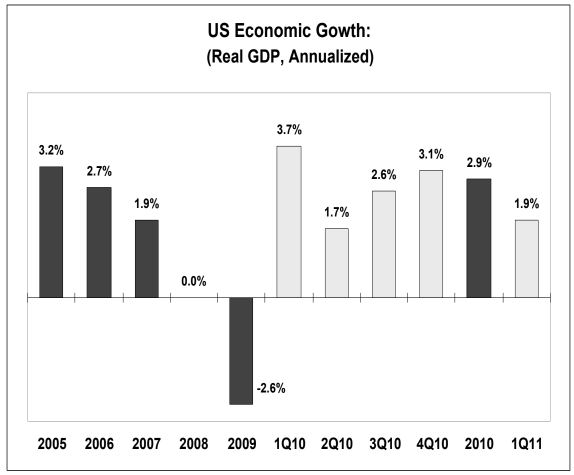
Investment Update
Second Quarter, 2011

There is little question that the global economy has been going through a soft patch recently, much like it did last summer. In response, stock markets were mostly down for the quarter, though late-June rallies did help to limit the losses. Higher-quality bonds and other lower-risk assets performed quite well.



In the US, annualized real growth in the first quarter of 2011 dropped to a reported 1.9% from 3.1% during the last quarter of 2010 (and 2.9% for all of 2010). The second quarter may be more of the same. Employment data has weakened, with weekly initial unemployment claims climbing back over 400,000 during early April and staying there through June. Measures of global private sector activity softened significantly in April, May and June, and commodity prices, especially oil, are down from recent peaks. However, there is good reason to think that this slowdown is mostly attributable to several unusual events in March and April and will therefore be temporary.

An unusually active and damaging start to tornado season and widespread Midwestern flooding both negatively affected US economic output, though not in a long-lasting or fundamental way. The more globally important event was the combination earthquake, tsunami, and nuclear accident that hit Japan on March 11. Japanese industrial output during March alone fell by more than 15% versus February as power generation was crippled. This decline in Japanese output has greatly disrupted global supply chains, with ripple effects on economic activity all around the world that are still being felt.

For example, US-based auto manufacturers, unable to source parts from their Japanese suppliers, slowed or temporarily halted production, and some moved up their usual summertime retooling shutdowns. These production declines have clearly affected overall employment, consumer spending and other economic activity, but again, not in a fundamental or long-lasting way. Consider that while overall US industrial production showed no growth in April, production ex-autos was actually up more than 5% annualized.

The global Purchasing Managers Indexes, which are good measures of the direction of activity in the service and manufacturing sectors, were still showing expansion during May and June, just at lower rates than were seen prior to April. The fact that stronger expansion in the service sectors helped to offset slower expansion in manufacturing supports the notion that the rapid contraction of Japanese industrial output was behind much of the recent slowdown. We think that these indexes, particularly in the US, will rebound as the effects of Japan's disasters fade.

The European economies are more problematic, where the banking system remains very exposed to the weakest peripheral countries of Greece, Portugal, Ireland and Spain. If the big European banks are forced to recognize losses on their loans to these countries, there is the potential for another credit crunch, though it would likely be on a smaller scale, with less global impact, than the crunch of 2008.

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The Federal Reserve seems to be agreeing that this soft patch will be temporary by indicating that there is little chance of a third round of extraordinary quantitative easing. Though the Fed will likely keep short-term rates very low for another "extended period", without QE3, monetary policy will in effect become less accommodative. In the rest of the world, central bankers have already begun to address rising inflation by starting to tighten. In the US as in the rest of the world, less accommodative monetary policy will eventually mean higher interest rates.

The short-term outlook for US interest rates is complicated by Europe's ongoing sovereign debt problems, which have tended to increase demand for US Treasuries as safe-haven investments. Although it now seems likely that Greece will take the political steps necessary to secure the next round of bailout funds from Europe, the bigger question is whether this latest bailout only postpones the day of reckoning for Greece and its creditors. A solution patterned on Brady Bonds, which worked quite well when several Latin American countries defaulted in the 80's, will only work for Greece if it is able to make serious spending reforms while also improving its economic growth prospects.

China is also a source of worry. Most emerging markets, including China, have already begun to try to head off inflation via tighter monetary policy, and this approach always runs the risk of killing economic growth by tightening too much. Recently, China has appeared more willing to accept inflation that is above its official target, so for now there is probably less risk of China over-tightening. Of more concern is mounting evidence of a bubble in Chinese real estate, much of it financed by unregulated lending that is often done 'off the books'. Using official statistics, China's real estate market does not appear to be over-leveraged, but the picture would be quite different if unofficial lending is taken into account. A Chinese hard landing, if and when the real estate bubble bursts, is more likely if high leverage is involved.

On a brighter note, some policy developments in the US are distinctly positive for long-term economic growth. Without taking sides in a partisan debate, a couple of news items are particularly important. First, the AARP, long one of Washington's most powerful lobbies and for years an implacable foe of any Social Security reform, has officially accepted the need for revisions to ensure the program's viability. Second, major cuts to agricultural subsidies are likely to be part of any bipartisan deal to address long-term federal deficit and debt reduction. The Senate has already voted to greatly scale back subsidies for ethanol production. If cuts to these previously untouchable programs are being debated seriously then the prospects for real, long-term fiscal reform are that much better.

That deficit reduction is a major policy issue now and that plausible fixes are being proposed that do not automatically include tax increases are both reasons for optimism – even more so that we are able to have this debate without rioting and blood in the streets.

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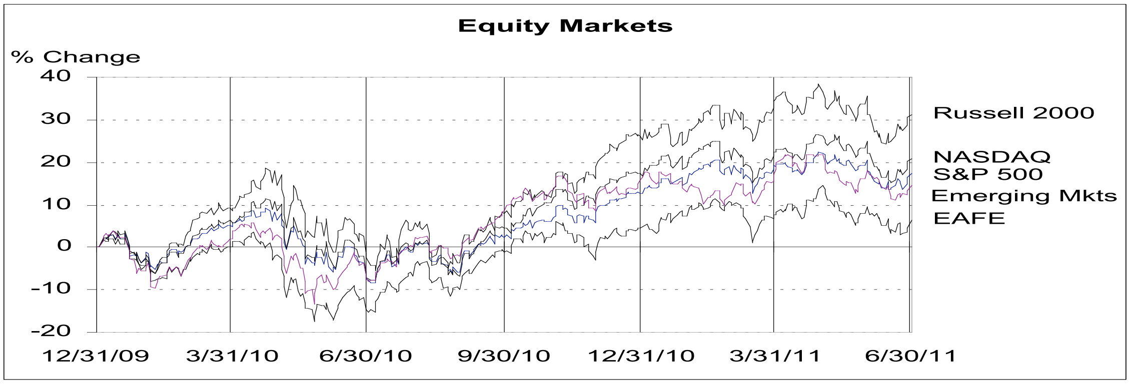

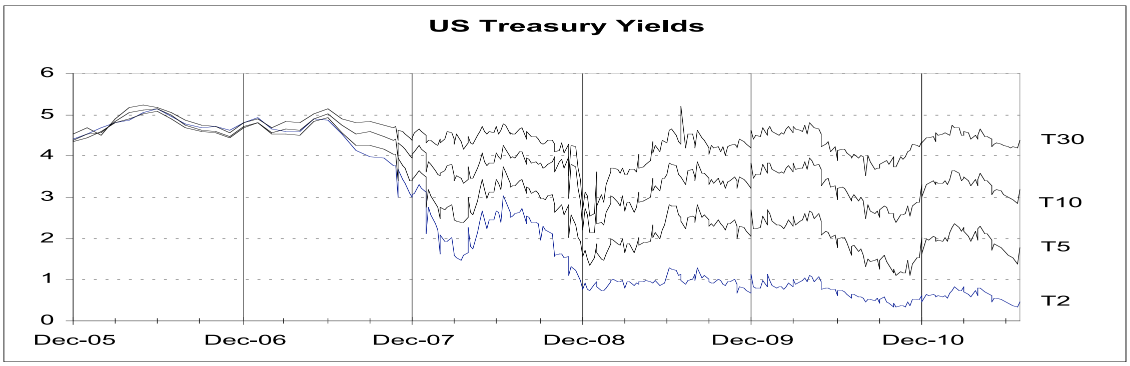

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