

# QUARTERLY ECONOMIC UPDATE

JULY 1, 2011

We favor the productive side of the economy in the developed world and the consumer side of emerging economies.

## The Wisdom of Yogi

As the second quarter of 2011 unfolded, we found ourselves turning to the wisdom of the esteemed investment guru, Yogi Berra. Now those of you who are familiar with Yogi probably think of him as a N.Y. Yankee great. But we, as investment managers, have little time for such baseball trivia. It is the behavior of the markets and those factors impacting the markets which pique our interest. So our interests were indeed piqued over the past quarter by the budget battles, weak employment numbers, anemic housing sector, slowing economic growth, economic aftershocks from the Japanese earthquake and tsunami, and discouraging news regarding sovereign debt issues in Europe. As we watched equity prices and bond yields slide in the face of the events, we took solace in Yogi's words, "It's like déjà vu all over again."

Now to make sure there isn't any confusion, we are not talking about a repeat of the meltdown of 2008. What we're referring to is spring and early summer of 2010. To refresh our readers' memories, between April 23rd and July 2nd of last year the S&P 500 fell 16% while the 10 year Treasury yield slid from 4.0% to 2.9%. As a comparison, between April 29th and June 15th of this year, the S&P 500 fell 7.2% while the 10 year Treasury yield fell from a high of 3.6% to a low of 2.9%. Indeed this period of time is eerily similar to that of one year ago. In fact if we pulled out references to oil in the Gulf of Mexico and replaced

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### Economic Statistics

	2nd Qtr (6/30/11)	1st Qtr (3/31/11)	% Change	1 Yr Ago (6/30/10)	% Change
S&P 500 Index	1,320.64	1,325.83	-0.4%	1,030.71	28.1%
10 Year Treasury Yield	3.16%	3.47%		2.93%	
Gold Spot (\$ / oz)	\$ 1,500.35	\$ 1,432.30	4.8%	\$ 1,242.25	20.8%
WTI Crude Oil (next future)	\$ 95.42	\$ 106.72	-10.6%	\$ 75.63	26.2%
GDP Qtr / Qtr	N/A	1.9%		1.7%	
CPI Y / Y	3.6% (May)	2.7%		2.3%	
Unemployment Rate	9.1% (May)	8.8%		9.7%	

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them with impacts of the tsunami on Japan we likely could have passed off last year's Economic Update as the current edition. Don't think we didn't consider doing just that!

While equity markets and interest rates rebounded somewhat in the last two weeks of June, it doesn't do any good to simply repeat our positive position of a year ago. There are many fundamental shifts occurring in the world today, and if we don't understand them, we and our readers will be more susceptible to making errors of judgment. Or, as Yogi put it, "You've got to be very careful if you don't know where you are going, because you might not get there."

To help our understanding, we'll focus on two groups of countries. The first group consists of much of the developed world – primarily the U.S. and Western Europe. The second group consists of many of the world's emerging nations – primarily Latin America, Southeast

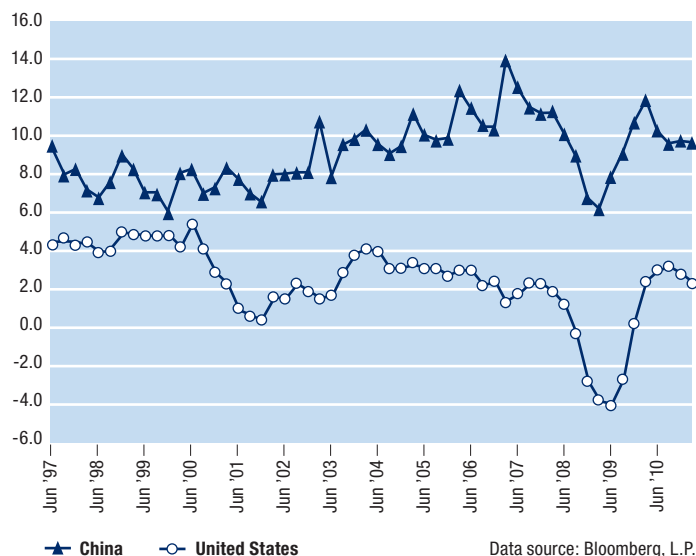
Asia, India, and China. During the decade leading up to late 2007, the developed countries found themselves in a period of easy credit and economic expansion. This was driven by several factors including

loose monetary policies and expansionary fiscal policies. While consumer prices remained largely under control, asset prices accelerated. Consumers and financial institutions utilized leverage, collateralized by rising asset prices, to fuel additional economic growth.

Simultaneously, the nations in the second group, having suffered through successive economic and debt crises from the mid 1970s through the late 1990s were finally getting their collective houses in order. Instead of borrowing heavily to fund redistributionist policies, these nations were utilizing their abundance of cheap labor – and in some cases natural resources – to produce goods and services for the developed nations to consume. This production growth among emerging nations led to increased living standards and economic growth well in excess of growth experienced in the developed world. This then led to increased demand for goods in these emerging nations.

To the emerging world's credit, it did not spend more than it consumed. In fact, as a whole, these emerging nations took the money they made from exporting to the developed world and reinvested those funds back in

## Percent GDP Growth (Year Over Year)



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the developed world. Looking at it from the other side of the coin, the developed world borrowed funds from the emerging nations to permit it to consume more than it produced. That extra consumption in fact came from goods produced in the emerging nations.

For a while, this arrangement worked nicely. Increased borrowing, propelled economic growth in the developed world, and increased production propelled economic growth in the emerging world. Asset prices rose, everyone was getting richer, and all was well. Of course, this arrangement was not sustainable. Excessive borrowing and rising asset prices, particularly in real estate, led to price bubbles which eventually burst. Asset prices declined, lending slowed, and economic growth reversed – particularly in the developed world.

Where did this leave us? In the developed world, nonfinancial corporations actually came out in reasonably sound condition. Although revenues and income were severely reduced, corporations generally went into the recession with strong balance sheets and were able to withstand the downturn. Consumers in the developed world were harder hit. Unemployment rates accelerated and wealth eroded. The easy credit spigots were closed off, and individuals could no longer supplement their spending with borrowing. Consumers reversed course and began reducing debts. Some accomplished this by

spending less than they earned, while others accomplished this by defaulting on their debts. Financial institutions were also particularly hit hard. Loans defaulted, equity shrank, and those that did not collapse were forced to devote much of their efforts to raising fresh capital and recovering what they could from their diminished asset base. To supplement the weak economies, governments increased spending well in excess of tax receipts. As a result, since the depth of the recession in early 2009, debt burdens for many governments have rapidly increased. Now we find ourselves with several European nations on the verge of default and the U.S., at the federal, state, and municipal level, facing its own debt crisis.

result of actual payments of debts, restructurings of debts, or reduction of effective debt levels through inflation.

Second, irrespective of how deleveraging occurs, the developed world will likely go through a period of several years where production outstrips consumption. As a result, final demand growth will likely be weak, but those who produce goods for the export markets may find themselves in a favorable environment.

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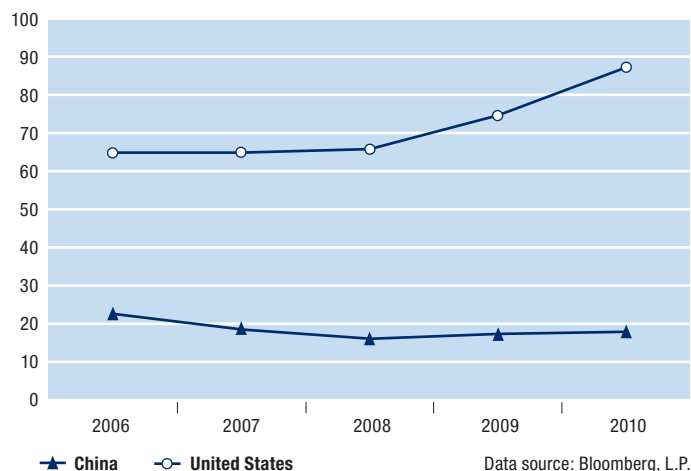
Third, to maintain their growth, the emerging nations will have to increasingly shift from economic models based on exports to economic models based on satisfying domestic needs. This should lead to a strong demand for infrastructure and consumer goods in these countries.

Such transitions are rarely smooth. On both a global and local level, wealth is being transferred among various economic sectors. In the short run, individuals, businesses, and politicians may make misjudgments and exacerbate current problems. Or, there may be a lag in time before one action, such as a reduction of debt by a borrower, leads to another action, such as an increase in spending by a lender who has been repaid. As a result, negative impacts of many of the shifts may precede positive impacts of those same shifts. For this reason, it may be considerable time before the economies of the world are firing on all cylinders. While waiting for these shifts to take place, investors may prove to be skittish. On other occasions, investors may be overly optimistic. This may result in continued volatility in both the equity and bond markets. While we are optimistic that these shifts will eventually lead to sustainable global growth, we, nor anyone else, can predict short term investor sentiment. It is our job, however, to recognize the shifts taking place and translate them into individual investment decisions – especially when investor sentiment may be erratic.

## Equity Strategy

The second quarter was obviously difficult. Though stocks rebounded in the last two weeks of the quarter, the S&P 500 still finished down 0.4% before dividends. Not surprisingly, less economically sensitive stocks such as Kraft (KFT) and Mylan (MYL) performed well. Several technology stocks, including IBM (IBM), Intel (INTC), and Microsoft (MSFT) also performed well, though

## Debt as % of GDP



The emerging nations fared much better. While their economies were impacted by the lack of demand in the developed world, the combination of a net savings position and a growing middle class permitted them to experience a slowdown which was less severe and shorter in duration than the developed world. Many nations in this group are at this time experiencing relatively brisk economic growth.

Today, this leaves us with three overriding drivers of behavior. First, for several years we will be in a period of deleveraging. Borrowing levels relative to spending will have to decrease. This may manifest itself in consumption growth in excess of debt growth and / or actual reductions in debt levels. If consumption growth outstrips debt growth, it can only come from increased production. On the other hand, reduction in debt levels may occur as a

the performance of Hewlett Packard (HPQ) remains a disappointment. On the negative side, many of our industrial holdings lagged the broad market. Caterpillar (CAT), Apache (APA) and Timken (TKR) all generated negative returns. While we are never happy with such performance, we still believe these stocks are attractively valued and have exceptional prospects. As such they remain core holdings in client portfolios.

Late in the quarter, there was a bit of investment activity. We sold two stocks, Temple-Inland (TIN) and Brasil Foods (BRFS) from all accounts. TIN, a manufacturer of linerboard and corrugated boxes, was one of our favorite stocks. In addition to an attractive valuation, we felt that as U.S. industrial production increased and capacity was constrained, both volume and prices would accelerate for TIN's products, with most of the revenues flowing to the bottom line. Their largest competitor – International Paper (IP) – had a similar perspective. As IP saw increasing demand and capacity constraints, the company made an unsolicited bid for TIN. We took advantage of the buyout offer and sold the stock.

The BRFS sale resulted from an interesting situation. BRFS is a food producer in Brazil. Roughly half their business is for the consumer market and sold in stores. The other half is the export of chicken, beef, and pork to the rest of the world. The company resulted from the 2009 merger of two Brazilian companies, Perdigao and Sadia, and was partially financed by an arm of the Brazilian government. Two years after the merger, the antitrust arm of the Brazilian government known as CADE raised objections to the merger. BRFS is now faced with the potential of having to jettison parts of its business or even be split apart into its original components. While we believe the prospects for BRFS are still excellent, even if split apart, we expect that this will be a drawn out battle with an unknown time frame and unknown consequences. With other investment opportunities still available, we decided it made little sense to wait it out.

For those clients who had available cash and were not limited by equity tolerances, we first bought Companhia Brasileira de Distribuicao Grupo Pao de Acucar (CBD). The name is a mouthful, but CBD is the largest retailer in Brazil with both an upscale and midscale grocery chain. They also have hypermarkets (think of Super Wal-Mart), electronic stores, convenience stores, and drug stores. If after the purchase of CBD clients had room to buy additional equities, we bought SAB Miller (SBMRY). SBMRY, the parent company of Miller Brewing, is a South Africa based company which produces and distributes beer throughout the world. The company derives less

than 30% of its revenues from the U.S. and Europe, with the rest coming from Africa, Latin America and Asia. The company recently made a bid for Foster's Group, a dominant beer producer in Australia. Valuations on both of the equities are quite attractive. And, they benefit from the major trends we described above.

Going forward, we don't see major changes in our overall investment posture. Equities are still, in our opinion, attractively valued. While certain segments of the economy are likely to experience weakness, others will experience robust growth. As suggested in our general discussion, we favor the productive side of the economy in the developed world (industrial and technology companies) and the consumer side of emerging economies. Ultimately, we want investments that fit our strategies and have attractive valuations. Therefore, we may also find attractive opportunities in stocks that don't fit precisely this broad world view.

## Fixed Income Strategy

Where does one find acceptable returns in the fixed income markets? We feel like a broken record, but unless one is prepared to take on considerable risk, the returns just aren't there. Yields remain stubbornly low. Even though yields have rebounded slightly from their mid June lows, the 10 year Treasury yield at 3.2% is less than the consumer price index (CPI) of 3.6%. That means investors are willing to give up the difference of 0.4% each and every year for 10 years. Yes, the CPI may fall in the near term as energy prices have backed off. Still, we believe over the course of the next 10 years, the real return after inflation is not likely to be more than 0%. It may in fact be less. Further, when we look at corporate bonds, yields are quite low as well. While the risk spread, or additional yield over Treasuries one earns for taking on corporate risk, is not excessively low, it is not very high either. When added to excessively low Treasury yields, we find ourselves with very few attractive opportunities.

Viewing the overall yield curve, we don't believe the current environment is sustainable over the long term. Unfortunately, as we have witnessed, the short term can be frustrating. When will rates rise? To quote Yogi Berra one last time, "I wish I had an answer to that because I'm tired of answering that question." In other words, we just don't know. What we are doing at this time is focusing on preserving capital. At some point, yields will be more attractive. It is our intention to invest our clients' funds conservatively so that there might be sufficient capital when a more attractive fixed income environment finally does arise.

