

June 2011

## QUARTERLY REVIEW AND OUTLOOK

During the quarter just ending, investors and securities markets have demonstrated clear evidence of bipolarity. Following generally positive results in the first three months of the year, equity markets rose in April, reflecting confidence in the outlook for global economic expansion. But, beginning in May, data points began to weaken and investor sentiment began to sour. The seeming suddenness of change and the perceived severity of the downward trajectory in a variety of recent economic reports led to an extended sell-off in most global equity markets. At the same time, U.S. Treasury issues reversed their earlier lackluster performance and strengthened as many investors sought a safe haven, despite continued weakness in the U.S. dollar.

So, are we in a temporary slowdown or a more prolonged and deeper period of economic contraction? Are the factors that led to a similar period of global economic uncertainty and equity weakness a year ago recurring? While it is impossible to stake a position with complete certainty, our view is that economic activity in the U.S. and abroad will improve in the second half of 2011 for a variety of reasons in which we have rising levels of conviction.

There seems to be general agreement amongst economists, corporate executives, and financial analysts that the drop-off in economic momentum in various world sectors was the result of severe disruptions of supply chains following the Japanese disasters in March which impacted many end-user industries and the sharp rise in many key commodity prices which affected consumer and business demand patterns and inventory policies. In addition, the unusual and prolonged periods of harsh weather in the U.S, China, Australia, and other areas also contributed to manufacturing, transportation, and consumption distortions. This confluence of negative events served to suppress activity, rather than destroy it; and, we expect a reversal in the months ahead with a positive effect on economic output globally.

Two areas of current concern were also present last year: The European sovereign debt dilemma and China's growth prospects. While neither can be dismissed as unimportant, we suspect that some greater clarity will be forthcoming in the near term and could alleviate some of the prevalent negative investor sentiment.

As to Europe, there is a greater sense of urgency to address the peripheral country debt situation to avoid a domino effect on the banking industry. An immediate, iron-clad solution is unlikely; but, a plan that includes debt maturity restructuring, private sector involvement, and a firewall to prevent contagion would be a positive development for investor confidence.

China continues to struggle to balance its substantial infrastructure requirements with the growing needs and expectations of its consumer sector. Inflation concerns remain an on-going issue, and central bank monetary policies still swing from stimulus to restraint with undue frequency. We expect that China will bounce back from its recent modest economic slowing and will remain a major consumer of industrial raw materials and an increasingly important end market for a wide variety of consumer goods and technology and industrial products.

The prolonged slump in the U.S. housing industry is another recurring concern. Mortgage availability and home affordability measures have improved steadily, but the growing level of foreclosed properties has increased the stress in this sector. While it is not in the cards to find the elements for a bullish housing outlook, it is likely we are near a bottom. Reduction of the excess stock of housing built during the earlier cycle has been proceeding at a good pace. Population growth has been rising at a faster rate than household formations during the past four years. When employment improves and is sustained, household formations increase and residential housing demand expands. We are at the points in the economic and corporate profitability cycles where such positive shifts begin to take hold.

An important, clear, and continuing fundamental strength supporting a positive outlook for the U.S. is the corporate profits sector. The two-year recovery in profits, profitability, and cash flow has been dramatic and is projected to continue through 2012. While much of the expansion has been the result of strict cost controls, operating profits and margins have also benefitted from productivity-enhancing equipment and international sales growth, particularly in emerging markets. The expected future gains in profits are predicated on continued strength in business capital spending and export opportunities in emerging economies, as well as a moderate upturn in domestic consumer outlays.

Political issues remain a thicket of uncertainties for investors. The posturing related to the U.S. debt ceiling and the budget deficit is frustrating. And, the confusion resulting from the new package of financial regulations is impacting the banking sector, at the same time that additional fiscal measures are being considered to stimulate economic activity and employment growth. We think the most likely outcomes include passage of a debt ceiling increase coupled with shorter term tax incentives for individuals and businesses along with the longer term spending cuts of significance. Additionally, we expect some modification or easing of the financial regulations which could encourage bank lending and investing.

Monetary policy is likely to remain supportive for a prolonged period. Although the Federal Reserve's program of substantial open-market purchases of Treasury issues is nearing completion, the Fed will continue to reinvest interest payments and maturing proceeds in Treasuries. Investors are warily eyeing inflation data, but the Fed judges most price trends to be benign and plans to maintain its managed interest rates at very low levels. Of additional importance to investors, system liquidity remains healthy and growth of the monetary base is continuing, contrary to the situation a year ago.

It is our strong sense that the disappointing recent economic data and concerns about political and financial policies in the U.S. and abroad have resulted in pervasive and deepening negative investor sentiment. Abetting such gloomy feelings have been numerous articles and much commentary listing the obvious worries, but few which consider the underlying positives and those things which might well improve in the weeks and months ahead.

If our somewhat more optimistic stance gains credibility and corporate profits and dividends continue to expand and global economic activity ratchets up led by the emerging nations, then world equity markets offer attractive potential returns. Stocks in the U.S., in particular, appear to be well situated in light of positive earnings support and low interest rates. We strongly believe that there are significant unmet infrastructure and consumer needs throughout the world which U.S. - based companies are uniquely qualified and positioned to address and fulfill. Therefore, we continue to emphasize dominant companies in the basic materials, industrial equipment, and technology sectors. In addition, we have increased our exposure to consumer product companies with a global reach and health care issues which have strong product offerings in what seems to be a gradually less-threatening regulatory environment.

In an uncertain world with continuing crosswinds, we recognize the appeal of fixed income securities. While we acknowledge the “safety” aura of Treasury issues, we do not find that their current market yields provide adequate risk-adjusted compensation when compared with good quality corporate issues of intermediate maturities as well as a significant percentage of large capitalization stocks which offer current dividend yields above the five-year and ten-year Treasury issues. While economic and political uncertainties will certainly persist, we believe the option of favoring growth of earnings, cash flow coverage, and dividends supports a preference for corporate securities --- particularly if the economic and policy clouds begin to lift and part.