

Recent Thoughts
July 2011

Stocks ended the second quarter essentially where they started the quarter. That is not to say, however, that the quarter lacked newsworthy events. Quite the contrary. In fact, the quarter proved to be quite eventful. The Dow Jones Industrial Average reached a three year high in May before succumbing to a six week losing streak near the end of the quarter. The Russell 2000 small cap index reached an all-time high during the quarter before relinquishing some of its gain. The Federal Reserve's bond buying program (QE2) officially came to an end, bond market troubles flared again in Europe, the debt ceiling debate reached a fevered pitch, and the nearly 10 year search for Bin Laden came to an end.

Five of the ten sectors in the S&P 500 turned in positive results for the quarter, while the other half posted negative returns. Health Care, Utilities, Consumer Staples, Consumer Discretionary and Telecom Services stocks were in the former category and Industrials, Materials, Information Technology, Energy and Financials in the latter. All sectors, with the exception of Financials, generated positive returns through the six month period ended June 30. The large-cap segment of the market, as represented by the Russell 1000 index, outperformed its small-cap counterpart, the Russell 2000 index during the quarter. Nevertheless, the small-cap and mid-cap indices maintained their lead over the large-cap index spanning the 1, 3, 5 and 10 year time horizons.

June 30th marked the official end of the Federal Reserve's most recent bond buying program, also known as QE2. As with most economic policies, it is quite difficult to infer what the economy would have looked like in the absence of a given policy. Such is the case with the Fed's two attempts to stimulate the economy (QE1 & QE2). Critics of the programs cite soaring commodity costs, a weakened dollar and a still weak economy as evidence of ineffective policies. Proponents, on the other hand, see the programs as having warded off a period of Japanese-style deflation. Based on public statements from Federal Reserve officials, they seem intent on holding back on any major new stimulus programs, but will, nevertheless, maintain an "easy money" stance for now. Some have even gone so far as to call for tightening of policy. However, should the economy remain weak, the calls for a third installment of quantitative easing will grow louder.

The debt ceiling debate has taken center stage in Washington. The numbers involved are astonishing: \$14 trillion in total public debt outstanding, roughly \$4.5 trillion of which is owned by foreign governments. That equates to nearly \$47,000 for every U.S. citizen and is approaching 100% of Gross Domestic Product. Everyone agrees that this is an untenable position and that something must be done to correct it. When the discussion turns to an actual solution to the country's fiscal troubles, however, the debate turns bitterly partisan. The parties agree that spending cuts are required as part of any credible plan but disagree, in most cases

vehemently, over the use of higher taxes and cuts to entitlement programs in crafting a long-term solution. It is vital that Congress reaches an agreement and advances a long-term solution that puts the U.S. on a more sustainable fiscal path. S&P has lowered its outlook on U.S. debt to negative from stable. Any failure to act that results in a U.S. default would likely prove catastrophic for the markets. We do not believe the U.S. will default, however, and Washington appears willing to do whatever necessary to avoid that fate.

Concern over European debt woes flared again during the quarter and put a damper on stocks around the world. Greece has dominated the headlines as it attempts to avert an outright default through a combination of austerity measures and debt restructuring. Greece, Portugal, and Ireland have been the hardest hit of the European countries thus far. Yields on government bonds in those countries have soared to 15-20% in some cases. Spain and Italy have also seen yields soar on their government debt, albeit to levels much lower than Greece, Portugal and Ireland. The fear of contagion is what has most global investors on guard, especially in light of the recent bond market turmoil in the much larger and economically important countries of Italy and Spain. European governments are actively working on a plan that will hopefully alleviate any additional stress on the region's debt markets.

The uncertainty generated by events discussed in the previous paragraphs has stalled the multi-quarter rally in the markets and reintroduced a degree of volatility that had been somewhat absent recently. More of the same should be expected until some of these issues are resolved. With that said, however, we reiterate our belief that patient investors will be rewarded with attractive returns over the coming decade. Filtering out short-term political posturing and daily headlines and instead focusing on the long-term fundamentals of the economy is essential in any attempt to decipher the future direction of the market. Consistent with that approach, a combination of attractive valuations, future earnings growth rates and inflation projections form the basis for our positive long-term views.