

The Oarsman Outlook

July 2011

After strong gains in each of the last three calendar quarters, the April-June 2011 period saw modest declines among most categories of equity (stock) investments. Despite a furious four-day rally to end the quarter, major U.S. stock benchmarks were roughly flat from March 31st levels. Non-U.S. stocks fared somewhat worse, on average, with emerging markets experiencing the weakest results. Real-estate securities also fell modestly, paced by declines in timber-related issues. Most industrial commodity prices declined, though gold eked out a modest gain. On the positive side, falling benchmark yields and narrowing credit spreads produced healthy returns for most bond investments (the 10-year U.S. Treasury ended the period at 3.16%, compared with 3.46% at the end of March).

Among U.S. stocks, relatively strong results came from the Consumer Staples, Health Care and Utilities sectors; generally weaker returns came from Capital Goods, Energy and Financial Services stocks. Small-company stocks, on average, performed about in-line with their large-company counterparts, while “growth”-oriented stocks, as a group, did better than those in the “value” category (a reversal of the recent trend).

Benchmark Performance – Equities

	<u>Second Quarter 2011</u>	<u>Last Twelve Months</u>
S&P 500 Index	+0.1%	+30.7%
Large-Cap. Core Mutual Fund Avg. (Lipper)	-0.2%	+28.6%
Small-Cap Stocks (Russell 2000)	-1.6%	+37.4%
Non-U.S. Stocks (Dow Jones World ex-U.S.)	+0.5%	+30.1%

Benchmark Performance – Fixed Income

	<u>Second Quarter 2011</u>	<u>Last Twelve Months</u>
Barclays Intermediate Gov't/Credit Index (taxable)	+2.0%	+3.6%
Barclays Municipal Bond Index (tax-exempt)	+3.9%	+3.3%

Review

A drumbeat of disappointing news accompanied investors during the second quarter of 2011. The after-effects of the Japanese earthquake/tsunami and spiking commodity prices put a damper on global economic growth; the U.S. economy, which seemed to be firming early in the year, took an unmistakable turn for the worse, as house prices continued to decline and the unemployment rate ticked higher; the long-simmering fiscal/debt crisis in ‘peripheral’ Europe transitioned to flare-up mode; fears intensified that inflation in fast-growing emerging markets (e.g., China, Brazil and India) might lead to policy over-reactions that could derail an important engine of global growth; and political stalemate in Washington prevented agreement to raise the nation’s debt limit ahead of a looming early-August cash crunch. In fact, the news flow was so unrelentingly bad that several research services noted that their gauges of macro/economic “surprises” had reached near-record negative levels (much worse than during last year’s May-June market downturn).

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 +0.1% S&P 500 total return?

Second Quarter (April-June) 2011		
Dividend Income	+0.5%	+0.1%
+ Change in Earnings	+3.4%	
+ Change in Valuation	-3.8%	
=Total Return	+0.1%	

Our read: *We're surprised how well the earnings projection held up during a period of clearly slowing growth and persistently negative news; negative revisions seem likely unless growth clearly picks up.*

A few shafts of light nevertheless pierced the gloom. Slowing global growth, combined with a surprise release of strategic reserves, allowed the price of oil to fall by some 15% from the May peak. The resulting easing of inflation fears, and the clear weakening of the U.S. economic recovery, most likely postponed the need for the Federal Reserve to begin tightening monetary conditions (i.e., raising interest rates). Accordingly, bond yields (and, importantly, mortgage rates) fell after the sizeable run-up that began in late 2010. And finally, U.S. companies again notched impressive profit gains, continuing to bolster corporate balance sheets and allowing stock market valuation to improve modestly.

In addition to the decline in benchmark (i.e., U.S. Treasury note) yields, credit spreads – the premium investors require to lend money to less-than-pristine borrowers – also narrowed. This effect was most pronounced in the municipal bond market, which had seen a sharp sell-off in late 2010/early 2011 amid widely shared, but perhaps overblown, fears of a 'crisis' in state and local government finances.

Outlook

The near-term investment landscape is dominated by the Greek debt crisis and, to a much lesser extent, the negotiations over raising the U.S. debt limit. Both dramas, should they end badly, have the potential to start an unpleasant chain reaction in financial markets. Most observers believe that a 'disorderly' default by Greece is unlikely (the risk of a U.S. default is judged to be near zero, despite the many headlines). A greater probability that Greek (and perhaps Portuguese and Irish) debt will eventually need to be meaningfully (and collaboratively) 'restructured' has been widely acknowledged and analyzed for some time,

allowing financial-market participants (especially large European banks) to prepare. As we prepared this letter, the Greek government passed a new austerity package that is expected to allow disbursement of new tranches of aid and postpone restructuring for at least another several months. Meanwhile in Washington, the debt-limit negotiations appeared to have entered a decisive, terminal stage.

Beyond these immediate worries, the key to the medium-term outlook is to discern whether the recent deceleration in economic growth was due largely to transitory factors and is therefore likely to reverse. On this score we are cautiously optimistic. The supply-chain disruptions following the Japanese earthquake/tsunami are widely estimated to have shaved at least a half-percentage point from U.S. growth in the second quarter; this will largely be made up over the course of the year. Likewise, the spike in commodity prices, which has had the effect of reducing consumers' disposable income, appears to be unwinding. According to Capital Economics, the recent decline in gasoline prices could boost consumption by as much as \$50 billion; meanwhile, the Bank Credit Analyst notes that the gasoline-futures market suggests a further drop in prices over the rest of the year. Other hopeful signs include the first month-to-month uptick in house prices in almost a year (April over March); a return to growth in (non-mortgage) consumer credit and bank lending, suggesting the pace of private-sector deleveraging is abating; and levels of auto sales and housing starts so far below the pace needed to keep up with obsolescence and population growth that both will eventually rise meaningfully. Admittedly, many of these indications are tentative at this point; moreover, a return to a more normal rate of growth seems to be a widely held forecast, so there is clearly potential for disappointment.

Another cloud hanging over the markets is the perceived risk of a substantial slowdown (or 'hard landing') in one or more of the large emerging-market economies (e.g., China, Brazil, India) that have accounted for a disproportionate share of global economic growth since the 2008-2009 financial crisis and ensuing recession. While expert observers seem about evenly split on the likelihood of such a downturn, we suspect that, should it occur, its impact on the U.S. and other developed-world economies and financial markets might be somewhat less dire than feared. Despite its size and rapid growth, China actually remains a small market for most American companies, especially the smaller firms that contribute most, at the margin, to domestic employment and wage growth. Moreover, the one sure result of a downshift in emerging-market growth would be substantial declines in the prices of many industrial commodities – including oil – which would be beneficial to the major developed economies. Finally, analysis by researchers at the *Bank Credit Analyst* suggests that a slowing Chinese economy might result in an even greater surplus of savings in that country, which could have the salutary effect of keeping downward pressure on U.S. (and probably European) interest rates.

Looking beyond the next few months, the global economy and financial markets will encounter some daunting impediments that we have discussed in past letters. Even if the current 'soft patch' subsides, the U.S. economy likely faces several years of subdued growth as the process of private- (and eventually public-) sector deleveraging continues. This period will probably feature persistently high unemployment, slow wage growth, recurring fears of renewed descent into recession and a contentious political environment. At some point, but probably no earlier than late next year, the Federal Reserve will also need to undertake the complicated and fraught task of normalizing monetary policy by selling the trillion or so

dollars of bonds it has acquired over the past two and a half years and raising the level of short-term interest rates.

A combination of sluggish and uncertain growth, reduced liquidity and rising interest rates is rarely supportive of strong investment returns. Successfully navigating this difficult period will hinge upon how well corporate profits hold up, whether the Federal Reserve can maintain its inflation-fighting credibility and whether Washington policymakers can demonstrate some ability to work together (compromise may be necessary!) to address the nation's long-term fiscal challenges. Investors currently seem fairly pessimistic about the prospects beyond the rest of this year, so there may be room for intermittent pleasant surprises.

As detailed in the “*What’s Changed?*” box above, a combination of rising profits and flat prices allowed stock-market valuation to improve modestly during the second quarter. Now trading at just over 13 times estimated 2011 earnings, and boasting cash dividend rates that compare favorably with yields available from high-quality bonds, stocks (represented by the S&P 500 Index) do not seem expensive. However, with profit margins high and the level of future demand uncertain, the trajectory of corporate earnings is surely less clear than in the earlier stages of the recovery. Wall Street analysts’ current projections for 2011 and 2012 profits – which call for gains of 17% and 14% percent – seem to reflect a fairly benign economic scenario; these estimates would have to be revised substantially lower if economic growth were to disappoint. As we have noted previously, one of the best ways to adjust for the uncertainty of future profits is to value stocks on the basis of a ‘cyclically adjusted’ level of earnings, such as the average of the past 10 years. On this basis – which currently captures both the record profits of 2006-2007 and 2011 as well as the depressed results from 2002-2003 and 2008-2009 – the S&P 500 sells for a considerably less compelling 24 times earnings. Nevertheless, it is worth noting that this measure has, with brief exceptions, held consistently above its long-term average of around 16 for most of the past 25 years.

In sum, we foresee a complicated investment landscape that may feature near-term improvements but is clearly blighted by longer-term obstacles. We remain encouraged – in a contrarian vein – by the persistent skepticism and pessimism that seem to pervade the markets. Two telling statistics: Credit Suisse research notes that since January 2009, bond funds have captured 85% of all cash flows into retail mutual funds; and a June Merrill Lynch survey of institutional investors revealed only 27% were overweight (i.e., bullish with respect to) equities. Apparently, despite the strong investment results of the past two years (the S&P 500 Index has a total return of more than 100% from its early 2009 low point), we have not entered a new era of greed and complacency.

We hope you are enjoying the early summer and encourage you to let us know if you have questions about our management of your investments.

Sincerely,

Alan Purinton, CFA
Principal & Portfolio Manager

Robert W. Phelps, CFA
Principal & Portfolio Manager