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Market Commentary July 2011

Momentum that carried stocks higher through the first four months of the year fizzled in May as investors became increasingly concerned about a slowing economy (exacerbated by supply chain interruptions stemming from the Japan earthquake) and fears that a Greek default would spread contagion to other weak EU members and rattle the European and even global financial systems. Those concerns, particularly relating to Greece, intensified as the second quarter progressed, and a modest retreat in May worsened in June before we saw a late-month rebound as it became increasingly likely that the EU and IMF would manage to kick Greece's debt can down the road at least one more time.

When the dust settled, stocks wound up roughly flat for the quarter.

The Big Picture Matters—Here's Our View of the Macro Environment

Our big-picture view of the economic and investment landscape did not materially change over the past quarter, but, towards the end of the period, market volatility increased in response to disappointing economic data and renewed fears of a European sovereign debt crisis (among other things). Our assessment of these and other factors and their impact on our portfolio risk and return expectations is ongoing and intensive. Given the fluidity of the situation we may make portfolio changes at any time.

Following are some of the key issues we are currently focusing on as well as a recap of the broader U.S. economic situation:

Greek Debt Crisis Fears (Again)

It appears that the European Union, the European Central Bank, and the International Monetary Fund will once again provide Greece with additional financial assistance (i.e., loans at below-market interest rates) in return for Greek promises of more fiscal austerity. The aim is to buy more time with the hope that Greece will ultimately be able to get its fiscal house in order and pay back the debt. However, we, and most other investors, believe some type of Greek default, "restructuring," or "reprofiling"—in which the debt repayment schedule is extended but the principal value is not marked down—is inevitable given the severity of their situation.

Since the financial crisis in 2008 we have worried about the risks and repercussions stemming from excessive debt levels in the developed world (United States, Europe, Japan, and United Kingdom). It's the key reason we are underweight to equities in our portfolios. Greece is only one factor of this risk. By itself, a Greek default is probably manageable for the global financial system without causing a crisis. However, the big risk is that a Greek default could spiral into a broader European debt "contagion" spreading to other heavily indebted European countries, such as Ireland and Portugal, and possibly even Spain or Italy. (Given the size of the latter economies, if that happened there is universal agreement that the financial/economic system would be overwhelmed.) While at this time we are not

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planning any portfolio changes based on the recent developments in Greece, this remains a rapidly evolving situation. Should there be a crisis in the near-term related to Greek debt, we'd expect Treasuries and "risk assets," such as stocks and emerging-market currencies, to fall. Treasury bonds are still perceived as a "safe haven" asset class—despite the United States' own debt problems.

China Hard Landing

Another risk that we have highlighted recently and is growing in importance in our macro assessment is a potential "hard landing" for the Chinese economy (as opposed to a smooth manageable slowdown) and the global ripple effect that would result. Most experts we have talked to agree that there is a bubble in at least some segments of China's property market. The general consensus is that this bubble is not widespread and can be managed by the Chinese government, as it has been in the past. There is a risk, however, that the bubble may have already grown very big and, if pricked, will result in a sharp contraction for China, which we believe has not been priced into risk assets. We have talked to and read analysis of both the optimists and the pessimists, and it is hard to really know who is right, partly because of the lack of reliable information from China. However, we find ourselves leaning toward the bearish side because of the following big-picture observation.

The U.S. Economy and Debt Ceiling Debate

The U.S. Treasury estimates that without further borrowing, the government will run out of money around August 2, 2011, and has given this date as a deadline for Congress to raise the debt ceiling. This is a newer source of short-term uncertainty for the markets. As with the Greece situation, we think the most likely outcome is a political agreement that avoids a near-term market upheaval. But the longer-term structural problem with our debt and deficit will likely remain unresolved, and possibly won't be seriously addressed until after the 2012 presidential election. (We hope we are not being optimistic in thinking that it will at least be addressed at *that* point.) There is also a chance the two sides don't reach an agreement and the debt ceiling is not raised by August 2. If this happens, we'd expect a sharp negative market reaction until an agreement is reached (which we expect would be quickly forthcoming). But, we won't be making a portfolio change based on speculation about this outcome.

There Are Signs the Economy is Slowing

Recent U.S. economic news has been disappointing, with sluggish GDP growth and continued weakness in employment and housing (which are important drivers of consumer confidence, income, and spending).

The Federal Reserve also revised significantly downward their GDP and employment forecasts for 2011 and 2012 at their recent June meeting. (The Fed governors also revised slightly upward their inflation forecast for 2011 and 2012.)

On the housing front, the widely followed S&P/Case-Shiller National Home Price Index fell 4.2% in the first quarter of 2011, following a 3.6% decline in the fourth

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quarter of 2010. The index is now 5.1% below its year-ago level, 34% below its peak in the second quarter of 2006, and down to a level last seen in 2002.

Debt Remains a Problem

Finally, the ongoing headwind from very high debt levels in the United States has not materially lessened in aggregate. On the positive side, consumers have continued to reduce debt. For example, the ratio of household debt to GDP fell to its lowest level in five years and household debt as a percentage of disposable income has dropped to a near seven-year low. On the negative side, as we all know, government debt continues to climb, so the overall U.S. debt picture has not improved much.

Our Asset Class Return Expectations in Various Scenarios

We continue to view the range of potential scenarios looking out over the next few years as skewed towards subpar returns for equities. It's worth emphasizing again that we think about potential asset class returns across a *range* of macro scenarios that we think are probable or has some reasonable likelihood of playing out. Our portfolio positioning, therefore, is not based on a big bet that any single outcome will occur. Moreover, we continue to view the range of potential outcomes as being *particularly* wide at this time, reflecting the high degree of uncertainty as to how the aftermath of the 2008–2009 financial crisis will play out over the next several years. We are facing an extremely challenging debt situation in the United States and globally. Our portfolios currently have a conservative bias because:

- we do not have a high level of conviction in any particular scenario playing out over the next several years;
- in most scenarios our analysis suggests the returns to traditional stock and bond indexes will be subpar; and
- we see some potentially very negative scenarios that could play out as a result of the excessive global debt problem.

They are constructed with the aim to generate satisfactory returns in the scenarios we think are most likely, while mitigating (but not avoiding) losses in the more severe scenarios that we think are lower probability but cannot be ruled out.

A Concluding Reminder About Downside Risk

The good news for our clients is that in the event of a severe market downturn, our relatively defensive positioning should enable us to redeploy capital from lower-risk investments into equities or other higher-risk assets with much better return potential. As we've written in our past commentaries, if there is one thing we can be almost certain of, it is that there will be market shocks over the next few years and they will create investment opportunities for us. There may also be events that magnify risks that we will want to further protect against. In the long run, investing based on our research conviction has paid off for our clients, and we are confident it will continue to do so.