2011 Second Quarter Commentary
Navigating Storm Clouds On The Horizon

Despite spending the majority of June in negative territory, the S&P 500 rebounded strongly the last week of the quarter. This bounce put ***the broad stock indices at breakeven for the quarter and up 5% for the year***. Just like the weather in Texas, wait a few minutes and things will change.

On the surface, this sounds good as we are on pace to produce annualized gains of 10% for the year. However, there was considerable volatility during the quarter and, in our opinion, ***the underlying concerns have not gone away***.

Greece still has a debt problem which will be restructured one way or another. For the time being it appears we have "kicked the can down the road". However, eventually Greece will either have to make some serious cuts or they will default on their debts—or both. Only time will tell how it will play out. We are just hoping that this one relatively small domino does not topple much larger and significant ones.

Greece is not the only one in this predicament as Portugal, Spain, Italy and Ireland are not far behind. Our concerns about their outright default are less, but they are still in a fragile condition.

Domestically, we still have ***high unemployment and weak economic growth***. This should surprise no one. As we have written for months, unemployment is far higher than the government officially states. Even in its "massaged" state unemployment has started to creep back up again. And although governmental economists had projected that GDP growth would be close to 3%, they have revised those numbers down to about 1.8%. No one can consider that to be robust.

Compounding these problems is the fact that ***commodity prices have been increasing leading to inflation across many sectors of life***. This pressure weighs upon households to afford even the basics as pay raises have been slim.

Another problem stems from ***continued weakness in the housing market***. Previous stimulus for first time home buyers temporarily boosted home prices. With this artificial stimulus gone, we are seeing the housing market for what it really is—weak. We would not be surprised by a "double dip" recession in housing, but think the overall economy will avoid a recession this year.

June 30 also marked ***the end of QE2***—or the second try at "quantitative easing." This strategy involved the government using its financial resources to buy up US Treasury debt in the open market. By doing so, the prices of debt stay high and the yield stays low. This artificially attempts to keep borrowing costs across broad segments at generational low levels. A secondary affect is that ***the value of the US Dollar, relative to other world currencies, becomes weak in an environment of this nature***.

Since QE2 began, the Fed has bought about 85% of the net Treasury issuance over the past eight months. However, this game can only be played so long as you are functionally just moving money from one hand to the other.

As QE2 wound down, Treasury investors began to balk at buying new bonds which sent prices lower and yields higher. The yield on the benchmark 10-year note reached 3.11%, it's highest since May 25. Yields on the 10-year note have risen every day this week, adding about ¼ point since Friday and sparking speculation that the bull run in the bond market may have passed its peak.

The Federal debt ceiling continues to make news as politicians on both sides of the isle blame the other for our fiscal nightmare. Ultimately, ***the debt ceiling will be raised as the US cannot afford a default***. However, our political leaders will seize upon this opportunity to grandstand as they pronounce the need for discipline and tax reform.

Meaningful tax reform will be difficult to pull off even for the most left leaning of Democrats. It is very hard to recommend a tax increase with growth under 2% and the jobless rate at 9.1% and climbing. The White House game here can only be an attempt to see if he can use the prospect of a debt-limit financial panic to scare Republicans into voting to raise taxes.

Our tax revenue problem is the result of the mediocre economic recovery. Tax collections in 2009 fell below 15% of GDP, the lowest level since 1950. Remarkably, tax receipts stayed that low even in the recovery year of 2010. This year tax receipts are growing at a healthy 10% clip, so the Congressional Budget Office (CBO) January estimate of 14.8% of GDP is probably low. We suspect revenues will be closer to 16%, but even that would be the weakest revenue rebound from any recession in 50 years, and far below the average tax take since 1970 of 18.2%.

When one recalls the fact that just three months ago we were cleaning up from an earthquake and nuclear meltdown in Japan it is easy to get depressed in a hurry.

Despite these numerous concerns, we don't see a huge 50% stock market drop looming on the horizon. Financial companies have restructured and are well on their way to cleaning up bad mortgages. Leverage has been reduced and corporations have significantly stockpiled cash. If only governments could do the same.

As odd as it may sound, the multi-national blue chip company may be not only the best, but the safest long term investment around. We continue to see tremendous long term value in these companies--many of which sport dividends well in excess of the 10 year Treasury yield. As such, the long term investor who can stomach some shorter term volatility still has the opportunity to make some decent returns.

This also has traditional fixed income investors looking to the stock market to produce some positive cash flow for their portfolios. Although this can work, you need to prepare for a bumpy ride.

Finally, on Monday we celebrate the 4th of July. Most of us will do so with tons of food and a fireworks show. ***However, let it also be a meaningful reminder of what was sacrificed to produce the great nation we live in***. Although it is far from perfect, it is still the best game around.

If you have any questions on this, or anything else, don't hesitate to stop by or give us a call.

Sincerely,

Dave Warren

Dave Sather, President
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