



Investment Commentary

July 2009

The second quarter of 2009 rewarded investors who played the oversold theme. Adding a degree of tactical risk back to portfolios here early this year – by partially restoring positions in U.S. stocks, fully restoring weightings in large non-U.S. and emerging market stocks, initiating high yield exposure and beefing up other bond holdings – eventually proved beneficial through its halfway point.

As the term “oversold” indicates, these decisions, and indeed the returns that followed, were driven more by price than by fundamentals. Now that pricing has rebounded, thus becoming less of an anomaly, we need to see the beginnings of a follow-through on the fundamental side, one that goes beyond just an easing of the downtrend, to support continuing returns. The “less-bad” declines in economic and corporate performance that cheered investors a few months ago now need to start phasing into actual increases. This is a challenging period of transition as we try to recover from a recession amid reminders that it has been unusually deep.

Financial market behavior as the second quarter progressed in fact suggested a hand-off from the price-driven investor mindset to the fundamentals-driven one. April and May saw very strong returns in stocks, particularly in non-U.S. developed and emerging markets, as well as most bonds that carry more risk than Treasuries, and commodities, all recovering from very depressed levels. But on the heels of this quick run-up, June ushered in a time-out, take-stock mentality, and returns paused. The post-party sobering has continued into early July, much of it tied to a disappointing unemployment report for June, which brought the number of jobs lost over the last 18 months to a staggering, and economically debilitating, 6.5 million.

Specifically, the S&P 500’s 15.9% quarterly gain was almost entirely achieved in the first two months. (From the March 9th low to its interim high on June 12th, the S&P gained roughly 40%; this still left the index 40% below its October 2007 level, compared to the near 57% drop at the low point.) Overseas equity markets followed a similar pattern. The MSCI EAFE index’s 25.4% quarterly gain included a 0.6% June retreat, and the MSCI Emerging Market index posted a 34.7% quarterly gain despite giving back 1.4% in June. Respective year to date gains in the S&P, EAFE and Emerging Market indices thus stood at 3.2%, 8.0%, and 36.0% through six months. The GSCI commodity index, reflecting renewed optimism about the path of the global economy, rose 19.2% in the quarter, including a flat June, leading to a 6.6% year-to-date gain.

Likewise, in the bond markets, increased investor openness toward risk was well illustrated in the second quarter (and again, mostly in April and May), building on trends established in the previous three month period. U.S. Treasuries, the highly popular safe

haven and 13.8% gainer in 2008, lost 3.1%, bringing their year-to-date loss to 4.5%, the worst six month stretch in over 30 years. Meanwhile, investment grade corporate bonds enjoyed a 10.8% return, and high yield bonds, at the other end of the risk spectrum, posted a 23.2% return; year-to-date gains thus stood at 9.2% and 29.4%, respectively. Both bond categories benefited greatly from the normalization of their yield spreads over the Treasury yield from what had been record-setting levels six months ago; the corporate yield premium narrowed from 6.0% to 3.4%, and the premium for high yield contracted from 17.0% to 11.0%. Municipals also moved back toward normal yields expressed as a percent of Treasury yields – returning to the 90-100% range after approaching an unprecedented high of 200% early in the year – and posted a quarterly gain of 2.7%, bringing the year's return up to 7.3%.

The magnitude of these various gains suggests a combination of relief that the depression scenario had receded and growing confidence that the recession soon would run its course. Most economists are looking for economic growth to return by year-end, at which time the downturn will have reached the two year mark. On a parallel track, Wall Street analysts generally expect a two year long streak of quarterly earnings declines to turn around, fairly sharply, with this year's fourth quarter results. The underlying hope is that a restoration of corporate profitability can lead to much needed improvement in employment and consumer spending power.

If for no other reason, fourth quarter results for both our economy and for corporations should turn positive because of very easy comparisons to last year's fourth quarter. But as we move through this transition period, questions about the magnitude and sustainability of what recovery comes our way, in 2010 and beyond, loom ever larger. Part of the picture has to do with how well we address some of the core problems that led to the crisis, including the fragility of banks and credit markets. Also, as underscored by the continuing carnage in the labor markets, we need to consider the state and prospects of the consumer. Consumer spending has been a steady contributor to economic growth, with fairly minor variations over longer periods, but clearly there are big near term challenges, and two thirds of our economic output is consumer-driven.

As for banks, the government-administered stress tests, completed in early May (with plenty of advance intelligence over the preceding several weeks), concluded that most of our largest lenders are reasonably healthy, though several were deemed in need of additional capital. Generally, the results were taken well by investors. Tapping improved sentiment, banks as a group have been able to return to the public markets to raise equity, around \$65 billion in total. Also, J.P Morgan, Goldman Sachs and Morgan Stanley were able to sell bonds without Federal Deposit Insurance Corporation backing. This new infusion of capital effectively has allowed the Treasury to shelve its plan to buy impaired loans off bank books. The plan has been termed "the greatest program that never occurred", as the concept by itself seemingly created enough new confidence in banks so that capital could be raised.

But while these benefits have accrued to the top dozen or so lenders, important mid-sized banks are not in the same position to raise equity in the public (or, to any great extent,

private) markets, and may be set back by the absence of the loan sale program. They remain saddled with bad loans, many of them tied to commercial real estate, where tenant square footage cutbacks naturally lag the major reductions in headcount that we've seen since the recession began. Taken as a group, the mid-sized and smaller banks represent an important engine for economic growth in the U.S. A persistent inability to lend, combined with continuing loan losses, pose an obvious threat to the recovery picture.

Along with bank lending capacity, the direction of interest rates and government borrowing levels will have a direct bearing on how well the financial system can support economic recovery. The weakness of Treasuries, with the ten year rate rising from 2.3% to 3.5% over the first six months of the year (briefly touching 4% in early June) generally has pushed up other borrowing rates, including mortgage rates. Higher Treasury rates may be an ongoing necessity as the U.S. government floods the market with unprecedented amounts of new debt – now expected to exceed \$2 trillion for the fiscal year ending this September 30th. Recent Treasury auctions have been well supported, but the lion's share of the issuance still lies ahead. And even success in luring investor demand, through higher rates or other means, carries an undesirable side-effect: much of the bond buying power comes from people and institutions who otherwise might invest in the private sector, expanding enterprises and creating jobs.

While rates are still low by historical standards, recent consumer borrowing cutbacks suggest much higher than normal sensitivity to even modest rate increases. Along with an increase in savings rates, to 6.9% in May compared to zero just over a year ago, major contraction in outstanding consumer credit tells us that retrenchment and deleveraging has become firmly established, probably for some time. Early in the recession, consumers were very slow to accept belt-tightening, and were propped up by roughly \$500 billion of home equity extraction. Now, on the heels of a 25% drop in house values, \$12 trillion in lost stock value, and the 6.5 million job losses over the last 18 months (and an even grimmer picture if you take into account the millions who are underemployed and related trends in hours worked), consumers are not well placed to lead us to economic recovery. And, consequently, what recovery we have will not be particularly robust.

Overall, the rest of 2009 and start of 2010 should see an improving, but dull economic picture, with smaller declines than earlier this year transitioning to modest growth, perhaps closer to the 2% rate than the 4% clip that has characterized previous recoveries. As for corporate performance, we should see benefits from cost-cutting, payroll slimming and productivity improvements. And severe inventory de-stocking over the course of the recession sets the stage for an above-average rebound, even without a robust consumer, helping manufacturers and all links in the supply chain. Coming off a very low base, a solid earnings recovery later this year and into next seems a reasonable expectation. But at some point in 2010, we will need actual top-line growth at companies, a significant jobs recoupment and improved consumer spending to support continued recovery.

In the longer run, our fate may hinge on the merits of Barack Obama's weighty and ambitious economic programs that the massive Treasury bond placements will be

supporting. The White House approach is a bold one and the thinking is big, but this also means the stakes are unusually high. If Obama's vision of cost savings down the road pans out, aided by streamlined health care and energy usage, we may be able to get through this period of heavy debt issuance. If not, we will have intractable structural problems that stymie all elements of economic output. The jury is still very much out on whether the stimulus plan, enacted in February, will truly create or even save jobs. Both the health care and energy initiatives are controversial, and there is a good chance that neither will become legislation.

An energy bill did pass the House by a small majority in late June, and it will face a tough Senate fight later in the summer. If passed, it will put a price on carbon emissions, creating both burden and opportunity. One way or another, we should continue to see, as we do today, new avenues of innovation in pursuit of energy efficiency. What is less known is whether the U.S. will be the leaders; recent industry surveys claim that new energy technology companies are better established in Japan and Europe, and, more recently, China. Whether here or abroad, while much is made of the "green" push, economic viability and a positive impact on jobs and profits, not environmental improvement, will be the key requirements for lasting success.

Heading into the third quarter, we are trimming exposure to small and mid-sized U.S. stocks as well as high yield bonds, each of which helped drive second quarter gains and was a clear beneficiary of renewed investor willingness to take on risk. The remaining exposure to corporate bonds and stocks is biased toward higher quality securities, which participated less robustly than their lower quality counterparts in the spring run-up. Further, we have added to non-dollar exposure within the bond segment. As we watch unprecedented amounts of dollar-denominated government bonds flood the market and fiscal deficits mount, we see increasing odds of dollar weakness. Finally, as we have noted in the last two letters, we continue to stress active managers; robust credit and equity analysis becomes ever more critical as we move through this period of economic uncertainty and transition.

We hope this letter finds you well and enjoying the summer. As always, please let us know if you have any questions or concerns.

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