1) the US government has pumped a massive amount of money into our economic system 2) the government continues to propose huge spending plans 3) this indicated huge increase in money in the system will be chasing a relatively modest amount of goods from our production due to the slow economy. More money chasing the same amount of goods equals price increases (inflation!).

The deflation argument relates the evidence from the Japanese deflationary experience of their "lost decade" to our experience with our twin bubbles of real estate and stock prices which broke in 2007-2008. Additionally and closer to home, the ongoing deleveraging process continues as consumer credit contracted by $3.2 billion in May. While reducing this debt from the recent very high levels and building liquidity is a sound goal, deleveraging serves to diminish economic activity. Beyond the consumer, the financial sector is also likely to deleverage from currently very high levels. Continuing the argument, with a sluggish, sub-standard recovery, the economic base to support real estate and stock prices is at a lower level. This is corrected by falling prices and voila! deflation.

To the extent consumer and corporate debt will diminish, it appears this decrease could be swamped by the huge surge in government debt required for funding the various programs (Health Care, Medicare, Social Security, etc). Investors are asking the question, "Will a government somewhat dependent on the support of the voters, have the courage and determination to take away the stimulus/punch bowl?" Clearly it's a fine line between providing just enough stimuli to pump up the economy, but not so much as to create inflation. Wall Street has reacted cautiously to statements from the Federal Reserve discussing an exit strategy of reducing the monetary stimulus from their programs.

Clearly the outcome affects both bond and stock prices and is a topic that we are watching closely. With core CPI recently reported at .1% and gold hovering around $915, it appears other factors, principally the economic recovery, are driving the course of stock prices in the near term.

Conclusion: Remaining in Act 3

Since the closing high on June 12, the market began trading in a typically sideways correction. With the late June employment report prices broke lower and at quarter end the correction was continuing. Although experienced investors know such corrections are a normal part of market activity, seeing prices decline and gains evaporate is painful. This development presents an opportunity to make certain asset allocation and portfolio structure is appropriate.

As investors we must remember the stock market has its own clock and calendar and behaves indifferently to the conventionally accepted time norms. For example, our analysis indicates the market entered into a new period with the market low on March 9, 2009. We consider this Act 3, the period between the market low and the end of the recession (Act 1 was the decline last autumn and Act 2 was the consolidation from October through March). During Act 3, Materials, Technology, Consumer Discretionary sectors could be expected to outperform

Conclusion: (cont'd)

along with International equities, especially Emerging Markets for global investors. Investors should, of course, maintain a diversified portfolio of assets that is consistent with their risk tolerance, income needs and specific considerations unique to each investor.

The correction is occurring in International markets as well as domestic, and we anticipate this correction could continue for some time and with additional price declines. With the low volume dog days of summer upon us, re-igniting the vitality of the market advance will likely require a new catalyst, such as earnings reports exceeding expectations, reports of economic conditions improving or stronger stock accumulation/distribution ratios. Whatever the catalyst may be, at this time our research models support the conclusion the next significant move will be a resumption of this market advance.

Stories Making News This Quarter

Regulation

- The White House announced a proposal for massive reorganization of the agencies responsible for financial market supervision. Although nearly all agree on the need to prevent the abuses of the recent past, many viewed the proposal as being too restrictive.
- It was reported the White House is considering nominating someone other than Ben Bernanke as Fed Chairman.
- Bernie Madoff was sentenced to 150 years in prison for his undetected Ponzi scheme bilking investors out of an estimated $50 billion.

Areas of Tension

- Protests over the disputed Iranian election, stepped up US military activity in Afghanistan, and pullout of US troops from parts of Iraq kept the Mideast in turmoil. North Korea fired several missiles and exploded a nuclear device.

TARP

- Several larger financial institutions that successfully passed their “stress tests” have started to repay the TARP money they received from the government last fall. Whether raising new capital or having sufficient capital, this is a positive development for the strength of these financial firms.

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