

CAPPING THE IMPACT

The explosion of the Deepwater Horizon Macondo Prospect oil rig in April was one of the most unfortunate events taking place in the second quarter. As in most tragedies, the news media devoted significant attention to the accident, in this case the environmental damage, the contentious Congressional hearings of oil industry executives, the oil soaked birds and dying sea life, and the disruption of lives of Gulf area residents. In turn, numerous hours were spent by TV viewers with 24/7 live monitoring feeds of the flow of oil from underwater cameras, watching the cleanup response, and listening to industry experts and to politicians who looked to protect the interest of their constituents through new proposed rules and regulations. It should not be a great surprise with the heightened attention on the oil spill, business conditions softened during the quarter, especially for retailers.

More frustrating, the blast and aftereffects, which resulted in the loss of life, property damage and significant spillage of hundreds of millions of gallons of oil into the Gulf of Mexico waters, was perhaps another example of a lack of preparedness and contingency planning for a known potential incident, a result of complacency by industry and regulatory officials. The accident is highly similar to other recent events including the inadequate levee system and flooding in New Orleans after Hurricane Katrina, collapsing bridges and an aging infrastructure, poor coal mine safety practices, as well as the risk posed to the financial system due to careless sub-prime mortgage origination, speculative real estate development lending, and the demise of Lehman Brothers and Bear Stearns following excessive balance sheet leverage. While political grandstanding may appear impressive to some, once the damage is exposed and the pristine sandy beaches are soiled the real calamity is the lack of oversight and unwillingness to tackle important issues. These issues often seem to get pushed aside until real trouble strikes and the damage has already been done. As we have experienced, the cleanup costs end up being many multiples of what the expense would have been by addressing the issue before something serious actually occurred.

The financial concerns in Greece and contagion related market selloffs were a wake up call to highly leveraged entities to get their debt and spending under control or the bond vigilantes may begin to look in their direction. In the short run, the U.S.

dollar and Treasury market rallied as they remain the world's reserve currency and safe haven investments, especially given the uncertain future of the Euro. Gold has rallied on the same merits as a currency hedge and store of value alternative. However, with U.S. debt at ever increasing levels, state and local municipal debt high, tax revenues down, private and public defined benefit pension plans in an underfunded status due to low equity market returns and outsized promises, and social welfare programs moving toward deficit status, there may be greater confidence in our debt than is justified, unless addressed before becoming even more severe.

While we have already started to see some improvement in the form of higher savings rates and debt reduction efforts, there remains significant room for further improvement. As for the future, financial austerity programs, whether for individuals, corporations or Governments will have a moderating effect on economic growth. Expiring Bush tax cuts, other tax increases and spending cuts to pay down deficits will have a similar effect. Historically, periods of increasing tax rates are not the most favorable for equity returns and the increased burden on higher income wage earners is reducing the incentive for entrepreneurial activity. We expect this moderate level of economic growth to persist for a number of years, in line with the square root sign shaped recovery we highlighted several quarters ago. Unfortunately, this rate of growth is unlikely to cause any dramatic improvement in the level of unemployment, something desperately needed to improve the situation for recently displaced workers. This will continue to act as a depressant on consumer confidence and willingness to embrace risk by investors and business managers.

Some economic forecasters are predicting a "double dip" recession and the bond and equity markets are reflecting this concern. While business trends have softened moderately, we put a low probability on this scenario. The Federal stimulus program has assisted in the recovery, but has not been the sole source. Renewed end-consumer and business demand, inventory rebuilding and government spending have been the main factors behind GDP growth of 2.7% in the first quarter and the expected 2.5% growth in the second quarter. Looking out toward the second half of the year, the next round of stimulus spending is directed towards work related projects and should have a more desirable multiplier effect on business

CAPPING THE IMPACT (CONTINUED)

activity. A growth rate of 2% in the second half, while below normal recovery rates at this point in the cycle, does not look like a double dip to us.

Corporate America has been especially diligent in improving their balance sheets and reducing costs. As a result, 2010 earnings are expected to grow appreciably from a depressed 2009 figure to \$80.00 for the S&P 500, and are presently estimated to rise to \$90 in 2011. At a current S&P 500 level of 1060, the equity market's valuation is reasonable at a 13.25x multiple on this year's operating earnings and 11.8x using 2011 projections. An annuitized earnings yield of 7.5%, using nominal growth rate assumptions, also looks especially attractive relative to the 3% return on 10-year Treasuries. Unfortunately, with disappointing historical returns over the last 10 years, a highly uncertain economic picture and a bearish sentiment among investors, it is difficult for many to want to embrace risk in their portfolios.

In an environment where the fundamentals are highly uncertain and emotions are running high, many investors are turning to "technical analysis," the art of looking in the rearview mirror at charts showing historical stock price trends, volumes, and moving averages. Terms such as the "death cross," defined when the shorter term 50-day moving average crosses below the "longer term" 200-day moving average, does not invoke optimism by investors utilizing this strategy or individual investors watching CNBC. The May 6 "flash crash," where computer assisted trading programs temporarily took the Dow Jones Industrial Average down roughly 1,000 points in a very short timeframe before a similar rebound, also provided little confidence to the traditional investment community. We prefer to stick with investing based on the longer-term fundamentals.

While we are waiting for some greater clarity on the broad economic picture, there are some interesting trends beginning to develop. The big rally off the March 2009 market bottom was dominated by smaller, highly leveraged, lower quality rated, lower profitability and more cyclical companies. During this market recovery period, many companies achieved their bottom line earnings results through cost cutting and expense control. However, meeting bottom line results is no longer the primary focus of institutional investors. Companies of high quality ratings, stable business models, predictable earnings streams and are able to exceed expectations on the revenue line are gaining favor. Institutional investors want to know their portfolio companies have growth potential with attractive end demand characteristics. Anticipating this scenario, we positioned portfolios primarily with companies having more defensive characteristics and performance trailed during most of the year as a result. As investors have now started to embrace this philosophy, relative performance has begun to improve over the last couple of months. Interestingly, these higher quality companies have better valuation characteristics, allowing investors the unique opportunity to improve quality and enhance potential return relative to more risky sectors of the market.

We fully appreciate the difficult economic environment and expect volatility to remain elevated as conflicting data is reported. In an environment where competition is fierce, some businesses have increased the risk they are willing to take. While quantifiable risks are appropriate, speculative risks are unacceptable, especially when the potential costs are high. In an uncertain world where even investment professionals are questioning longer term strategies, evaluating what has worked in the past and what will work in the future, a disciplined, risk-controlled process is especially important at this time. While a proven strategy may not generate immediate results every time, it will certainly help prevent major accidents in the future.

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