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Investment Matters

For the quarter ended June 30, 2010

Soft Patch or Slippery Slope

From its recent high of 1220 on April 26th the S&P 500 has declined nearly 16% in just 46 business days. Such a precipitous fall has analysts and commentators struggling to determine whether this is the start of a major decline or just a temporary pullback. Here are some reasons for believing the market and the economy are not about to go into a tailspin:

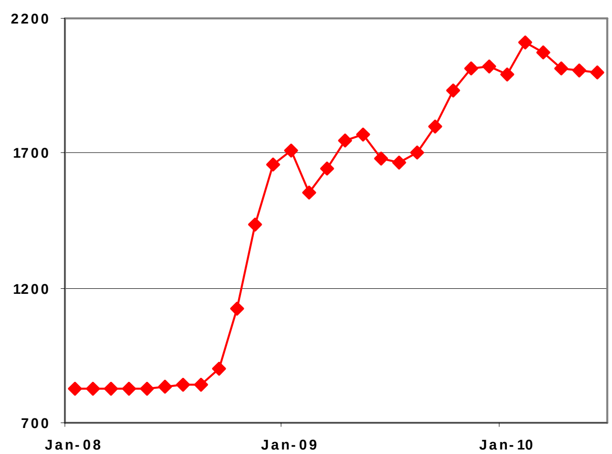
- The Federal Reserve has its foot firmly planted on the economic accelerator, with low interest rates and an expanded money supply. The economy has never gone into a double-dip recession while the Fed continued to offer easy money.

- The Conference Board's Index of Leading Economic indicators is still rising as it has been since April, 2009. This index has a good record of forecasting economic trends and turning points.

- U.S. export growth is strong, especially for manufactured goods.

- Unlike in 2000 and 2007 the stock market is not expensive, relative either to sales or to profits.

- U.S corporations are financially strong with low debt and high cash ratios.



THE FED BOOSTED THE BASE MONEY SUPPLY IN 2008.

The recent pullback in stock prices is arguably the result of three factors:

- Up 80% at the end of April, the stock market had gone too far too fast, outpacing reasonable improvements in economic expectations.

- On April 30th the one time federal tax credit for home buyers was terminated, thus ending this temporary prop for housing prices and home building.

- The sobering effects of the BP oil spill and the European debt crisis. While these have turned sentiment sour they are not large enough to cause a new recession.

"The Federal Reserve has its foot firmly planted on the economic accelerator..."

We are in a fragile recovery with very anemic job growth and a dispirited private sector. However, the underlying trend is likely to remain positive until the Fed changes course or some larger problem intervenes.

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The Worst Month For Stocks

OCTOBER: This is one of the peculiarly dangerous months to speculate in stocks. The other are July, January, September, April, November, May, March, June, December, August, and February.
- Pudd'nhead Wilson's Calendar

Turns out Mark Twain was slightly off the mark. September is the most dangerous month for stocks, or at least it has been since he wrote that line.

Since the Dow Jones industrial Average was created in 1896, returns for the month of September have averaged minus 1.2%. The average for all months over this period was plus 0.7% per month. The month of September has also had below average returns for 10 out of the last 11 decades. In the last 84 years, September has had positive returns only 43 times. In the same 84 years, annual returns were positive 57 times.

This looks like powerful stuff, but despite that, in more than 100 years of investing, no one has come up with a satisfactory fundamental explanation for why this apparent anomaly should exist. Perhaps there is a good reason – perhaps it's just a statistical curiosity. It does exercise the imagination if you let it.

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Debt: continued

The table below shows the average returns of the S&P 500 Index for each month since 1942. The data is interesting and with a little luck, may be profitable.

January	1.2%
February	-0.4%
March	1.1%
April	1.4%
May	0.7%
June	0.2%
July	0.7%
August	0.1%
September	-0.6%
October	0.8%
November	1.1%
December	1.9%

Both the Consumer Price Index and employment in Japan have recently declined to 1992 levels

The Genesis of Uncertainty

Ed Hyman, the acclaimed Wall Street economist, recently commented that he has never seen such a wide range of market expectations among his professional clients. Over the next year some expect the stock market to climb toward a new all time high while others expect a return to early 2009 low prices. Some expect interest rates to soar while others are looking for a plunge in rates. Expectations for the economy and the dollar are similarly wide ranging.

There are two key issues which are at the root of this uncertainty:

The first is monetary policy which is controlled by the Federal Reserve. In September, 2008, as the financial crisis was breaking out, the Fed countered with the biggest increase in the money supply in U.S. history. Weeks later they also dropped the target rate for short term interest rates to zero, which was also unprecedented.

The Fed believed that a heavy dose of money and low interest rates were just the right medicine to stop a financial panic and prevent deflation from causing a depression. To the Fed's credit the medicine seems to have worked. The economy is recovering (albeit slowly) and the drop in home prices has not spread to other assets. The problem however is that historical evidence points to easy money as the primary cause of high inflation. To be sure, with inflation holding at 1-2%, there is little evidence that this is yet happening. But with the twin destroyers of prosperity, inflation and deflation, both threatening at the same time, it is little wonder that economic opinions reflect high levels of uncertainty.

The second major issue concerns the role of government in the economy. In response to the financial crisis and the recession, the federal government increased spending to unprecedented levels, raising the current deficit from billions to trillions of dollars. Some of this spending was devoted to shoring up the financial system. The rest went for various programs under the heading of 'economic stimulus'. Some went to nationalize businesses like AIG, Fannie Mae and General Motors.

The results of this spending are hotly debated. While it is clear that the financial system needed emergency help and that extending unemployment benefits alleviated personal misery, the broad economic effects of increased government spending are questionable. And by dramatically increasing the size and scope of government for the foreseeable future, many fear a long economic decline resulting from unsustainably high debt, crippling tax burdens and lack of U.S. competitiveness in the world economy.

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Greece, Spain. Portugal, Finland and the UK are all raising their VAT tax rates by about 2% to cover spending shortfalls

The Bottom Line: 6/30/2010

Market Indicator	Current Value	One Year Change
Large company stocks *(S&P 500 Index)*	1032	14.4%
Small company stocks *(S&P Small Cap Index)*	328	22.2%
Short term interest rates *(3 Month T-Bill Yield)*	0.2%	No change
Long term interest rates *(10 Year T-Bond Yield)*	2.9%	From 3.5%
Inflation *(Consumer Price Index)*	217.2	2.0%
Energy *(West Texas Intermediate Crude Oil)*	75.66bbl.	8%
The economy *(Inflation adjusted GDP)*	14.6trillion	2.4%

QUOTABLE

"I fancy that overconfidence seldom does any great harm except when, as, and if, it beguiles its victims into debt."

Irving Fisher

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