May 2010 Interim Market Commentary

The stock market volatility this week seems to us to reflect a contagious recognition that the debt crisis that began in 2007 is not yet over. As we have known for some time, the credit expansion bubble of the last 25 years did not come to a sudden stop with the collapse of mortgages and Lehman Brothers. Much of that debt has been soaked up onto the balance sheets of developed market governments. Some of the debt has been transferred outright (bank bailouts, Fed mortgage purchases, etc.) and some has been transferred via roundabout means (Cash for Clunkers, house purchase tax credits and generalized deficit spending).

We will offer our take on this week's market turmoil by first reviewing the big-picture backdrop of our current investment positioning.

The world economy is still not out of its debt crunch. As we wrote more than a year ago, *tens of trillions* of dollars of debt needs to disappear before we can get back to normal growth and savings rates. There are three ways to reduce debt. (1) Pay it off. This is a drag on economic growth, but does get the job done. (2) Default. This gets the job done faster, but is an even bigger short-term drag on economies. (3) Inflation. If you do it right (see post-WW II America), it gets the job done over a couple of decades. 10 years of compounded 4% inflation wipes out almost half the national debt!

Yes, inflation erodes the dollar. Inflation since the end of WW II has eaten away 90% of the dollar's purchasing power. But, let's flip that equation over – the price index has risen by 10 times. Per-capita income, however, has risen 30 times. That is a 3x increase in per-capita purchasing power and standards of living. Inflation was there, but it was swamped by income increases. Can we do it again? Yes – if we don't turn our back on education and incentives to entrepreneurship.

We believe that this is our future: Inflation will return to the low-mid single digits and our national debt will be inflated away. Since there is no free lunch in economics, who pays for that? The owners of the debt, that's who. Most specifically, holders of the long-term bonds. Our strategy? *Don't be a long-term bond holder!*

We believe that the economic recovery will continue, albeit in fits and starts. This view is not driven by some unique insight that we think we possess, but rather by our inherent optimism in the American economy and in democratic institutions. *We are not Greece; we are not Japan.* We have seen and heard some shockingly ill-informed punditry on the cable news programs the last few days. We reiterate: We are not Greece. The dollar is not going to collapse. Our foreign creditors are not going to show up on our doorstep demanding money. That's not how it works, and these pundits need to take a freshman college course in money and banking.

10 years from now, we think the American economy will still be the most productive in the world on a per capita basis. We do, however, think that growth will be below the long-term trend of 3.2%, and more like 2.2%. This will be driven mainly by our need to absorb and fund the costs of the retiring baby

boom. It's not going to be cheap, but we have a consensus view in this country that we need to step up and take care of our elders.

As the stock market and bond markets come to recognize that (1) growth will be below trend; and (2) inflation will be restored to a sustained level in the mid single digits, they will both go through periodic panics and corrections.

Individual thoughts from the three of us:

Lenore: The business community is having a very tough time making any commitments to expansion. The gridlock in Washington leaves the entire banking system in limbo; major tax cuts are due to expire at year-end; a national sales tax ("VAT") might be in the works, but nobody can say what it would look like. There is talk of trade sanctions against China, but then maybe not. All of this creates a volatile business environment that will continue to dampen business enthusiasm for expansion.

Andy: Inflation is coming. It's just a matter of time. The Fed, as led by Chairman Bernanke, is trying hard to trigger some inflation. They will eventually get what they want. Interest rates will react and jump up to a new level. This has the risk of triggering a short-term stock selloff. But it will also create buying opportunities for us.

Rick: The economy won't really get jumping again (nor inflation started) until banks are lending. Right now, banks can borrow from the public (eg, checking accounts) at zero interest and from the Fed for 0.25% to 0.50%. They can then buy Treasury notes at 2-3% and lock in risk-free profits. Why would they lend to small businesses? Only when the Fed cuts the banks off from this risk-free "carry trade" will the economy get moving again.

We entered this past week significantly underweighted in stocks and long-term bonds. None of our client portfolios have suffered anywhere near the losses that you are seeing on the Dow or S&P 500.

Should stocks fall another 10-12% from current levels, we will strongly consider adding to stock holdings. Our focus will be on the largest global companies and energy companies. As of right now, we are not eager to buy long-term bonds. We need to see much higher yields before doing so.

In sum, we entered this week with portfolios structured *specifically* in anticipation of an eventual stock correction. The panic coming out of Europe just doesn't concern us all that much.

As always, please don't hesitate to call or email us.