Prepared Comments from 7/15/2011 Conference Call

My last conference call was on April 15th. US stocks have since fallen about ½%. The 2nd quarter brought losses of 0 to 2% for US stocks, foreign stocks rose a bit over 1%, and bonds gained 1 to 3%. The quarter began strongly, in April, and then the economy stumbled in May and June. The stumble was partially due to the disruption in the global supply chain that resulted from the Japanese earthquake and tsunami, less-than-desired job growth, the end of the Fed's stimulative 'quantitative easing II', continued/increased financial troubles for several European countries' debt, and increasing concerns about the US debt ceiling. These concerns have continued, and in some cases exploded, in July. We have had a series of nail-biting weeks, and it looks like that is the forecast for the coming months.

Let me first address the debt ceiling. The two political parties are far apart in their views on the best course for the government, as it relates to revenue (taxes) and expenditures (spending). Both sides feel passionately, which makes a compromise very challenging. I expect, and am hopeful, that the closer we get to the deadline of August 2nd, the harder it will be for members of Congress to refuse a reasonable compromise. Let me reinforce this point, no one, NO ONE, will like the compromise. It will, by its nature, contain no component that everyone likes. The goal is to find a compromise that stinks less than every other alternative. The closer to the deadline we get, the more rushed and less 'optimized' the solution will be. I believe that at the end of the day, our Congress persons are adults, and will behave as such as the deadline is upon them.

If I am flat out wrong, and Congress fails to act, no one is certain as to what will result. I conclude that some functions of the federal government will be stopped, and this will cause those affected to speak up loudly to their members of Congress. If indeed it appeared likely that Social Security checks would NOT be issued, you can bank on people demanding that Congress does its job and stop acting like children. I therefore expect that even if a deal is not struck 'in time,' the result would be MUCH greater pressure to close the deal.

In the meantime, I am not convinced that a ‘technical default’ would lead to horrific consequences. As I explained, I expect such a state, if it were to occur, to be short-lived. Furthermore, some analysts have suggested that a technical default would lead investors to conclude that Congress cannot work well together. I find it very hard to believe that even if an 11th hour deal is struck, that investors would not, regardless, conclude that Congress can work well together.

Onto Europe. Just today a report has been issued noting that eight European banks failed the EU’s Stress Test. These banks are in Austria, Greece, and Spain. Many others didn’t look great, but only eight had less than a 2% capital ratio in an ‘adverse scenario.’ There is a reason that Greek government debt yields close to 20% annually.

It is likely that Greek government debt will be forceably restructured/bailed out. The overriding concern is that this doesn’t become a game of dominos where one (country’s) failure leads to others. Restructuring involves losses to investors, while bail outs involve losses to taxpayers. Neither party is leaping at the opportunity to pitch in. However, a flat-out failure of Greece (or the other troubled nations) will severely harm large European (primarily German and French) banks, and carry with it the notable risk of a European financial meltdown that spreads across all industries, across the continent, and likely with further painful ramifications.

The European government debt problem is not a single problem, it is the sum of five problems, problems in Portugal, Ireland, Italy, Greece, and Spain. Each county has unique features. In the past week Italy leapt to propose a sweeping austerity program (having the government cut its spending sharply), an approach that Greece has been very slow to adopt. As such, it is improper to treat this as a single issue.

I expect that the parties (the European Union, the debtor countries, the lending countries, and the banks) will painfully forge five separate sets of solutions, generally putting out each fire just before it roars. The incentives to avoid a blow-up are simply too great to not believe that these crises will be addressed in a way that is less painful that the most dire predictions.

Now let's discuss the US, and its economy. It continues to grow, but at a low rate, 1.9% in the 1st quarter. Job growth has similarly been low, but positive, while the unemployment rate rose in May to 9.1%. Interestingly, the country's unemployment is partially victim to the housing crisis—while there is unemployment of less than 7% in ten states, those living in the seven states with over 10% unemployment are often saddled with a home that is worth less than the mortgage, and they cannot afford to move to where there are more jobs. This is a bit of a chicken:egg conundrum.

Housing prices are low, housing starts are low, housing sales are low, while housing inventories are high. It appears likely that housing prices will remain low for many quarters, for in addition to the inventory (houses already on the market), there are many homes that owners would list if they felt that prices were more fair, and there are even more homes owned by banks, which the banks will put on the market when they are no longer afraid of this action further driving housing prices down.

So where is there good news? Ultimately, stocks represent a share of a company, and companies are in very good shape. They shed workers dramatically in 2008, and have been lean and mean ever since. Their profit margins are near record levels, and their finances are incredibly strong. They have less leverage, borrowing, than any time in the past fifteen years. Similarly, they have more cash than they have for a long time. This gives them the ability to boost dividends, buy back shares, purchase other companies, hire employees, and buy plants and equipment. The first three actions benefit investors, the last two benefit the economy. Companies are waiting to hire employees and buy plants and equipment until they are convinced that they will have enough customers for their goods and services to utilize their increased capacity. This is largely tied to consumer confidence.

Consumer confidence is another chicken:egg dilemma. If consumers were more comfortable, they would buy more, which would drive companies to hire more, which would produce more confident consumers.

You can't jump-start a chicken:egg dilemma—instead you inch both sides up slowly, and that is what has been happening for the past two years, and I believe will continue for another two or so years, gradual thawing of our economy.

I think that for the next few months we will similarly be balancing the negative political news with positive economic/corporate news. While we have heard a steady stream of news about debt ceiling negotiations, in the past day a financial and a technology company each announced earnings up more than 20%, and a third company, a consumer defensive company, is the announced target of a takeover.

My quarterly Market Review and Outlook from last week has been mailed out and posted on our website. We find good value in stocks, we currently use 58/42 as a US/foreign balance for clients' stocks, and we use a 75/17/8% balance for large/mid-cap/small-cap stocks. We have a six-prong approach for bonds, with the greatest share in intermediate-term high quality bonds (emphasizing corporate or municipals, and avoiding treasuries), a good amount in short-term high quality, then high yield, multi-sector, bank loan/floating rate, and foreign unhedged. This approach is designed to have clients' stocks and bonds handle the most likely future scenarios well, while also providing some protection against less likely scenarios.