2nd Quarter 2011 Commentary

"I'll gladly pay you Tuesday for a hamburger today." - J. Wellington Wimpy

Wimpy, of Popeye cartoon fame, would be a perfect character for the current times. Wimpy was soft-spoken, intelligent, appeared to be well educated, but was somewhat of a scam artist and was just trying to make it through each day. Popeye and friends became popular during the heart of the Depression, and the Wimpy character was a reflection of the times. Wimpy's personal mantra of asking for something now with the promise to pay for it in the future resonates today as well. The European sovereign debt situation, which I have discussed frequently in my recent quarterly commentaries, remains the bunion of the global economy. It's fair to say that Europe's financial problems are a pain higher up on the anatomy as well. It simply won't go away because it can't go away. Greece/Ireland/Portugal should hire Wimpy as their spokesman, which would be ironic, since they couldn't pay Wimpy next Tuesday anyway.

The Wimpy strategy in Europe, with Greece at the forefront, is to kick the can down the road and pray for a miracle. Last year Greece could not refinance its debt obligation and required a bailout (which caused a big hit to global stock markets for about 4 months last summer), followed by Ireland. Each of these small countries, both by physical size and economic profile, needed over $100B (that's B as in billion) of financial assistance. In May 2011, Portugal joined this infamous list and, after repeatedly saying they did not need a bailout, agreed to a bailout. Portugal also needed over $100B. Now, Greece needs more money, a second bailout of another $170B not even a year after the first one. I have commented previously that Spain is the real line in the sand with regards to this Sovereign debt crisis situation. If Spanish bond yields start to blow out and head higher, making the ability to refinance its debt cost prohibitive, then all bets are off. Spain's economy and its debt obligations are larger than Greece, Ireland, and Portugal. There was news recently that a Spanish region Castilla-La Mancha (where the Man was from?) was declared totally bankrupt by its incoming administration and did not have money to pay its government employees. Spain had one of the worst housing bubbles in Europe and has 20% unemployment already. It doesn't sound too optimistic there either.

As the graph on the next page shows, yields on the 10-year bonds of Portugal and Ireland have effectively doubled in the last six months and are now above 12% (Greece 10-year yields are in a league of their own, above 16%). The yields are soaring because the bond values are plummeting, as investors believe these countries will default on their debt obligations. Investors that own these bonds will take a significant principal loss if they sell before maturity. Also, these countries are effectively shut out from selling more bonds to the market because it is too cost prohibitive for them to sell bonds at these yield levels. So, the only means for these countries to refinance their debt at reasonable rates is to receive bailouts from government led institutions.

An intelligent person would ask, why do they continue to give countries drowning in debt more debt? Because they (the European Central Bank, the International Monetary Fund, and European banks collectively) are scared to death of what may happen if they allow those countries to default on their debt obligations. And a big reason they are scared to death is because the biggest holders of the debt of these countries are the European Central Bank and European banks. Many major European banks will not have sufficient capital if they have to take a massive hit on a write-down of those debt holdings such that the banks could go under unless they raise more capital from the financial markets to cover these losses.

Now you know how the financial circle of life is working in Europe. The people of Greece, Ireland, and Portugal are being cast into a depression and burdened with debt they will never be able to repay in order to save the European banks and European Central Bank from catastrophe and possibly drag the rest of the European economy down the drain with them. Will the citizens of these countries sit there and take this hard medicine, accept depression-like economic conditions and throw away their futures. Very unlikely. You are already seeing massive unrest and pushback in Greece with major strikes and violent protests as Greek Parliament voted for a new austerity budget in late June. The Greeks are a passionate and volatile lot (My Big Fat Greek Wedding). In Ireland, they have pubs and drink so it's a lot more low key but don't think for a minute that the Irish are planning to accept depression-like conditions for 10 years for a debt burden they have no chance in hell of repaying. If I were Irish (my Mom is a Mulligan so technically I am, at least on the golf course where I proclaim my cultural heritage at least once a round), I'd be in the pub every night.

Gee Mark, that's pretty interesting, stuff (in a perverse sort of way) but what does that have to do with us here in the US? Yes, US financial institutions have very little direct European Sovereign debt exposure. But, some US financial institutions, like insurance companies, investment

banking firms, and some major banks with investment banking businesses, have sold insurance (called credit default swaps or CDS) against European bond defaults and they would be on the hook for making payments to CDS holders should a default occur. If that happens, there will be some financial impact to some companies here in the US, but the size of the impact is still unknown. But, just given the size of the debt outstanding from these countries already in trouble, it is not going to be an insignificant amount.

The Great Debt Deleveraging remains the single biggest overhang for the global economy. As a nation, the US is drowning in debt ($14+ trillion and counting), and the national deficit and how to get it under control is a political hot potato. In August, the US will hit our national debt ceiling limit without an agreement to cut spending or raise taxes. And the debt rating agencies have put our nation's debt rating (unbelievably the US is still rated AAA) on watch for a downgrade. The US has serious debt issues of our own that hang as an albatross around our collective necks and will have an impact on the economy and consumer sentiment for the foreseeable future. The Baby Boom Generation and the one before it have been great beneficiaries of government largesse and deficit spending. These benefits have been financed by tax dollars from future generations and we are now spending well beyond our means and ruining the future for the younger generations of Americans. It remains to be seen if the older generations of Americans are willing to "sacrifice" some of their government provided (and unfunded) social benefits so that America can get back on the right path.

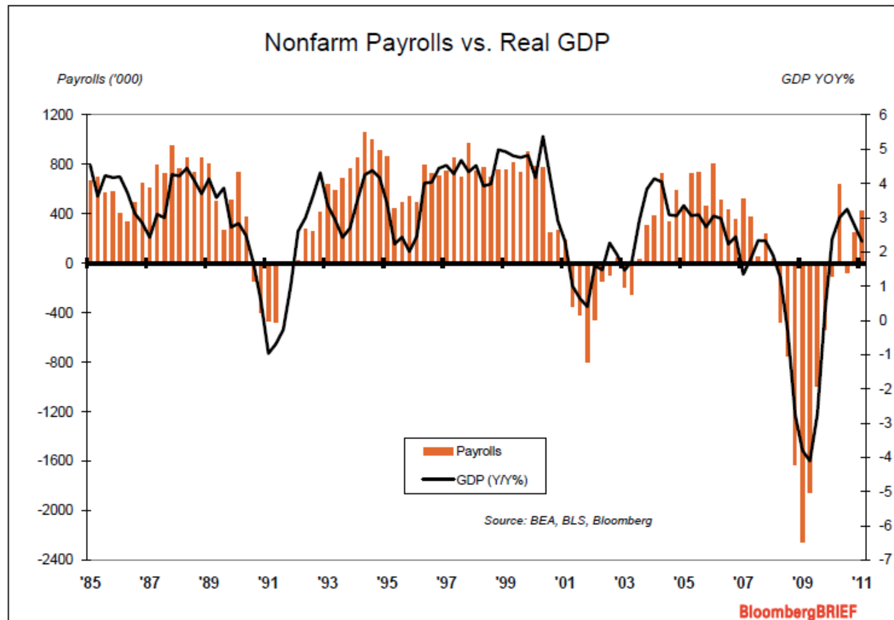
The Infamous General

Back on the home front, you may have heard or read about General Malaise. He's a rogue general, the worst of his kind. General Malaise hangs like a cloud over the country as citizens are unsure of his next act and don't want to get caught in the cross-fire. As a result, they stay home more, venturing out for only the essentials like a run to the grocery store, to fill up the gas tank (an annoying experience in its own right), and to get to/from work. Maybe a date and a movie every so often. Other than that, batten down the hatches and hope someone is brave enough to assassinate the S.O.B.

How long General Malaise will hold power over the country is unknown. But, we see constant signs of his presence. Weekly unemployment claims that remain over 400,000 two years after the recession supposedly ended, an unemployment rate that remains over 9% (with the real one more like 16%), an economy that has trouble generating decent growth (1.8% last quarter, pretty lame), and a housing market recovery that makes a mockery of the word recovery.

The following chart is a personal favorite of General Malaise.

Economy Isn't Advancing Fast Enough to Engender Job Creation



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Don't Mess With Texas and a Career Politicians Rant

I heard a fascinating statistic from the head of the Federal Reserve Bank of Dallas when he was recently interviewed on CNBC. Texas has created close to 40% of the jobs in the US since the recession ended. Don't mess with Texas, indeed. What does Texas have that apparently the rest of the country is missing?

First, Texas has sizable exposure to the energy industry. High energy prices encourage energy companies to invest and hire so Texas is a major beneficiary. Texas was a basket case 20 years ago when oil prices hit very low levels and Texas banks were a mess. Today, with oil near $95 a barrel, it's a different story. Well-paid workers confident about their job security spend money, which flows through to hiring in other segments of the economy. Second, Texas has no state income tax, which means there is more take home pay for workers to spend. Third, Texas did not have a housing bubble and bust (it had its housing bust period during the late 1980's S&L crisis) and so it is not dealing with the negative spending effects of underwater homeowners. Lastly, Texas passed legislation a few years ago that significantly cut down on the number of fraudulent and frivolous class action lawsuits that raised the costs of doing business in Texas. As a result, foreign and domestic companies looking to build plants and invest for growth have Texas at the top of their focus list. For example, Caterpillar recently announced a major plant expansion in Texas. Caterpillar's headquarters is in Illinois, a state in a serious fiscal mess (our own Greece). To try and deal with its deficit, Illinois has raised taxes on both individuals and corporations alike. Not surprisingly, Caterpillar is not investing its capital in Illinois. They like what they see a whole lot more in Texas. Can you imagine how the US economy would look if every state in the nation had some of the characteristics inherent in Texas? A whole lot healthier, that's for sure. Texas ranks Number 2 in the 2011 CNBC survey of America's Top States for

Business. It was #1 in 2010. Virginia is the top ranked state for 2011. The worst? Rhode Island ranks 50th. Have you seen the economy in Rhode Island?

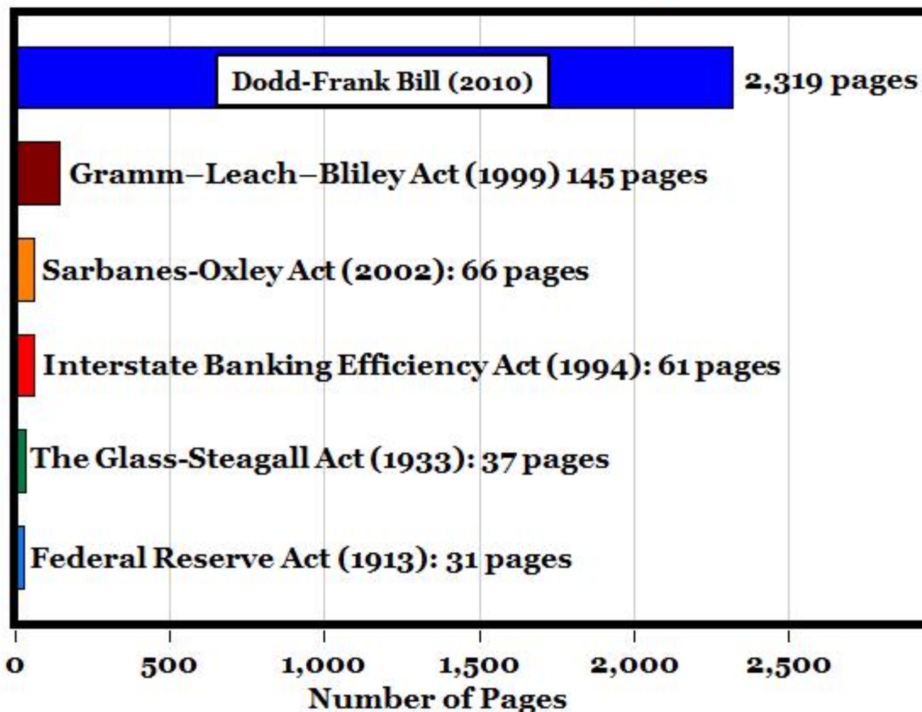
It would also interest you to know that the Texas Constitution limits the legislature to be in session only 140 days every two years. That works out to about 20% of each year. Even if they go into a special session, it is limited to another 30 days max, but it can have consecutive specials sessions if required. So, there are no full-time politicians in Texas and politicians serving there don't have all sorts of time on their hands to justify their existence to the voters. Many other states have part-time legislatures as well. Believe it or not, the US Congress was more of a part-time role up to the early 1950's. Unsurprisingly, as Congress went to full-time thereafter, government became more ingrained in our daily lives and the US started on a slow but steady decline to where we are today. How much better off would all of us be if our Congressional members were not full time and not so self-absorbed in their own re-election prospects such that their primary focus was serving only the interests of the American people? As much as I think Scott Brown is a desperately needed breath of fresh air for both Massachusetts and national politics, my ultimate hope is Scott Brown gets elected for one more 6 year term and then goes back to private life. Along the way, I hope Sen. Brown makes all sorts of tough political decisions and votes that are for the long-term benefit of the country instead of his re-election campaign. The reason we get so excited when a Scott Brown comes around is because it's a once-in-a-blue-moon event in national politics where career politicians dominate the political process.

Career politicians are usually involved in major legislation or oversight for some of the biggest debacles in our nation's financial history. Government sponsored mortgage entities Fannie Mae and Freddie Mac are two of the biggest. During the 1990's, politicians used their political muscle to get both Fannie Mae and Freddie Mac to ease lending standards that made it easier for more people to obtain mortgages (so called Affordable Housing initiatives). Unfortunately, too many of these people were not qualified and in the long run could not afford their mortgages and defaulted on them. The housing bubble burst in 2007 and both Fannie Mae and Freddie Mac went into conservatorship in 2008, taken over by the Federal government. What has it cost to the US taxpayer? So far, the tab is $153B (that's a B as in billion). The best guesstimate now is the ultimate cost could be in a range of $220B to $360B. Of course, once the horse was out of the barn, many of these same career politicians then became vocal advocates for increased regulatory scrutiny and eventually for the complete shutdown of both Fannie Mae and Freddie Mac.

In response to the 2008 Financial Crisis and to reign in Wall Street companies and the fat cats running them that screwed the American economy and people, career politicians felt the need and public pressure to respond with more legislation. One such bill was the Dodd-Frank financial regulatory overhaul bill (career politician Christopher Dodd of CT saw the handwriting on the wall and decided not to run for reelection). The Dodd-Frank bill was mostly designed to make sure Too Big To Fail institutions never came back to hurt the US again but it's too early to tell if it will achieve this main objective. Dodd-Frank is loaded with boatloads of other regulatory changes that will impact the US consumer pocketbook and economy over time.

Perhaps the following chart is one a career politician can be proud of but it puts into perspective how an intrusive, backward looking government run by career politicians who play both sides of

the aisle can get in the way of a normally functioning economy. Why is the US economic recovery so poor? It's not the only reason, but the Dodd-Frank bill is doing its part as is the high level of uncertainty brought on by the lack of clarity on government policy in many other areas. Unsurprisingly, as the Dodd-Frank bill's 2,319 pages of regulatory rules get implemented, banks and other financial services stocks are the worst performing sector of the stock market this year.



As John McEnroe often said to the chair umpire when he went on of his ballistic, rant filled tirades, YOU CAN'T BE SERIOUS?! The American people have no one to blame but ourselves for our current dilemma as we constantly re-elect self serving politicians who won't/can't make difficult decisions that will benefit the country in the long run. As Rep. Paul Ryan of Wisconsin, Chairman of the House Budget Committee says, if your not willing to lose this job, you can't be good at it. Amen, brother. If you haven't already, read a summary of Rep. Ryan's solution to the deficit situation. The **fact** is that we need to get entitlement spending under control and contained to get our country back on track. Even if you don't agree with all or some of his proposals, at least he is walking the walk and talking the talk.

As the situation in Texas shows, all is not lost and there are solutions out there. But there is going to be a lot of blood, sweat, and tears before we get there and some really difficult choices will need to be made to get the American economy back on the right track.

2nd Quarter Market Update

Even as the S&P 500 Index put up a solid return of 6% during the first quarter, the markets did not seem to incorporate all the risks inherent in the current global macro environment. As more risks came to the forefront during the second quarter, global stock markets experienced almost a complete reversal of the first quarter's returns into the last week of June. Then, over the course of the last four days of June, the market staged a substantial rally that culled most of the second quarter losses. During the second quarter, higher risk segments of the stock market performed worse while bonds outperformed stocks and had a solid quarter. By the end of June, and for the first half of the year, global stock markets have generated mid-single digit gains but it has been a very rocky road so far and the second half is unlikely to get any easier.

The table below shows some key market benchmarks for the second quarter and year to date through June 30th.

	2Q11	**YTD**
S&P 500 Index (large cap stocks)	0.10%	6.02%
Russell 2000 Index (small cap stocks)	-1.61	6.21
MSCI EAFE Index (international stocks)	1.56	4.98
MSCI EM Index (emerging markets)	-1.15	0.88
Barclays Aggregate Index (fixed income)	2.30	2.72

Below are changes since the end of last year for a few key financial markets indicators. These point-in-time readings hide the true volatility that has been experienced during the first six months of 2011. For example, oil hit a high of $114 per barrel before retreating all the way to almost where it was at the beginning of the year. That's a round trip of 50% in just six months.

	12/31/10	6/30/11
10 Year US Treasury Yield	3.29%	3.17%
Gold/ounce	1421.40	$1502.80
Oil/barrel	$91.38	$94.27
Eur/USD FX Rate	1.34	1.45

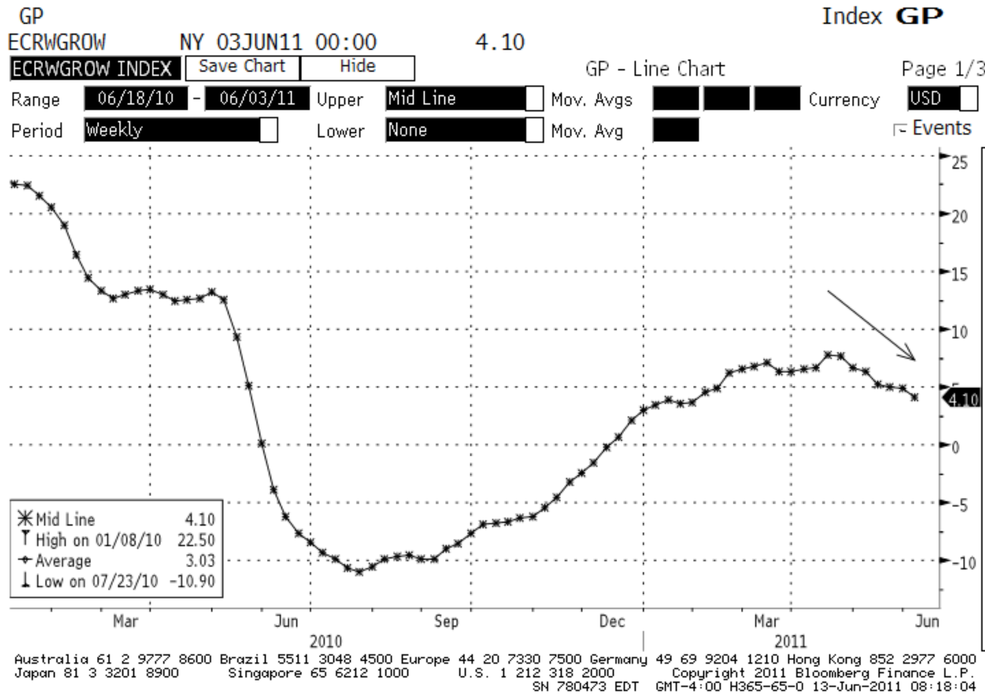
I have not changed my view yet of a full year return expectation of mid to high single digit returns for the US stock market (S&P 500 Index). If markets hadn't rallied so quickly in the last days of June, and with stock returns barely positive, my view was that US stocks were looking increasingly more attractive on the pullback. Now, post this very quick 5+% rally, risk/reward is once again balanced. It remains to be seen if the June month-end rally will hold as we move into July and second quarter earnings season. That being said, I believe fixed income and money markets are unattractive investment options, making stocks the best house on a bad block.

The market has absorbed two months of negative news headlines. Economic data slowed as the Japan earthquake and resulting slowdown in global supply chain worked its way through the

economic data. The ISM manufacturing index has dropped from a high level. The Conference Board's index of consumer confidence edged lower, to 58.5 in June from 60.8 in May.

The chart below shows the ECRI Leading Economic Indicators data, which is an index that captures and measures the strength of a broad set of economic inputs. You can see that it peaked in mid-April, about the same time as the stock market, and has slowed since then.

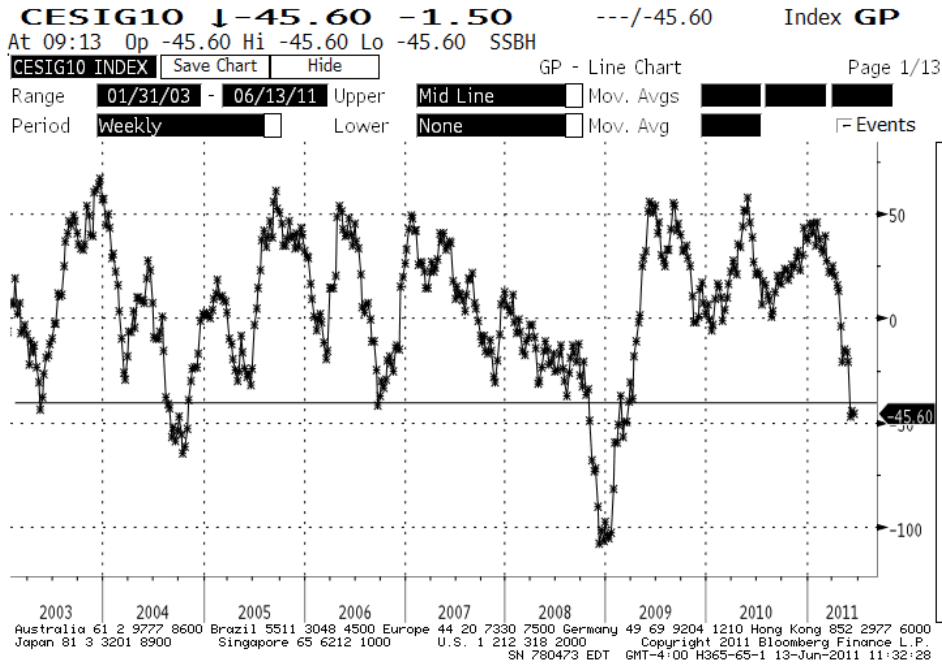
ECRI – Weekly Leading Index Growth Rate



Source: Bloomberg

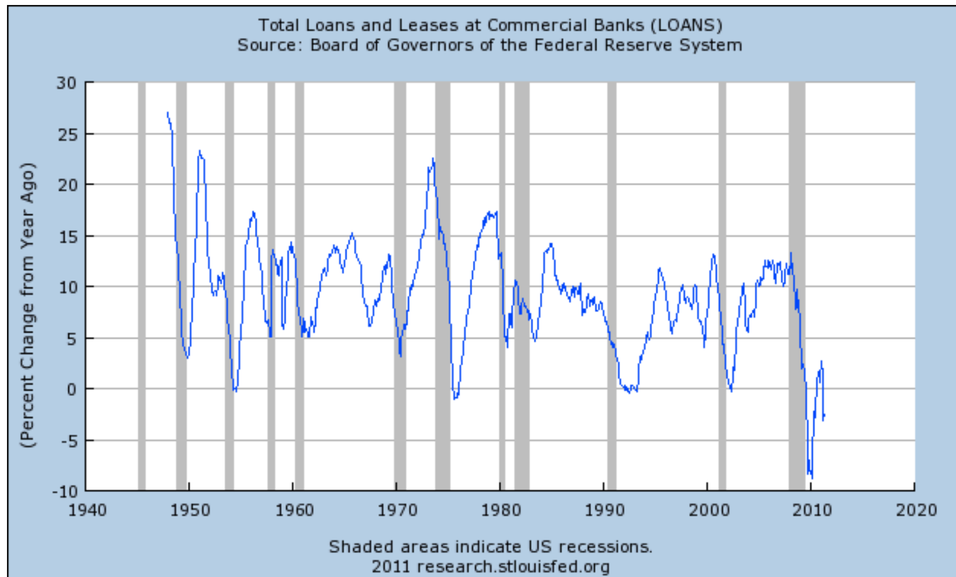
Another chart that capture more global economic data is the Citigroup Economic Surprise Index. As the following chart indicates, the slowdown in positive surprises for economic data goes beyond just the US.

Citigroup Economic Surprise Index



Source: Citigroup and Bloomberg

Another disappointing chart from the Federal Reserve captures year over year loan growth data. In a healthy recovery scenario, we would see steady progress in lending growth as the economy recovers and new businesses are formed. Instead, we see loan data rolling over again.



Oil's rapid rise is a key reason we are seeing weaker economic data as it has been a massive tax on the American consumer and businesses. Oil prices rose significantly to near $114 a barrel for WTI towards the end of April and gasoline peaked above $4.00/gallon. The dramatic increase had a notable negative effect on consumer confidence and, along with large increases in other commodity costs, businesses also grew more cautious. The slowdown in economic activity, as shown in the previous charts, captures some of the impact of higher oil prices. Importantly, by the end of June, oil had retreated substantially and was trading $20 lower per barrel from its recent peak and now gasoline prices are retreating as well. We are still well above the $72 price of oil from last summer but on the margin the recent sharp drop will put more cash in the consumer's pocket and businesses will see their cost pressures ease if oil stays below $100 a barrel into the second half of the year.

Taking all of these issues into consideration, my expectation is that as summer progresses, the macro data should start to improve again assuming WTI oil remains below $100 per barrel. The Japan supply chain disruptions brought on by the earthquake/tsunami and higher oil price headwinds appear to have peaked and are reversing. Recent Japan manufacturing data is showing a snapback as its industrial production come back online. The biggest wildcards and issues for global financial markets remain the China inflation/macro outlook, the European Sovereign debt crisis, and US unemployment. The news for all three needs to improve (or at least not get worse) in order for the global investors to get more confidence to invest and for US businesses to hire. Unfortunately, the first six months of 2011 is a microcosm of the fits and starts market environment we may experience for some time to come.

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July 2011

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