

2nd Q 2010 Quarterly Letter

What a Difference a Quarter Makes!

The second quarter of 2010 was a mirror image of the first quarter. The stock market rallied through the first three weeks of April reaching a 2010 peak on April 26th; only to see a dramatic reversal to the downside in May and June. World stock markets experienced their worst performance since the first quarter of 2009. What changed?

“Focus” is what changed.

Our last quarterly commentary distributed in April 2010 included the following comment:

“There are some budding concerns that have not gone away. They just went out of focus.”

Well, it now appears that investors around the globe once again focused on those concerns that were being ignored just a few months ago! What are those concerns? A few concerns that come to mind are:

- Unsustainable debt levels,
- Growing government deficit spending,
- Anemic employment growth,
- Below average economic expansion, and
- Political turmoil and ineffectiveness

All of those issues existed in the first quarter. So, why did the market ignore those concerns at that time and, then, choose to focus on these issues in the second quarter? The answer is: “psychology”. This is why we referenced last quarter Warren Buffet’s famous quotation about the short-term fickleness of the investing public and the stock market itself:

“In the long run, the stock market is a weighing machine. But, in the short run, the market is a voting machine.”

In the short term, the stock market can behave very emotionally with the ebb and flow of investors’ outlooks and dispositions. In the second quarter, the more negative issues and concerns arose again and elevated investors’ concerns and fears to the point that, as the “votes” were being counted, fear and concern were winning while stock prices were losing.

How did investor psychology shift so dramatically within a few weeks? You might recall that as the stock market rallied from the depths of the ‘credit crisis / recession’ market of late 2008 and ending in March 2009, investors were calling for and anticipated a ‘healthy correction’ to an otherwise strong stock market recovery. It was assumed that the markets merely needed a catalyst to start the correction and wash out the frothiness in stock prices. In March and April, the world received that unidentified, but nonetheless expected, catalyst! Investors around the world renewed their aversion to assuming too much risk as announcements ~ not news speculations or rumors or worries, but governmental announcements ~ regarding the fiscal plight facing Greece began to emerge. As importantly, Greece’s problems were not necessarily isolated to that one country. Similar fiscal concerns were exposed regarding countries such as Spain, Italy, Portugal, Iceland, Ireland, the United Kingdom and possibly others. The fiscal disrepair of these European states was not ‘news’ to investors in April and May. Investors around the world merely chose to ignore those warning signs for years and, again most recently, during February and March, as we warned in our last quarterly commentary.

We wrote at length last quarter about the ‘cracks in the economic foundation.’ During the quarter, a spotlight was shone on the cracks in Europe. In fact, the dialogue reached extreme levels and continues at that level even today.

By the end of the quarter, we heard prognostications regarding the end of the Euro as a currency and a possible unwinding of the Eurozone as a consolidated economic community. While we have difficulty seeing a complete unraveling of the Eurozone or the European Economic Community, the stark realities of the situation are that the governmental fiscal problems will not go away on their own.

Many policy makers for countries around the world are now calling for their country to pass an “austerity” plan. Many people know the meaning of the word “austerity” but consider the third definition as proffered by the Merriam-Webster dictionary:

aus·ter·i·ty

1 : the quality or state of being austere

2 a : an austere act, manner, or attitude **b** : an ascetic practice

3 : enforced or extreme economy

The word ‘austerity’ has been used in very intriguing ways over the past few months. Many government officials will define it as: “*benign steps to simply rehabilitate the fiscal house back into order.*” This approach to austerity frequently means material or significant cuts in spending; in this case, cuts in government spending.

On the other hand, the people being impacted by such government spending cuts will define the word ‘austerity’ to mean: “*draconian violations of their rights.*” This chasm in definition became quite evident to the world when cable news networks bombarded us with images of Greek citizens protesting, sometimes violently, in the streets over their government’s announced austerity programs (read: spending cuts including social services cuts / reductions). Further, it became clear that many other countries were stepping forward with their own statements about cutting spending to reduce deficits. In fact, the word ‘austerity’ has been used in reference to speeches by President Obama, Fed Chairman Bernanke and former Fed Chairman Volcker where they are talking about the need to attack our ballooning debt levels. Is there any wonder why the markets have decided to focus on the potential negatives again?

Indeed, policy makers around the world are going to have to make unpleasant, and very unpopular, decisions in order to get control of the economic realities imminently facing their countries in the coming years.

Wow! Did that last sentence register with you?? Policy makers around the world are going to have to make unpleasant, and very unpopular, decisions in order to get control of the economic realities facing their countries in the next decade. And yes, policy makers in the United States of America are going to have to make unpleasant, and very unpopular, decisions in order to get control of the spending realities facing the U.S. in the next decade. Government overspending and financial over-commitments are staring the U.S. citizenry right in the face as well. The U.S. will not be immune to the economic reality that this country’s policy makers have created. Hopefully, the citizenry of the U.S. will not be as self-interested as the citizenry of some of these troubled European countries’ citizenry were when such difficult decisions have to be made and implemented here in the U.S.

These more negative forces and their potential economic impact began to shift into focus for investors once again during the 2nd quarter. While Greece’s fiscal problems might have been the catalyst for the beginning of a correction, all of these looming issues regained the attention of investors during the past two months. As we warned in our April 2010 commentary:

“When stocks go up faster than cash flow growth, the risks rise at an exponential rate because if/when cash flows begin to drop and/or expectations change, stocks will fall very fast.”

Investors woke up to this reality in April and began to price in the expectation of slower economic growth for the U.S. economy. That decision represented a change in perception and expectations by the investing public. The rapid

change in perspective by investors and the resulting correction reminds us once again that “*Stock prices ALWAYS fall faster than stock prices go up!*”

Stock markets dropped by more than 10% around the world in the second quarter and have now declined by approximately 13% from their peak in late April. We still find ourselves at a very difficult crossroads trying to determine where a “correction” ends and where a “bear market” begins to take control. A 7% – 10% correction is normal and healthy; indeed, such a “breather” was being prescribed for the stock market by many market pundits throughout the later part of the first quarter and the early parts of April 2010. However, a contraction of more than 15% is considered a significant correction begging the question: “Is this really the beginning of another bear market, instead of a normal, healthy correction?”

So Now What?

We consider the latest news regarding the fiscal problems of Portugal, Italy, Greece and Spain a positive in terms of a reality check for governments around the world and here in the U.S. Couple those countries’ mistakes with mistakes that have been made in the State of California that are now coming to the surface and we should have a reality check significant enough to serve as a “wake up call.” In time, we hope we can look back on the summer of 2010 as a turning point thanks to its exposure of the cumulative negative effects of too many years with unsustainable governmental and economic policies. And hopefully, this turning point will not only be for those European countries alone, but for federal, state and local governments around the world. Perhaps these fiscal challenges / realities will eventually be a catalyst not only for the ‘good, healthy’ stock market correction of 2010, but also for a dramatically different paradigm for government policy makers and their fiscal leadership around the world in the future. Such a reality check and awaking to effectively and efficiently address our fiscal problems would be a ‘silver lining’ to the most recently-announced Eurozone’s fiscal problems. And, in fact, there has been some broader, comprehensive proposals submitted for consideration to U.S. policy makers that would address our fiscal and structural challenges as well. We are encouraged by the breadth and the tenor of some of these proposals and look forward to progress in addressing these issues and to halting the ‘kick the can down the road’ decisions by our policy makers in the past.

Our reading of the health and condition of the stock market as this correction began in late April did NOT provide indications that the stock market had fully run its course and that it was ripe for a complete turnaround to a bear market. And while certain patterns traced out by prices over the past few months suggests the market has completed a ‘major top’ and is indeed turning bearish, other measures of overall supply of sellers as compared to the overall demand by buyers suggest otherwise. Nevertheless, and in spite of recent signs of a possible “bottom” for this correction, further evidence is needed to confirm that the stock market has indeed established a sustainable bottom and that the primary trend ~ bull market trend ~ that was in place for 14 months prior to the correction reasserts itself. Therefore, as usual, we will stay vigilant in our assessment of the current market and our outlook for positive changes.

One positive for sure: Stocks are a less expensive today ~ at a 13% discount ~ from where they were priced just three months ago! Lower stock prices usually indicate that a higher level of risk has already been priced into the stock market. The recent stock price ebbing / correcting in valuation over the shorter-term is positive.

For our client accounts tracking our Concentrated Cornerstone model portfolio, the portfolio’s larger-than-normal cash reserve position is indicative of the lack of complete clarity regarding company valuations and outlook. As of this writing, the Concentrated Cornerstone portfolio has approximately 20% of its investment assets ‘on the sidelines’ invested in money market funds. As we see more attractive valuations and business performance, we anticipate moving the majority of those investments in money market funds back into the stock market. Again, we will stay vigilant in our assessment of the current market and our outlook for positive changes as we go forward.

Regarding fixed income or bond investments, many market observers are viewing these high bond prices / low interest rates on bonds as a “bubble.” Importantly, describing the bond market situation as a “bubble” implies that things (read: interest rates) can change rapidly and dramatically (*Pop!!*). A significant factor driving these low bond prices is deflationary expectations that have now reached extreme measures! However, our greatest concerns fueling our fear of rising interest rates (declining bond prices) is the U.S Treasury and Federal Reserve Systems’ liquidation of a HUGE fixed income portfolio. Those portfolios were accumulated since late 2008 in an effort to offset or curtail a potential and expected rise in interest rates at a time when fearful investors were in a panic and dumping bonds at any price. This panic dumping could have driven interest rates higher during the credit crisis and only exacerbated the economic woes at that time. Fast forward to mid-2010 and with this huge portfolio of fixed income securities our financial regulators must liquidate, they now have a challenging task on their hands to avoid roiling the bond markets by dumping the large supply of bonds themselves. This huge selling volume of fixed income securities could drive interest higher, as necessary, to entice buyers to absorb the regulatory agencies’ significant selling volume. Therefore, we are concerned that interest rates could go MUCH higher from these currently low rates as this unwinding of their bond positions takes place over the coming quarters and years. In the short run, we expect inflation expectations to remain low, and accordingly, yields should remain low for awhile. However, with interest rates at very low levels (and bond prices at high levels) and the potential liquidation of the regulatory agencies’ large portfolio of fixed income securities, we continue to be long-term bearish on fixed income investments (i.e., bonds). We prefer to utilize income securities that have the structural or contractual opportunity to increase their payouts to investors due either to higher earnings, to variable interest rate provisions, and/or to inflation pass-through provisions.

Please do not hesitate to call upon us should you need anything. It is a pleasure continuing to serve you.

All our Best,

CAZ Investments.