QUARTERLY COMMENTARY
Second Quarter 2010

The comfort of the prior four quarters was sharply shaken in the June-ending quarter as the stock market, measured by the S&P 500, declined by 11.4%. For equity holders there was no place to hide except for a few emerging markets, generally too small and risky to attract traditional investment money. Most declines were in double digits. In our domestic market, all sectors declined with only the defensive utilities, telecom and consumer staples avoiding double digit losses. The S&P 500 closed 2010's first half down by 6.7%.

Bonds continue to be the most productive asset class, as the Federal Reserve has kept short-term rates just above zero. Virtually all bonds have done well during this period of Fed largesse. At the short end of the fixed income curve cash returns are practically non-existent. By dropping rates to all-time lows, the Fed has forced investors to take risks to earn any return whatsoever. So far that risk-taking has had positive results. As yields have come down, however, risk levels have risen. And a great many investors, who have already lost considerable personal wealth over the past decade, can ill afford having that risk realized and losing yet more money. This is especially true of retirees and institutions that cannot easily replace lost capital.

In this environment in which most investors have experienced losses, we are pleased that our clients have earned small positive returns both for the quarter and for the year-to-date. Great uncertainty still exists, however, both domestically and internationally. There exists a broad range of potential outcomes for the world economy. Several countries are arguing strenuously for the imposition of austerity measures to rein in loose monetary and fiscal policies that have characterized the worldwide rescue effort. The U.S., among other countries, is still leaning toward further stimulus despite the massive debt that has already been created. How this debate and many other economic uncertainties unfold will have profound effects on the securities markets in the quarters and years ahead.

In his July 21 appearance before Congress, Fed chief Ben Bernanke categorized the economic outlook as "unusually uncertain." Because the Fed normally attempts to keep investors and consumers confident, such words likely betray a far greater concern about possible economic outcomes than have any recent Fed releases.

There are clearly conflicting indicators for the probable direction of stock prices over the remainder of the year. Generally, second quarter corporate earnings are coming in better than had been expected. While a great deal of technical damage was done to stock indexes in June, surprisingly strong repairs were accomplished so far this month. On the flip side, the housing crisis remains severe, and unemployment will likely drag on the U.S. economy for years.

There's an old saying in the investment business: In the short run, the stock market is a voting machine; in the long run, it's a weighing machine. In other words, investor sentiment controls markets in the short run, while the fundamentals prevail over time. We don't have a strong feel for how sentiment will develop over the next few quarters. On the other hand, debt levels, because of rescue efforts, have gone from dangerous to extremely perilous throughout major sections of the world. We do not yet know whether the concerted efforts of world governments and central banks will effect a lasting recovery. We do know, however, that our children, grandchildren and their grandchildren will be burdened with the greatest debt legacy in world history.

A second major fundamental concern is valuation. As indicated in our last quarterly commentary and on my blog site (www.ThomasJFeeney.com), contrary to the contentions of most financial analysts, stocks are not cheap. Measures of price to dividends, book value, sales or cash flow are at or near all-time highs except for the bubble period from the late-1990s to 2007. Price to earnings is less extreme, but still above long term averages. From valuations at or near these levels, stocks have historically performed far worse than average.

We urge clients to remain conscious of where markets are in their long term cyclical patterns, which we have discussed intermittently over the years in commentaries and at our seminars and conferences. As we have frequently explained, the latest long weak cycle began in 2000. The two century-old pattern of alternating long strong and weak cycles reveals that both strong and weak cycles tend to last on average about a decade and a half, although with considerable variation. That this current cycle has so far lasted only about two-thirds as long as the average is far from determinative by itself. A far more important indicator that we probably remain in the long weak cycle is the fact that all prior weak cycles have continued until investors largely gave up on stock ownership and valuations plummeted to extremely low levels. In this cycle, not only have stocks not descended to such valuation depths, valuations have actually remained closer to historic highs than lows. While this does not mean that stocks won't rally from here, it is unlikely that we are yet at the beginning of the next long strong cycle. Should markets head higher in the short run, such an advance would likely retrace before a more lasting bull market rally could evolve.

Given unprecedented debt levels throughout the world and speculation common about first world countries in danger of default, the risks to economic progress and to common stock holdings are at historic highs. Investors must recognize that this is not a "business as usual" scenario. We can't know for certain that the risks will be realized. It would be foolhardy, however, not to recognize the potential for huge losses in risk-bearing assets should government rescue efforts fail to achieve long-term success. The financial system was essentially broken just a year and a half ago but for government rescue. From that point the economic recovery has been significantly substandard by comparison with prior recoveries from recessions, despite the greatest stimulus effort in history. If consumer and investor confidence cannot be sustained, it is highly improbable that governments will be able to restimulate their economies with anything like the same firepower that they unleashed in their initial effort. We are at an extremely tenuous point in the recovery. Continuing success is dependant upon lasting consumer and investor confidence. The outcome is unknowable.

Many of the same considerations affect the fixed income markets as well. As mentioned earlier, the Fed has pushed the return on risk-free securities essentially to zero. Safe cash equivalent yields are non-existent. Bonds, which have been wonderfully profitable for the past three decades, are inevitably approaching a point below which yields will not go. The possibility exists that bonds could remain productive, despite current low yields, if business conditions remain weak and especially if deflationary forces prevail. On the other hand, with 10-year U.S. Treasury notes yielding less than 3%, there is far more room for interest rates to rise than fall. Few current investors know how dire conditions can be for bondholders once rates begin a rising cycle. For more than four decades from 1941 to the early 1980s, rates rose and the total return on bonds was considerably less than the return on risk-free cash equivalents. In a highly uncertain environment, conditions can change dramatically and quickly. Should foreign lenders to the United States turn squeamish about sending more money to this country, rates could rocket upward and bonds would take big losses. While not likely in the short-run, that outcome is certainly possible and should impose discipline on those inclined to blindly stretch for yield.

Conditions are likely to change rapidly over the next several quarters. I have attempted to keep clients and other interested readers in tune with our shorter term thinking through weekly posts on the blog site mentioned earlier. I encourage you to take a look.

Thomas J. Feeney
President
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