

July 13, 2011

2011 Second Quarter Review
“The Endless Intervention”

The second quarter of 2011 was not quite as eventful as the first with, thankfully, fewer disasters. The financial markets see-sawed, but most equity indices essentially remained very near the same levels of three months ago. After a rise in April was followed by a six-week decline through May and late June, most of the indices struggled back up to finish very near where they stood at the end of the first quarter. The S&P 500 Index finished June up 5% so far this year while the Nasdaq was up 4.6%, both slightly lower than they were at our last report of March 31st. The same story held for long term bonds, although they rose slightly for the quarter, with corporate bonds doing a little better than Treasuries. The iShares Barclays 20+ Year US Treasury ETF finished the second quarter roughly unchanged for the year so far. Gold prices rose again by about 5% for the quarter, while oil prices slid, dropping from a high of almost \$115 a barrel in late May to finish at \$95 by June 30th.

Financial news has dominated the headlines recently with concerns about possible European Union defaults, a possible US government shut down at having reached the debt ceiling, high domestic unemployment, and the lingering amount of repossessed real estate hanging over the residential housing market. Just today, the stock market is up sharply (after a few days of decline) because Mr. Bernanke has mentioned the possibility of “QE3,” or another round of monetary stimulus. It is a continuation of what some analysts have called “the endless intervention” by the Federal Reserve Board in an attempt to stabilize the economy. Gold has just rallied to a new high on this possibility of a third round of “quantitative easing”. Investors are buying gold based on the perception that the Fed will never stop printing money until economic growth resumes at a more healthy clip and unemployment is reduced. Given recent statements, that seems to be a reasonable assumption.

However, today’s rejoicing may be premature for several reasons. First, if another stimulus is needed it will be because the economy is in worse shape than was thought. Second, the political will for such a move appears to be substantially lacking. Third, if the first two “QE’s” haven’t done the job, perhaps we shouldn’t bet heavily on the third one working. Fourth, while further “easing” may be good for gold, it may have other adverse consequences, including a contraction in Price/Earnings ratios for stocks in general. That would mean that investors may not be willing, for example, to pay 17 times the earnings of a company in an inflationary environment, but may be willing to buy at a lower price of 15 times those same earnings. That marginal adjustment alone (based on the same earnings) can take a market down 12% without any decrease in the underlying earnings or economic activity. The S&P 500 Index (excluding financial and utility companies) is currently valued at about 17.5 times the earnings forecasts for 2012.

It may be that the unemployment problem is not cyclical and short-term but more intractable. The effect of the Fed’s policy of easy money may be blunted as corporations appear to be soaking up the liquidity that the Fed is providing and putting it into fast-depreciating equipment, not hiring new employees. Banks are using the liquidity to buy treasuries and play the yield curve, not to increase the loans they make. In the meantime, the policy of quantitative easing has had adverse consequences in raising the costs of the necessities of life and by penalizing savers, placing more pressure on the middle class. As a result, end-demand from consumers in our economy may disappoint in the months ahead, and consequently so might corporate profits. In addition, and without belaboring the point,

politicians are perennial easy targets. However, the dysfunctional nature of our political discourse has led to a type of economic brinkmanship regarding the debt ceiling and economic reform that may further add to our current problems while fiscal imbalances are kicked down the road. That road to the self-sustaining economic recovery that we hope for may yet get bumpy.

Problems often bring opportunities. Financial stocks have been driven lower across the board for many obvious reasons. In general we are avoiding the large banks, even though they are statistically cheap, because of the numerous headwinds they now face: new regulations that change the business model and reduce profits, proven poor management during the last cycle, stock issuance that has diluted earnings per share, the reduction or shedding of their high return businesses like proprietary trading and derivatives, and the impaired nature of their client base. Big businesses don't need them, and they are slow to lend to small businesses. The consumer is on the ropes and residential real estate is slow. However, insurance companies may be the baby that is being thrown out with the bath water. As a sector, the insurers look to have strong profit growth in 2011 and 2012, their valuations are cheap at about 7 times next year's earnings estimates, most are buying back their own stock (not issuing it), their return on investment is improving, and the sector is currently severely underweighted (by nearly 40%) in the mutual fund universe. We smell opportunity and plan to act accordingly.

Another area fertile for finding opportunity may be in Japan. The Japanese economy has been stuck in low gear for years now. (Do you remember the fear that they were going to buy everything in America in the 1980's?) The Japanese market is statistically cheap, and the earthquake and tsunami disasters may be the shock that gets the engine of growth started for them with their rebuilding. As always, a case for value will be the prevailing consideration. That case looks increasingly interesting.

Capital preservation is of utmost importance to us and to you. We see a microcosm of the investment world among our own clients. Some are terrified into inaction with fear of another market correction while others are eager to catch every rally. The former are focusing primarily on risk, the latter almost solely on the rewards. Balancing the two is an act that we perform on your behalf in the attempt to preserve your capital and take advantage of the opportunities when they arise. It is not an easy job, but it always seems easily improvable with the benefit of hindsight. Our mix of investments won't match every rally in the market. No successful investment style does. But we strive not to subject your portfolio to excessive risk in the pursuit of profits. Consequently, our strategy of building a core of holdings of those large companies' equities paying good dividends (and having some pricing flexibility in an inflationary environment) appears to us to be most reasonable. We add to that some investments that correlate with the price of precious metals, and some individual value investments, and we believe we have a good foundation for both the risks we face and the rewards we strive for.

Enclosed are your portfolio statements and reports for the second quarter. As always, please give us a call if you have any questions or comments, or you would like to discuss any aspect of your investments. I hope you enjoy the rest of the summer of 2011.

Sincerely,

Claude Carmichael CFA