



## QUARTERLY INVESTMENT REPORT June 30, 2011

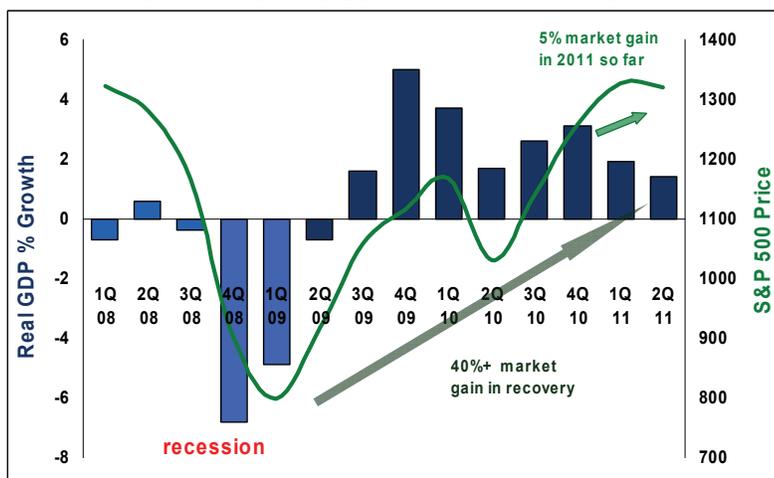
Dear Investor:

**Our two year old economic recovery gets no respect.** The media tells us that it's in a slump, it's sluggish, feeble, anemic, weak, and lackluster. Wordplay aside, the recovery is typical vis-à-vis our more recent recessions. Though, when we compare it to the post-recession recoveries before the 1990's, this one does seem somewhat listless. Before the 1990's gross domestic product (GDP) growth shot back at a 5%-6% pace. Currently, the recovery is averaging less than 2.0% GDP growth and the stock market swoons weekly worrying if economic growth will vanish right before its eyes. A healthy GDP growth rate is 3.0%+, which would go a long way towards pushing unemployment numbers down. Yet, our analysis of the data implies that the patient is fine with no serious set-backs expected.

The stock market has rebounded from the recession quite vigorously in the face of obscene national debt levels, a shaky housing market, and too many folks still in search of jobs. Stocks are up 40% over the last two years; a breather now and again should be expected, especially in the face of government default threats if the debt ceiling isn't raised.

Profound debt burdens weigh heavy on the United States and Greece and both countries are reaching for the political will to pull up their respective bootstraps and embrace austerity. For the US, in the next few weeks we expect to see a multi-year package of spending cuts and perhaps tax increases followed by bipartisan agreement to raise the debt ceiling and prevent disruption from debt payment defaults. Whether the fix is permanent or temporary is irrelevant at this point, the goal is to get bipartisan support on *something* and then lift the debt ceiling.

### Economic & Stock Market Growth



Economic growth has slowed down and so has the stock market. Stocks were flat in the 2<sup>nd</sup> quarter of this year; year-to-date the market has increased 5%.

We also expect to see Greece finalize an austerity driven debt restructuring plan; the country has no choice, despite the fury of protesters. That doesn't mean that Greece is out of the woods, the probability is low that they can grow out of their problems.

Given current macro economic conditions, it's unrealistic to expect strong growth any time soon. Yet, we also don't expect a descent back into recession. Recovery is a long-term story and it takes time to get through the deleveraging process and for the housing market to improve.

**We are now thinking more seriously about inflation.** Up until recently we have been complacent about it. Over the last few years as many have pointed to our national debt, the outsized Federal Reserve balance sheet, agricultural commodity prices, and gold prices to explain the inevitability of the lurking inflation monster, we held back and said not yet. We believed that the forces keeping inflation in check were stronger than the forces fueling inflation. We now think differently two years into the recovery. That doesn't mean that we expect prices across the board to jump tomorrow, next week, or next month. We just think the timeline for high single-digit or low double-digit inflation is within rather than beyond the next couple of years. The current "stated" annual inflation rate is 3.6%.

### Inflation: Improbable or Inevitable?

Inflation is <u>controlled</u> ...	Inflation is <u>coming</u> ...
<p><b>No wage growth:</b> How many people do you know in corporate America these days boasting about salary increases? You may know more people out of work willing to work for the same salary or less. Inflation is often linked to workers demanding higher wages to compensate for rising prices in the economy. Since wages &amp; other compensation are one of the biggest costs companies' face, when these costs increase companies usually deal with it by passing it to consumers through price increases. When high unemployment and no wage growth persist, inflationary pressures are held at bay.</p>	<p><b>Changing emerging market economies:</b> Remember how for decades China, India, and other emerging nations exported deflation to the West? Well, looks like those days are ending as they, especially China, begin to deal with inflation in a big way. We may see China exporting wage inflation for the coming decades (wages are growing at a double-digit rate). Also, the transformation of emerging economies from agrarian to manufacturing &amp; industrial creates enormous new demand for commodities. This intense demand is inflationary.</p>
<p><b>Excess manufacturing capacity:</b> We have a lot of manufacturing capacity in our economy. The normal utilization percentage is 80% or more for a healthy economy. It was as high as 85% in 1994-1995 and as low as 67% in 2008-2009. We currently are using about 77% of our manufacturing capacity. This means that when consumer demand picks up there will be a time lag before new factories are needed to fulfill it; this ready supply of output dampens inflation pressures.</p>	<p><b>Fiscal &amp; monetary policy:</b> Our national deficits and debt are out of control (national debt as % of GDP exceeds 90%). The excess money in our banking system (from stimulus policies) can ignite inflation once banks resume their normal lending. Our monetary policy of a very low fed funds rate is also fuel for inflation once normal lending resumes.</p>
<p><b>Weak housing sector:</b> The stagnant housing sector plays a major role in keeping inflation under wraps. First of all, housing accounts for about 42% of the Consumer Price Index (CPI). When the industry suffers, so too do many other industries that depend on it. Also, more than a million jobs lost during the recession were directly related to the housing industry, and very few of them have come back.</p>	<p><b>Weak dollar:</b> The dollar often shows short-term interim strength in response to Europe's problems, but the general direction is weakness because of record low interest rates and huge deficits. A weak dollar can be inflationary in a couple of ways. It forces emerging economies that peg their currency to the dollar to devalue, and that is inflationary. Also, since commodities are priced in dollars they look cheaper to non-pegged currency holders and demand is encouraged. Increased demand pushes commodity prices up which fuels inflation.</p>

From the inflation table on the previous page it should be evident that there is no easy answer to the question of where on the horizon inflation may lurk. We think the table speaks to an event time-line and a coming tipping point. These past two years of our recovery have not been strong or long enough to trigger inflation. Layoffs, excess manufacturing capacity, and weak housing have trumped the inflationary effects of emerging market growth, fiscal and monetary policies, and a weak dollar. We anticipate a strengthening economy that embraces a stabilizing housing market, job creation, and more vigorous consumer demand. If growth is moderate we may experience stagflation (low growth with rising prices) and sidestep a hyper-inflationary environment. As such, a timely fix to our fiscal and monetary ills may not be possible, and once the lending spigot opens up, all bets are off.

### **What's our best defense against inflation?**

Commodities or commodity producing stocks may be a logical place to invest for certain investors. Commodity prices tend to increase when inflation kicks in and the dollar weakens. Other than energy stocks, we tend to avoid the area due to the cyclical nature of commodity assets and their often excessive price volatility.

Equity Real Estate Investment Trusts (REITs) are another area to consider. When inflation takes hold, tangible assets seem preferable. Studies have shown that real estate is a great hedge when inflation is rising at a steady (less than 5% annually) but not rapid pace. We favor apartment REITs in an inflationary environment because they can increase rents.

Treasury-inflation protected securities (TIPs) may be another logical investment. TIPs adjust their principal and coupon payments with changes in the Consumer Price Index (CPI). TIPs, like all investments, have a value to them that may or may not be correctly displayed in their price. Inflation expectations can drive up prices on TIPs beyond their intrinsic value. Also, because TIPs are bonds, their prices are sensitive to changes in real interest rates. We use TIPs carefully in portfolios.

Emerging market stocks are a good way to participate in the growth of emerging economies as well as other currencies. We have stayed consistently invested in the area.

Large multi-national companies are the best investments to combat inflation; companies that have the ability to pass through their increased commodity costs in the form of higher prices where possible. We call these types of companies "wide-moat" companies since they are better capitalized than their peers. They typically have the best brands and people are willing to pay more for their products and services. Also, wide-moat companies can consistently increase shareholder dividends.

No matter how risk averse investors try to be, volatility still rules the day. There are too many domestic and global uncertainties to contend with. Though we invest for the long-term, it may be comforting to share with you the fact that July has historically been a very strong month for the market. The Spring and Summer months from May through September have historically been a weak time for the markets, but July bucks the trend and usually trades higher. And, the traditionally best performing months of the year, November and December, are just around the corner...

We wish everyone a relaxing July 4<sup>th</sup> weekend!

Sincerely,



Ellen P. Le, CFA  
President

