

The Oarsman Outlook

July 2010

Following a year of steady gains that saw major equity benchmarks advance 50% or more, volatility returned to the markets and stocks gave ground in the April-June period. Domestic stock indices fell around 10% from March 31st levels; non-U.S. stock returns varied, but losses were somewhat less severe, on average. A renewed flight to safety pushed Treasury yields sharply lower (the 10-year yield declined to 2.95% from 3.83%) and, despite some widening of credit spreads, nearly all categories of bonds produced solidly positive three-month returns.

Among U.S. stocks, the strongest relative performance came from those in the Communication Services, Consumer Staples and Utilities sectors; weaker returns came from Capital Goods, Energy and Technology names. Small-company stocks fared slightly better than large-caps, while “growth”-oriented stocks, as a group, modestly outperformed their “value” counterparts. Real estate securities with a U.S. focus were among the best performing asset classes, while those with international orientation were down in-line with most equities. The prices of most industrial commodities declined, although gold rose to a new record high.

Benchmark Performance – Equities

	<u>Second Quarter 2010</u>	<u>Last Twelve Months</u>
S&P 500 Index	-11.4%	+14.4%
Large-Cap. Core Mutual Fund Avg. (Lipper)	-12.3%	+12.1%
Small-Cap Stocks (Russell 2000)	-9.9%	+21.5%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	-11.9%	+11.6%

Benchmark Performance – Fixed Income

	<u>Second Quarter 2010</u>	<u>Last Twelve Months</u>
Barclays Intermediate Gov't/Credit Index (taxable)	+2.8%	+7.7%
Barclays Municipal Bond Index (tax-exempt)	+2.0%	+9.6%

Review

The April-June quarter was nothing if not eventful; developments likely to have a noticeable impact on financial markets included: a gigantic oil spill in the Gulf of Mexico; a crisis surrounding the public finances of Greece and other ‘peripheral’ European nations; a noticeable weakening in U.S. economic data; changes-of-government in the U.K. and Japan; a war scare on the Korean peninsula; passage of new U.N. sanctions against Iran; a mysterious Wall Street ‘flash crash’ that erased and then restored hundreds of billions of dollars of stock-market value in a matter of minutes; a G-20 economic summit that revealed more and deeper differences than usual; and finalization (though not yet passage into law) of a major overhaul of U.S. financial-industry regulation. It is no surprise that markets were increasingly choppy, reversing a year-long trend of steadily ebbing volatility.

What's Changed?

To provide insight regarding recent stock market performance, we can deconstruct the three-month return from stocks into three components:

- 1) Dividend Income (for three months this is the annual yield divided by four)
 - 2) +/- Change in Earnings Per Share* (average for S&P 500 Companies)
 - 3) +/- Change in Valuation (Price/Earnings Ratio)
- = Total Return**

* based on forecast earnings for next 12 months (Source: S&P Outlook)

So, *what changed* during the recent quarter to give us the -11.4% S&P 500 total return?

Second Quarter (April - June) 2010		
Dividend Income	+0.6%	-11.4%
+ Change in Earnings	+2.6%	
+ <u>Change in Valuation</u>	<u>-14.6%</u>	
=Total Return	-11.4%	

Our read: *Although on the surface the second-quarter decline in stock prices was 'explained' entirely by falling valuation, we suspect earnings will be revised lower in coming weeks.*

While all of the above likely contributed to the markets' decline, we believe investors were most focused on two near-term worries: the multiple and uncertain impacts of the European public-finance crisis and an apparent flagging of the year-old economic recovery.

The simmering crisis concerning public finances in 'peripheral' Europe (Greece, Portugal, Spain, Ireland) seemed to reach a climax in May – when the European Union and International Monetary Fund announced a coordinated package of stabilization measures – but again reared its head as June drew to a close. This situation appears to be affecting global markets in a number of ways. Most acute has been the impact on the European (and to a lesser extent global) 'financial infrastructure.' In late-April/early May, European inter-bank lending appeared to be freezing up in a manner reminiscent of (though less severe than) the September 2008 failure of Lehman Brothers, as institutions worried about hidden or unquantified exposure to potentially at-risk debt. The joint EU/IMF plan announced in mid-May, combined with promised austerity programs in a number of nations, seemed to contain though not eliminate these fears. A second worry, however, has been that austerity programs themselves, combined with any lingering impact on credit conditions, will put a damper on what was already an anemic growth outlook for the Euro zone, which represents some 20% of global output and is an important market for many North American and Asian exports.

In the U.S., several key indicators of economic health clearly weakened during the quarter. Although the manufacturing sector continued to rebound, the much larger consumer sector seemed to face unrelenting pressures. Private-sector job growth slowed unexpectedly, while the residential real estate market had trouble digesting the expiration of buyer tax credits and a seemingly endless supply of foreclosed homes for sale. As a result of these

developments – as well as the decline in stock prices – consumer confidence took a steep dive from a two-year high. Whether or not these data signified a meaningful ‘downshift’ in the economy, they provided clear evidence of the daunting headwinds that continued to impede the recovery.

Outlook

The steady rally in financial assets that began in March 2009 eventually began to sow the seeds of renewed investor complacency, leaving markets vulnerable to a turn in the news. Market ‘corrections’ can be healthy developments, as they improve valuation and restore a degree of skepticism among investors, both of which can boost prospective (i.e., future) returns. Unfortunately, corrections don’t occur in a vacuum, but usually reflect worrisome developments that cloud the outlook. With major benchmarks down some 15% from April highs, the key question looking ahead is whether a sufficiently (or even overly) gloomy scenario is reflected in lower prices, or whether substantial downside still exists.

We suspect fears of a renewed financial crisis emanating from Europe are overblown. With the sting of the 2008 meltdown still fresh, investor skittishness is understandable. But we believe the EU/IMF stabilization plan, combined with announced and likely austerity measures, will contain the crisis. Equally important, the European Central Bank was an integral participant in the aggressive and successful interventions made by global authorities in 2008-2009, so it should be capable of managing this lesser threat, as well. Notably, financial stocks, as a group, did not underperform in the recent downturn, credit spreads widened only modestly, and the Euro has recently rallied from its May lows, suggesting other investors may be coming around to our view.

As for the near-term path of economic growth, we are less sanguine, but again suspect that recently voiced concerns may be exaggerated. When we wrote to you in April, we noted that very few economists were forecasting a ‘double-dip’ back into recession; while such pessimists are still a minority, weak data reported over the past couple of months have prompted some prognosticators to switch camps. We believe it is significant that most of the recent disappointments came from well known problem areas: real estate, employment, consumer confidence. At the same time, the manufacturing sector continues to show strength, and recent indicators of business spending have been healthy, as well. Productivity growth remains impressive (one reason why hiring is lagging) and corporate earnings, cash flows and balance sheets are strong. Moreover, incomes are growing while inflation remains almost non-existent, and the recent drop in bond yields has brought mortgage rates to fresh lows. We believe that, on balance, these data more likely indicate a relatively normal mid-recovery ‘pause’ than a return to economic contraction.

One risk that has surely increased since April is that potentially posed by ‘premature fiscal tightening.’ History provides ugly examples – most famously the U.S. in 1937 and Japan in 1997 – of stimulus programs being reversed too early during what were thought to be self-sustaining recoveries but subsequently became renewed (and prolonged) downturns. Drawing on these historical parallels – and the lack of evidence that investors (as distinct from politicians and their constituents) are becoming anxious about debt levels outside peripheral Europe – a number of economists have cautioned that a push for near-term austerity runs the risk of a similar outcome. *Financial Times* columnist Martin Wolf pithily described this view

as questioning the wisdom of always “giving markets what we think they may want in the future – even though they show little sign of insisting on it now.”

Another hard-to-categorize circumstance also worries us. It seems to us that investors, businesspeople and consumers are afflicted with an unusually high level of angst. We read about distrust of policymakers, uncertainty regarding future taxes and regulation, and a growing majority that feels the country is ‘on the wrong track.’ Much of this ennui can be explained by the economic slump, but it seems to go deeper. Nor, apparently, can it be blithely written off as dissatisfaction with progressive policies being pursued by the Obama administration: the same widely publicized poll that identified the ‘wrong-track’ majority counted even larger numbers in favor of increased regulation of ‘big corporations’ and legislation to reduce carbon emissions and promote alternative/renewable energy sources, even if that meant higher energy prices. So, while it is difficult to pin down its cause(s), this underlying dissatisfaction seems to be yet another obstacle to renewed confidence and optimism that would fuel a more robust recovery.

As alluded to above, declining prices have had a salutary impact on both investor sentiment and valuation. Complacency was clearly rising in March and April; the correction nipped that trend in the bud, although sentiment measures have yet to reach the bearish levels usually associated with market bottoms. As for valuation, we note in the ‘What’s Changed?’ box on page 2 that earnings estimates have continued to rise, with the result that the S&P 500 Index now trades at less than 13 times expected 2010 earnings. Using more conservative *reported* earnings, the figure rises to 16.5 times – still close to the long-term average and meaningfully below levels seen in 2007 (near 20) and 2000 (closer to 30). Given these readings, we believe that if second-quarter earnings (and managements’ comments about the second half) do not disappoint, stock prices are likely to regain some of the ground lost in May and June.