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Investment Matters

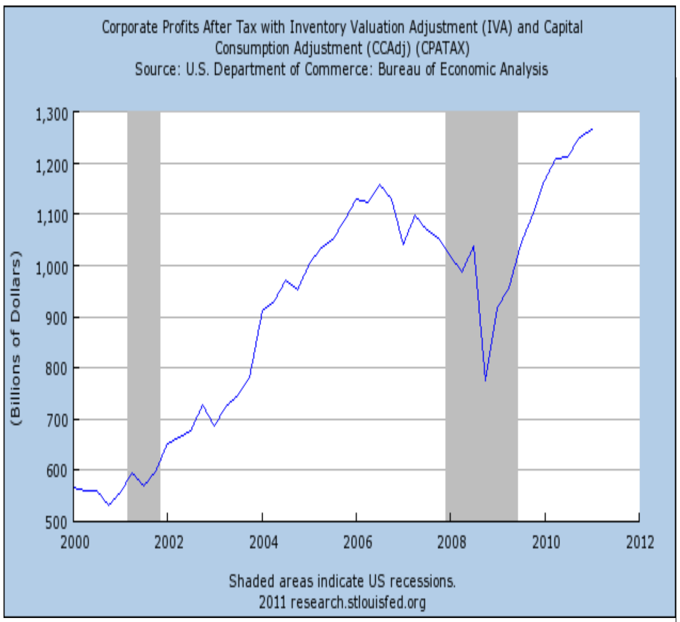
For the quarter ended June 30, 2011

Profits Boom, Confidence Declines

In the last eleven years, after-tax profits earned by U.S. corporations have risen 123% from $569 billion to $1,265 billion, while the S&P 500 Index has declined 8% from 1,442 to 1,326. If profits are truly the "mother's milk of stocks" why have stocks languished while profits have boomed?

The answer, in a word, is confidence. Stocks prices not only reflect the current profit reality but the level of investor confidence in the future. In 2000, stocks were highly valued because investors believed that profit growth would not only continue at the healthy rate of the previous twenty years but, based on wonderful new information technologies, would accelerate to a permanently higher growth pace. The market crash in 2001-2002 was a clear signal that this was not to be. Computers and the internet brought many benefits but they did not alter basic economic equations.

Although confidence and stock prices staged a weak comeback as housing prices boomed in mid-decade, the subsequent collapse of the housing market delivered a near fatal blow to the American sense of perpetual progress. Fully one third of people recently surveyed believe that future lifestyles are bound to decline.



PROFITS ARE UP 123% IN THE LAST ELEVEN YEARS

> *"Fully one third of people recently surveyed believe that future lifestyles are bound to decline. "*

Investors need to ask themselves which proposition they believe: that today's problems will overwhelm us, prosperity will falter and confidence will continue to decline, or that we will find ways to meet our new challenges, prosperity will return and confidence will return to historic levels.

Investors were excessively confident in 2000 and they were eventually proven wrong. Today they are excessively fearful and just as likely to be wrong again.

Not Widely Known

- According to a recent chart in the Economist magazine, over 23% of all goods and services made since the time of Christ were produced in the last ten years.
- Based on 2010 sales revenue of $414 billion, Walmart would rank as the 26th largest economy in the world, right behind Norway.
- If current trends continue, the Department of Education estimates that by 2014 there will be more administrators than instructors at American four year non-profit colleges.
- At the beginning of 2011 over 1.2 million patent applications were awaiting approval by the U.S. Patent Office, triple the backlog 10 years ago.
- Even after all deductions and exemptions, the effective U.S. corporate tax rate is the second highest in the developed world after Japan.
- The U.S. federal gasoline tax is 39 cents per gallon. In France, Germany, the United Kingdom and The Netherlands it exceeds $4.00 per gallon.
- The Federal Reserve reports that the total value of household real estate has fallen $6.6 trillion since mid 2007.
- Despite being the second

Continued on page 2.

Not Known: continued

largest economy in the world, China's GDP per person was only $4,283 in 2010, less than that of Iran or Ecuador.

- Tax revenues collected by state governments increased 9.1% in the first quarter of 2011, the largest gain in almost five years.

- In the 1950s fewer than 5% of American workers needed a license to engage in their chosen profession; today almost 30% of American jobs require a license from the government.

- North Dakota's economy is growing at three times the national average, personal income growth is four times the national average and employment is setting all time records. An oil drilling boom using new hydraulic fracturing technology is credited.

- Although prices of food and energy, have risen strongly in the past year, prices of items we buy infrequently, TVs, computers, appliances, furniture and clothing, have all declined.

Is American Manufacturing in Decline?

We hear all the time about the, "decline of U.S. manufacturing", how nothing is made here any more, and how everything that used to be made here is now made in China.

U.S. manufacturing output was $2 trillion in 2010 or 13% of GDP. In 1970 it was $250 billion or 24% of the economy. It has grown considerably, but not as rapidly as other parts of the economy. Interestingly, the picture is similar for the world as a whole. Manufacturing as a percentage of global GDP has declined from 27% in 1970 to 16.6% today.

In the late 1940s, 41% of U.S. consumer spending went towards basic household goods, food, clothing and home furnishings. By 1985 it had dropped to 20%. In 2010 it was only 13.5%. We spend less of our money on more and better goods.

The key to understanding what has happened to manufacturing is found by looking at changes in real productivity. In constant 2010 dollars, output per worker in manufacturing has increased from $19,600 per year in 1950 to $149,000 in 2010. It doubled in the 26 years from 1950 to 1976. In the next 21 years it doubled again. The last doubling took only 13 years. Productivity is not only growing, it's growing at an accelerating rate.

This is similar to what happened to farming. In 1900, 60% of Americans were involved in farming. Today it is less than 2%. Mechanization and the application of modern business practices enabled farming productivity to skyrocket. While farming accounts for only 1% of GDP, it produces all the food we need and plenty for export to other countries.

In China, manufacturing has held steady at about 40% of GDP for the last 40 years. On a relative basis, China has added manufacturing jobs faster than the rest of the world. That may be changing.

Pay for Chinese factory workers soared 65% from 2005 to 2010, reducing their relative cost advantage. With oil prices high, shipment of goods from China to the U.S. is becoming relatively expensive. Long supply chains from China require greater inventory levels and financing costs than items produced locally. The Boston Consulting Group estimates that by 2015, Chinese labor will lose its cost advantage. Manufacturing jobs could be coming back, at least those which require more technical expertise.

In fact they already are. Caterpillar, Sauder, NCR Wham-O and others have moved some production back to the U.S. Recently a Chinese national company proposed building a new 30,000 acre industrial complex in Idaho, just south of Boise. Volkswagen recently announced plans to begin selling Jettas made in Tennessee to South Korea.

Manufacturing is not in decline but the relative importance of manufactured goods is falling and services are taking a bigger piece of the economic pie.

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The Bottom Line: 6/30/2011

Market Indicator	**Current Value**	**One Year Change**
Large company stocks *(S&P 500 Index)*	1321	30.7%
Small company stocks *(S&P Small Cap Index)*	447	37.0%
Short term interest rates *(3 Month T-Bill Yield)*	0.1%	No change
Long term interest rates *(10 Year T-Bond Yield)*	3.0%	From 3.2%
Inflation *(Consumer Price Index)*	224.8	3.4%
Energy *(West Texas Intermediate Crude Oil)*	$95.27bbl.	27.0%
The economy *(Inflation adjusted GDP)*	$15.0 trillion	2.3%

QUOTABLE

"An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today."

Lawrence J. Peter

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